China M&A Round-Up
Cross-border investment trends

What's the Deal?

The art of the possible

The first salvo in what is now generally called the US-China Trade War was put in place on July 6, 2018, with the implementation of a 25 percent tariff on $34 billion worth of Chinese goods entering the US. Within less than a month, by August 2, the US proposed 10 percent tariffs on $200 billion of imports, and the next day China responded with added tariffs of 5 percent to 25 percent on $60 billion worth of US imports into China. The US Department of Commerce also added 44 Chinese companies to the export control Entity List, alleging that they presented significant risks to US national security.¹ By the end of February 2019, in place are tariffs totaling $250 billion on Chinese goods coming into the US and $110 billion on US goods entering China.

Since the 90-day truce agreed in the Trump-Xi meeting in Buenos Aires, negotiations have intensified, and both sides periodically express optimism about a potential resolution. From a number of indications, it is apparent that political pressure to find a resolution is mounting. In the US, a stream of recent reports assert that many companies are seeing profits pinched as input costs increase, consumers are experiencing substantial price increases on implicated goods, and farm debt and failures have soared as soybean and other export
markets collapse. In China, President Xi Jinping and Premier Li Keqiang have stated that US tariffs are contributing to China’s economic woe and projected gross domestic product growth slowdown, even as the US trade deficit with China reaches new records, increasing 11.6 percent in 2018 to reach $419.2 billion.

For CEOs, CFOs, CSOs, and really all C-suite executives, for a full three quarters, now the uncertainty surrounding the trade and investment frictions has complicated global strategies and planning, including supply chain optimization and organization development. Within the context of other changes, including the US’ withdrawal from Trans-Pacific Partnership, decision to renegotiate North American Free Trade Agreement and the threat of tariffs against EU, the risks that uncertainty itself presents have triggered significant overall business restructuring for some, new M&A strategies, and supply chain restructuring. While it is impossible to predict the timing and shape of an eventual resolution, we believe it is important for senior executives to reflect on the art of the possible, namely what elements of the US-China negotiation agenda are likely to be resolved in the near term or are even feasible to be resolved over time.

Key points awaiting resolution through the negotiations can be divided into three broad areas:

- The trade deficit
- Intellectual property and technology treatment
- The structure of China’s economy, specifically focused on subsidies to Chinese enterprises

Among these three areas, trade deficits can and are likely to be addressed with new trading agreements and commitments. IP protection can and likely will be enhanced, with new enforcement rigor and relaxation of rules governing technology transfer by MNCs investing in China. In fact, China’s National People’s Congress has just ratified a new Foreign Investment Law that promises to expand market access, provide equal treatment for foreign firms and domestic firms, eliminate forced technology transfer, and improve IP protection. Details of how these commitments will be implemented and monitored remain to be developed.

When considering the art of the possible, the last of these three broad areas, the structure of China’s economy, is likely the most difficult to address. Key business media are just beginning to discuss the issue. Yet, as China’s economy has become more and more significant for global MNCs, from China’s 2001 accession to the World Trade Organization (WTO) to the present, MNCs have consistently expressed concern about China meeting commitments to transforming state-owned enterprises into genuine, market-based entities and China’s overall WTO commitment to national treatment for foreign firms. At that time in place was a domestic campaign initiated by Deng Xiaoping himself to separate politics from enterprise (政企分开), a step in that direction.
Many MNCs consider the #1 challenge in the China market to be competing with state-owned enterprises (SOEs) that could not go bankrupt and were given consistent, sustained, and significant financial support from the state. And while current reporting on the negotiations more often focuses on subsidies that the US argues are made in violation of WTO terms, the issues around the structure of the economy in China are far greater and ultimately may prove intractable. In the article just cited on the difficulty of China meeting the requested structural changes, the author writes, "Revamping decades of state planning will not happen overnight, Chinese experts argue." In fact, one could reasonably argue that the structural changes being requested are not only at odds with policies decades in the making by state planners, but with ideas and practices that for millennia have been the pillars of Chinese governance and economic management.

China historically did not experience the debate over private property that in the West was advanced by Augustine, Thomas Aquinas, and John Locke among others, the gist of which is that the right to private property is a “natural law,” or, as Chinese critics might say, a “so-called universal law.” In Chinese history, a key debate was held in 81 BCE, called the “Discourses on Salt and Iron.” The discussion was in reaction to an intense re-centralization policy by a powerful Emperor, Han Wudi, who expanded monopoly control of key industrial activities in the hands of the rulership. The argument for the direct engagement of political leaders and imperial resources in the pillars of the economy was forcefully set out in those debates, and the emphasis on political control, administrative techniques, and direct management style in production and trading has been a consistent feature of Chinese governance, up to the present day. Importantly, China’s structural model has achieved a clear record as the longest continuous system for managing a large economy in the world, notwithstanding steep ups and downs over the ages.

This is why the structural issues on the table go far beyond subsidies. Pillar industries like steel, aluminum, glass, cement, power, energy, telecommunications, and banking are provisioned by state-owned entities that differ in fundamental ways from the MNCs competing with them. In the first decade of reform, China’s leaders developed the 1986 bankruptcy law applicable to state-owned enterprises that was intended to send a message that all enterprises had to do better than lose money. 15 percent of the national budget was being spent on propping up key enterprises. The first major revision, in mid-2007, applied to all enterprises. Importantly, it adds reorganization as a legal option, under the supervision of an appointed administrator. But it has not materially influenced the symbiotic economic relationship between the state and enterprises.

