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China M&A Round-Up

Keeping pace, marking milestones

What's the Deal?

China M&A Round-Up's new "What's the Deal?" series continues with the latest column from US CSG Senior Advisor Ken DeWoskin. Readers interested in broader M&A trends will also likely want to understand some of the environmental factors present in China. The following article provides an informed perspective and context on these developments.

China's Season of Debates

China is well into what could be termed its annual "season of debates," and this year's meetings and studies take on the special importance as the fifth year in the top national leadership cycle, when important policy and leadership decisions will be ratified at the quinquennial Party Congress in the late fall. The decisions made in the course of this half-year process will impact financial and monetary policy as well as broader regulatory trends shaping economic growth, the business environment for MNCs in China, and China's projection into external economies through aid and outbound investment.

Investment flows in and out of China will be directly impacted by decisions and policy directions set in the course of the series of 2017H2 meetings. Under continuous review are capital account controls, the administration of currency exchange values and terms, and the availability of credit to fund global expansion through acquisitions both domestically and abroad. The core of China's financial services sector remains the large state-owned banks, and the large group of state-owned enterprises constitute the main channel of new liquidity into the real economy. As a result, there are multiple, efficient channels through which policy decisions and processes impact the real economy, including many aspects of finance, production, consumption, and regulation that shape the opportunities for non-Chinese multinationals.

The kickoff event of the 2017 debate season was the National Financial Work Conference (NFWC) held July 14-15 in Beijing. The Conference itself is held every five years, a meeting cycle that was inaugurated in 1997 in the wake of the Asian Financial Crisis. Nearly the entire Politburo participated in the NFWC this year, and that meeting was followed by a second meeting of the Politburo focused on the state of China's economy and fiscal and monetary policy options. President Xi Jinping was involved in the NFWC, which had not typically been the case in the past, underscoring the exceptional importance of these meetings. (**Bloomberg News, July 17, 2017**)

In April of this year, China's official media already reported that the Politburo was focusing on what was termed "systemic financial risk." This term has been connected to concerns over very high leverage in the State-owned sectors of the economy and on the part of local governments. According to several reports, the broad policy options under discussion balance maintenance or even expansion of leverage against a broad financial tightening and potential for a significant slow-down in growth rates. While the problem is not new, in April as this topic was taken up somewhat publicly by the Politburo, rates on a number of key interest indicators moved up sharply. (**Financial Times, May 3, 2017**)

It is useful to remember that China's financial sector reform is not even forty years old. Post the establishment of the PRC in 1949 and the rolling up of all banks into one central entity, the first phase of banking reform was undertaken in 1978 as one of the first major economic reform steps. Prior to that, since 1949 China had a single bank, the People's Bank of China (PBoC), reporting to the Ministry of Finance. In 1978 the Bank of China, Agricultural Bank of China, and China

Construction Bank were established, and in 1983 the decision was made that the PBoC should function as a central bank, so commercial banking was pulled out of the PBoC and China's Industrial and Commercial Bank was set up. (Wen Si, "Banking Reform in China," Shanghai Academy of Social Sciences, March, 2015)

With each decade of reform, financial services diversified significantly, with the establishment of special purpose banks with shareholder structures, local city commercial banks, and even some private banks. China's equity markets and insurance sector grew rapidly, and large brokerage houses and domestic investment funds appeared. A trio of regulators was established, the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission, and China Security Regulatory Commission. They joined the top tier Ministry of Finance, the People's Bank of China, and the State Administration of Foreign Exchange. (**Official website of the Chinese Banking Regulatory Commission**)

But after the global financial crisis of 2007-2008, a market-driven reform picked up steam. There was a broad and massive diversification of financial services in China that were sometimes relatively unlinked to the State financial sectors, including the growth of the huge on-line triopoly of the Internet BATs (Baidu, Alibaba, Tencent), and broadly encompassed by the term "Total Social Financing" and more informally "Shadow Banking." Less than a decade old, this cluster of agents and activities quickly interfaced with the formal state players as innovators and distributors of a huge catalog of new financial products.

We reviewed this short and vibrant history to get a picture of what China's top leaders face in regulating a financial services landscape that has gone from a single bank allocating state resources to a financial system as complex as any other economy in the world in roughly one generation. This provides meaningful context for the current debates and is useful background for understanding the steps likely to be taken.

