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China M&A Round-Up

Cross-border investment trends

What's the Deal?

China’s M&A Boomerang

After a record year of Chinese investment flows into the US in 2016, 2017 witnessed a drop of 35% to a total of approximately US$29 billion. While 2017 was still the second highest year of Chinese investment flows into the US, the drop in new deals compared to the previous year was even sharper; the value of newly announced Chinese acquisitions in the US dropped by 90% compared to previous year.[1]

There are many reasons cited for this sharp peak in 2016 and subsequent fall off in 2017, and views among experts differ in both what the key drivers are and the potential future trends in Chinese outbound direct investment (ODI). We have discussed related issues in several previous editions of this column.

China’s outbound investment into the US is a small fraction of China’s total ODI, and China’s total ODI is a fraction of total M&A and restructuring if the Mainland and domestic transactions are considered. In fact, it may be the case that what we are witnessing is a significant return of investment interest and resources to the

Mainland by China's acquisitive enterprises, both private enterprises with significant cash resources and state-owned enterprises relying on substantial credit lines with the big domestic banks.

Headline reasons for redirecting resources to the domestic market include improving confidence in the strength of the RMB, promotion of public-private partnerships in financing key projects and players, stark imbalances in the free cash and debt positions of major private and SOE players, the continued buoyancy for IPOs on China's domestic capital markets, capital account controls and concerns over capital flight, the key element of the Chinese Dream—national rejuvenation-- and an increasing confidence that China can meet ambitious goals on its own set out in campaigns like Made in China 2025. And is the case with all enterprises in China, the broad interests of the state and Party in the use of resources adds political considerations to strategic commercial ones.

For more granular insight into this phenomenon, we will look at three kinds of transactional activities that are now flourishing within China's borders. The first is the redirection of investment by cash-rich private and state-owned enterprises into some cash-strapped domestic state-owned sectors. The second is the dismantling of some of China's most visible and aggressive outbound investors and the redistribution of their external and domestic assets. The third is the provision of major new big bank support to some very stressed enterprises, even insolvent enterprises, to enable them to make headline acquisitions of other domestic companies.

Private and state-owned companies step up to support the revitalization of a prominent SOE

Mixed Ownership Reform was an initiative announced by President Xi Jinping in 2013, as an effort to improve both the finances and governance of State-owned enterprises. Aligned with this initiative, the recapitalization of China Unicom is an example of refocusing capital flows into the domestic market.
China's second largest wireless carrier, China Unicom, was founded in 1994 by a group of non-telecommunications ministries (railways, electronics, electric power) as a competitor to China Mobile, itself an enterprise belonging to the restructured Ministry of Post and Telecommunications. The attraction of the highly profitable mobile business was strong, far eclipsing the revenue of China's monopoly fixed line provider. While the establishment of Unicom was a major achievement in advancing consumer choice, the enterprise was not provided capital resources to build any kind of network.

Unicom was established prior to China joining the WTO, and foreign investment was prohibited, but beginning in 1994 some 46 ventures with foreign investors were created by Unicom's provincial level entities, using a work around dubbed the "China-China-Foreign" model. Then, as China explored IPOs as a means of aggregating capital, regulators forced the dissolution of all the foreign investments, and from 2000 to 2002 Unicom undertook a series of successful IPOs in Hong Kong and Shanghai.

Various restructuring and consolidation activities filled the intervening years, but by 2017 Unicom was in need of recapitalization.
Unicom is an SOE, and with government support in 2017 announced a US$12 billion capital drive to be implemented by selling existing and new Shanghai-listed A shares of its subsidiary China United Network Communications. Ten state-owned and private strategic investors took part in the offering, but the lion's share of offering was taken up by state-owned investors, including the China Structural Reform Fund and China Life.[2]

Smaller investments into the recapitalization were made by the China's top ecommerce players and ride-hailing firms, all companies that heretofore had robust M&A programs abroad. The calculus supporting the decision of these fast-moving tech brands to redirect invest to a long-ailing SOE is beyond our scope here, but suffice it to say it does not promise either the capital gains nor operating ROIC of their typical investment profile. Rather it reflects the attention China's current leadership has placed on aligning use of capital with Party interests and goals.

One-time ODI leaders seeing the bank window close and selling assets

Among the biggest overseas investors during the 2016 surge were major insurance companies and major real estate developers. Enterprises in both sectors had access to large amounts of cash or bank credit, albeit for different sector-related reasons. Their common activities included a focus on overseas real estate investments and complex debt-supported financial structures to support their asset growth. Their common fate was often the inability to service mountains of debt, domestic and foreign, that had accumulated in the course of M&A sprees, including some significant landmark purchases of assets at prices that left markets stunned.