Two trends have emerged over the last decade that have not reduced but have reconstructed the relationship between the political leadership and China’s key industrial and commercial entities, both SOE and private. First, reorganization has become the prominent solution, as witnessed recently in the redistribution of assets belonging to several of China’s top overseas investors, who were
private developers and insurance companies. Secondly, since the global financial crisis and the beginnings of stimulus, the importance of direct subsidies has ebbed, because large SOEs have been provided massive new credit lines, have been enabled to carry huge debt loads and evergreen debt when required, and have diversified into China’s two major asset classes, equities and real estate. The need for direct subsidies, of the sort defined by WTO, was reduced with a policy of easing, but that does not mean the State is any less involved in the distribution of resources. Banks, all State-owned, are key, and bank credit is the primary instrument to keep SOEs operating, employing and supporting local economies, even if their core business activities are not producing positive margins. And if the indications of the 2019 National People’s Congress, which convened from March 5-15, are realized, China will reignite stimulus and easing to support growth in an environment that the President and Premier have both called “tough.”

This is not to say that change and progress are not possible, because obviously China’s modernization and the dynamics of technology and globalization have had a profound impact on China’s reforms. For example, China historically managed trade through intermediaries, as with the Central Asian and Mediterranean merchants who plied the Silk Road trade routes. China historically did not build its own global trading network (though it provided the manufactured goods), yet the “going out” campaign of reforming China saw massive outbound M&A investment develop a very significant Chinese overseas ownership landscape, a huge presence in global capital markets, and substantial control of overseas financial assets. Change is not only possible but inevitable, and a reasonable consideration of the art of the possible helps put parameters around what to expect.

Returning to the three major agenda categories, the deep structural realities of the political leadership and their involvement in the economy remain as the greatest unknowns on the path forward to a negotiated resolution of the trade war. For MNCs active in China, negotiated terms and the new Foreign Investment Law that promise things like negative lists and approval processes, newly opened sectors, and softened local partnership requirements may come, but many aspects of the current playing field will not significantly change in practice. Accordingly, new strategies will likely be needed to deal with the surface features and deeper realities of a post-trade war China.

**Footnotes**


Trends to watch

Chinese Premier Li Keqiang says foreign investment law shows Beijing is serious about opening economy further, SCMP, 3/15/2019
China investment in US startups keeps flowing despite new rules, WSJ, 3/15/2019
Global private equity snaps up Chinese commercial property, Bloomberg, 3/17/2019

Outbound M&A from China

Consumer
CESL Asia to purchase Portuguese cattle business, Macau Business, 3/1/2019

Energy, Resources & Industrials
Angang Group consolidating ownership of Gindalbie, S&P Global, 3/12/2019
Nzuri Copper to accept Chinese miner’s takeover offer, Small Caps, 2/27/2019
Chinese copper fabricating giant Zhejiang Hailiang enters the European market, Roskill, 2/8/2019
Haozhi Industrial to buy stake of European industrial automation company, Xinhua Silk Road Info. Service, 1/22/2019

Technology, media & telecommunications
YY announces completion of acquisition of BIGO, Globe Newswire, 3/4/2019
Hengtong extends Rockley partnership with $30 mln investment, Optics.Org, 3/4/2019
Reddit confirms $300 mln Series D led by China’s Tencent at $3 bln value, TechCrunch, 2/11/2019

Transportation, hospitality & services
COSCO Shipping Ports buys stake in Peruvian Chancay Terminal, World Maritime News, 1/25/2019

**Inbound M&A into China**

**Consumer**
SoftBank Vision Fund bets $1.5 bln on China used-cars giant, Bloomberg, 2/28/2019

**Financial Services**
HNA Group to sell stake in Hong Kong firm to Blackstone for $894 mln, Reuters, 3/10/2019
First Sponsor buying 36,405 square meters of Guangdong land for CNY 738 mln, Business Times, 3/4/2019

**China Domestic M&A and Industry Consolidation**

**Consumer**
Chinese startup WM Motor raises 400 mln euros, Electrive.com, 3/9/2019
Future Capital submits mandatory HK$901.7 mln offer for Yugang International, S&P Global Market Intelligence, 1/24/2019

**Energy, resources & industrials**
Jiangxi Copper to acquire 30% stake in gold smelter for CNY 2.98 bln, S&P Global, 3/5/2019

**Real estate**
Hong Kong’s Link REIT buys Shenzhen Mall for CNY 6.6 bln, Retail News Asia, 2/25/2019
China's Greenland takes half of CMIG's Shanghai mega-project for $1.8 bln, Yicai, 2/15/2019
Sunac buys pair of Shanghai and Beijing projects from Oceanwide in CNY 12.6 bln deal, Mingtiandi, 1/21/2019
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**Growth continues amid heightened uncertainty - Deloitte and AmCham China jointly released 2019 China Business Climate Survey Report**
Deloitte and AmCham China's 2019 China Business Climate Survey has served to take an annual pulse check on the business environment in China. This year's report reflects diverse views of AmCham member companies in all major industries. The report covers a wide variety of topics including investment trends and prospects, innovation and intellectual property, regulatory environment, and the impact of tariffs and bilateral trade tensions.

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