What is clear from the meetings so far is that the leadership is contemplating profound changes in both the direction of key policies and also China's regulatory and implementation players.

Under the general theme of de-risking the economy, attention has been paid to curtailing SOE debt and restructuring the financial options of local governments. These are not new ideas, but the consistency with which the de-risking concepts have been publicized, through publications, talks by the top leaders, and even press conferences at which senior Party entities have participated—a rarity—

suggests a stability and seriousness of purpose in achieving these goals. The State Information Office convened a multi-organ press conference that was even attended by the Central Leading Small Group for Financial and Economic Affairs, a top tier Party organization that normally would not step up to a public role in managing the economy. The press conference addressed SOE and local government debt, the housing bubble, and the need to supervise and regulate the shadow banking world. For local government debt, new types of revenue-backed bonds are being piloted to relieve the burden of local budgets on local branches of SOE banks. (**Raymond Yeung, "China Set to Bolster Regulatory Oversight," August 4, 2017**)

In terms of regulatory implementation and oversight, the NFWC announced the formation of a new Cabinet-level group, called the Financial Stability and Development Committee (FSDC). This appears to be an empowered group, under the State Council and co-located with the PBoC that will likely play a key role in coordinating industrial policy, fiscal policy, and monetary policy and will work to coordinate the enforcement activity of the PBoC and the three financial regulators. Details of how exactly the FSDC will work remain to be seen, including who will chair the committee, but it has the potential to be a more comprehensive policy and regulatory agent that can help fill in the supervisory gaps that have risen in China's fast developing financial service sectors. The establishment of this kind of uber-regulator is a familiar response when top Party officials feel the existing structures are unable to keep up with the pace of change. We have seen it in areas like Internet and information management, where the explosive growth of on-line services gave birth to both turf overlaps and gaps in regulation. The response was the establishment of a powerful Office of the Central Leading Group for Internet Security and Information. (**Communication from the Cyberspace Administration of China, 2014**)

Until the 19th Party Congress is convened and officially reports out, we will not have clarity on many of the policy trends raised in this discussion. And until the 19th Party Congress is actually convened, it is also highly unlikely we will see any dramatic changes in direction, especially those that might impact 2017H2 growth rates. But as we enter 2018, we believe we may see some important changes and commitments to press forward with these changes, which in the aggregate are intended to reduce leverage through steady and material financial tightening, tolerate slower rates of growth, reallocate capital flows domestically, and potentially soften the commitment to fight RMB depreciation.

Trends to Watch

China banks' leverage falls for first time since 2010, Bloomberg, 8/20/2017
Chinese investors warned of dangers that lie in wait along the New Silk Road, South China Morning Post, 8/20/2017
Cabinet outlines curbs on 'irrational' outbound investment, Caixin, 8/18/2017
China's economy gets smaller boost from trade, WSJ, 8/8/2017

Outbound M&A from China

Energy and Resources
Hong Kong's Cheung Kong Infrastructure set to acquire Germany's Ista in $5.3 bln deal, Fox Business, 7/27/2017

Life Sciences
Valeant to sell Obagi Medical Products business for $190 mln, Reuters, 7/17/2017

Manufacturing
Anhui Shanying to acquire Sweden's Nordic Paper for $353 mln to enter premium market, Yicai Global, 7/21/2017

Real Estate
London's Walkie Talkie building sold for record-breaking £1.3 bln, The Guardian, 7/27/2017
China's Fosun buys office property in Brazil for $140.1 mln, DealStreetAsia, 7/27/2017

Technology, Media & Telecommunications
Tatwah Smartech plans to invest in ASN Satellites for 40% stake, Reuters, 8/11/2017
Hutchison's Drei buys Tele2 to rival Carlos Slim's group in Austria, Reuters, 7/28/2017

Inbound M&A into China

Aviation, Transportation & Logistics
SK Holdings to acquire 11.7% stake in E-Shang Redwood for $333 mln, China Money Network, 7/31/2017

China Domestic M&A and Industry Consolidation

Manufacturing
China Communications Construction to sell 30% stake in Shanghai Zhenhua Heavy, Dow Jones, 7/18/2017

Travel, Hospitality & Leisure
Guangzhou R&F Properties buys Dalian Wanda assets from Sunac, The Standard, 7/20/2017

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