What's the Deal?

Business and ‘Buy-Sell’

One Chinese word for “doing business” is maimai (买卖), which literally means buy-sell. There is perhaps no more apt description for the rise and decline of Chinese M&A activity in the United States and globally. China’s outbound investment globally reached nearly $220 billion in 2016.¹ Then China’s global outbound M&A investment dropped precipitously in 2017 and again in 2018. Decline of Chinese investment in the US was a major contributor to the overall global decline. Last year Chinese companies completed acquisitions and greenfield investments in the United States worth only $4.8 billion, down 84 percent from 2017 and, given assets sales in the US, yielding a negative net investment for 2018. It is this shift from buy to sell that created the maimai transition in which we frame this discussion.

As quickly as China’s outbound investment went into hyper-drive and then sharp decline, so have the explanations and outlooks of analysts. One widely read report stated “China’s record outbound M&A levels in 2015 and 2016 could become the new normal” and spoke of the huge potential for China’s outbound M&A activity.² As activities slowed, many analysts considered it a cyclical pause, with the
expectation that pending certain domestic adjustments, China was destined to become the world’s biggest outbound direct investor.

Impossible though it may be to predict the future of China’s outbound activities, we see two important questions that bear on it. First, is the rapid buy-sell transition primarily a result of excessive debt acquisition by the several privately owned enterprises China’s leadership called out and pressed to sell down leverage, or is it a symptom of a broader, more systemic challenge China is facing with outbound investment and ownership? Secondly, how does the rapid buy-sell transition in outbound M&A fit into the larger picture of China’s current account activity, including the impact of the Belt and Road Initiative and overall pressures to open up capital account related financial services?

There were trends already identifiable in 2016 that raised questions about the sustainability of China’s robust outbound M&A growth. These included signs of a slowing economy, rapid accumulation of debt domestically, significant migration of labor-intensive manufacturing to other countries, and pressures on the exchange value of the RMB. But unforeseen were the tariffs, technology bans, steeper economic slowdown and strong stimulus, and policy push-backs against Chinese M&A initiatives that were preludes to or consequences of the trade war.

The foreign currency debt red line

Signs are emerging that suggest the sell down of foreign assets relates to a systemic challenge for China. Foreign debt, much associated with overseas acquisitions, has been a red line for Chinese leadership since the Asian Financial Crisis of 1997-1998. Foreign debt was the culprit. From 1993-1996 foreign debt rose from average of 100 percent GDP to 167 percent, so the pro-cyclical pressure of declining domestic currency exchange values contributed to a trigger a wave of defaults.

In China rising accumulation of debt in currencies other than RMB occurred concurrently and in the wake of the 2016 outbound M&A peak. This translated into increasing demand to service overseas debt from hard currency resources. Numerous media reported a sharp increase in Chinese corporate defaults on-shore in 2018, quadrupling 2017 and soaring again in 2019. In the first half of 2018, Chinese companies defaulted on at least $350 million in dollar debt, marking a 40 percent increase compared to the same period in the previous year. Chinese overseas bond issuance in the first four months of 2018 tripled the 2017 rate. Nearly 2/3 of this issuance was from companies associated with local governments, Local Government Finance Vehicles (LGFV), essentially exporting a slice of China’s local government debt overhang. In fact, in the comparable first four months of 2019, bonds from LGFVs alone were double the amount from the same period last year.

In mid 2018, several of China’s largest overseas real estate investors were required by the government to sell off assets to reduce their overall leverage. The initial phases of this disposal involved distributing some holdings to other
Mainland companies, which did not deleverage overseas debt. But within the following months, efforts were made to dispose of overseas assets to overseas buyers, reducing overall foreign debt associated with these assets. By mid 2019, all foreign assets were on the market and at least one of the major overseas investors, under government control, was required to stabilize foreign obligations in preparations to be sold in its entirety to a new purpose-built entity.

Other major pressures pushing up China’s foreign obligations include the Belt and Road Initiative (BRI, formerly One Belt One Road) as well as overseas costs related to stabilizing the offshore RMB markets. Initial BRI investments are predominantly loans to client states and their projects. But between the first and second BRI summits, concerns were raised about the level of debt client states were incurring, especially for projects with little prospect of providing adequate cash flow. As a result, in the most recent summit, Xi Jinping emphasized a new level of concern over the “sustainability” of debt moving ahead and promised more careful consideration in the future.

But defaults have occurred, in Greece and Sri Lanka, and another eight BRI projects are at high risk, in Mongolia, Montenegro, Pakistan, Laos, Maldives, Djibouti, Kyrgyzstan and Tajikistan. The Sri Lankan government was unable to service the Hambantota Port loan and handed 70 percent of equity to Chinese companies and a 99 year operating lease. In Greece, a similar fate for the Port of Piraeus, where Chinese companies bought a controlling interest in 2016 as part of debt relief. We discussed these two cases in more detail in the previous What’s the Deal edition. In both cases, China has taken on additional foreign currency encumbrances not contemplated in the original loans to improve, expand, or simply maintain operations.

Much of the burden of BRI debt falls on Chinese SOEs, including construction companies involved in the projects, who themselves are reported to have debt-to-EBITDA ration of 9.2X, compared to a global industry average of 2.4X. In other words, their solvency challenges are greater than the BRI projects they are called upon to rescue.

The current account transition

China’s engagement in global financial activity has grown enormously since the global financial crisis. The accumulated pressures we have reviewed have brought China to a watershed moment. In 2019, China is expected to become a borrower nation and see its first annual current-account shortfall since 1993. The 2019 projected shortfall is .3 percent of GDP, projected to reach 1.6 percent of GDP by 2030. Though this is a shift after over 25 years as a net creditor, China remains in a very strong fiscal position by emerging market standards, especially as exuberant overseas buying and leverage by big private and state-owned players has been constrained.

This transitional point in China’s reform evolution may invite a significant adjustment in the balance point China’s leaders seek between openness to new
inbound foreign investment and tight control of asset management and asset ownership by foreign interests in the Mainland. Through 2018, foreign investment into China’s A share markets and government and corporate bond markets has been miniscule, notwithstanding recently established “connect” programs with Hong Kong and London. Special Mainland foreign investor markets, like the Shanghai B share market trading in USD, or the Shenzhen B share market trading in HKD, have not been notably successful.

Officially a new level of openness to foreign financial services has been in the offing, but some such promises reach back to China’s WTO accession in 2001. Given the current stack of foreign currency obligations, there is a reasonable prospect that sustained and meaningful regulatory changes will be made, and those would align with the increased weighting of Chinese investments from MSCI and other market guidance. China will likely have to compete for capital with other growth markets. Along with increased capital inflows, China’s focus on deleveraging and de-risking the many dark corners of the shadow banking and wealth management sectors creates a reasonable prospect that China will admit substantially more foreign asset management companies into Mainland markets.

MNC financial executives should factor into their strategic visions the potential for this shift. Expanded opportunities to participate in financial services in the Mainland will likely follow precedents, like insurance, with various cooperative or joint venture models with domestic companies required in the early phases. But good planning can look beyond the early opportunities and doing so can help optimize even the early stage arrangements. As China moves more deeply into the sell side of a buy-sell transition, the implications for foreign investors extend far beyond the trading of luxury hotels abroad.

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Outbound M&A from China

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