China Insurance Regulatory Commission (CIRC) began a crackdown on particular overseas acquisition initiatives in mid 2017, citing relatively unknown rules from 2012 about foreign asset ceilings. In cases we have studied, this curtailed new spending but did not resolve the debt servicing challenge, and in late February of this year, the CIRC simply seized control of one of China's largest private insurance companies, removing its chairman and replacing him with a government official. There was not an immediate asset sale, and in fact in the interest of stability, announcements went out from the new leaders that domestic assets would not be sold and the company would continue operating normally.[3] This seizure, removal of the founder and chairman, and nascent plan to begin disposal of key assets was widely interpreted as a signal from the top of the leadership that China would no longer abide by risky overseas acquisition behavior, termed in the state-controlled media as "unreasonable," and perceived as creating systemic financial risk and reputational risk for China as a whole. In February of this year, the CIRC instructed three of China's largest insurance companies active in overseas M&A to "rectify" their overseas investment activities.[4]

In the interest of stability—a sweeping government overhaul

Another example, just now unfolding, involves a huge, diverse, and globally acquisitive Chinese group that publicly announced it cannot meet a very large debt repayment. The case is similar in origin to the ones just discussed above, but the apparent outcome is different. We will explore this in future columns, but suffice to say here that the path forward involves disposing of several large foreign assets while getting new bank support to acquire some very costly domestic ones. At present, there does not appear to be a management change in the offing.

None of these developments suggest China is withdrawing from outbound investment. The indications are two-fold. The leadership wants to address the systemic risks that are fueled by a lack of discipline in some outbound sectors, and they want a bigger say in where resources are directed. The concerns reflect the abiding focus on improving the stability of the economy overall and achieving better alignment with the Xi Jinping government's agenda. For ODI, that alignment encompasses directing resources where needed domestically and supporting the capital intensive Belt and Road Initiative.

To get there, we have seen a number of important changes in both the Party-state relationship and China's ministerial structure. These changes have generally sought to eliminate ministerial turf wars and improve the efficacy of regulation. Looking back to the Third Plenum in November 2013, this consolidation process began with the establishment of two powerful Party committees, both chaired by Xi. One focused on deepening economic reform and addressed the need for stability.

Subsequently, in the wake of the economic work congress in mid 2017, prior to the 19th National Party Congress, a new government entity was established, called the Financial Stability and Development Committee, headed by Liu He. That committee was intended to help coordinate the work of the insurance, banking and securities regulators, and collocated with the People's Bank of China. Less than a year later, on March 13, 2018, a more sweeping series of government reforms was announced in the official media, with 15 ministries being dismantled and new, more consolidated regulators put in their place.[5]

The most relevant to the changing financial landscape in China M&A was the folding of the CIRC into the Chinese Banking Regulatory Commission (CBRC), the latter perceived to be the stronger of the two. The new agency, the Chinese Banking and Insurance Regulatory Commission (CBIRC) will be led from the banking side, and former CBRC head Guo Shuqing appears to be moving toward appointment as the new governor of China's central bank. While we cannot draw a straight line between this and the issues raised by some large insurers investing overseas, quite explicitly this change is described as an effort to strengthen the regulation of the insurance sector. It also allows clarification of the PBOC as the policy-making body for both insurance and banking. Also important for the outbound use of capital resources is the establishment of a new central agency directly reporting to the State Council, the Office for International Development Cooperation, and that will provide new energy in support of ODI through the Belt and Road Initiative.[6]

Centralization of authority appears to be the thread that runs through all of these developments, seeking to enhance stability and improve capital efficiency. The vision is well-expressed in the words of new Politburo Standing Committee member Wang Huning:

> Unity of leadership is the prerequisite for the existence of any country… Where there is no central authority or where the central authority is in decline, the nation will be in a divided and chaotic state.[7]

[1] http://cim.rhg.com/notes/chinese-fdi-in-the-us-in-2017-a-double-policy-punch
[2] https://www.ft.com/content/cf5d76ca-8276-11e7-94e2-c5b903247afd, Deloitte analysis
[3] https://www.reuters.com/article/us-china-anbang-regulation/china-seizes-control-of-anbang-insurance-as-chairman-prosecuted-idUSKCN1G7076
[4] http://www.chinadaily.com.cn/a/201802/24/WS5a914bf0a3106e7dcc13ddd5.html
[5] http://www.scmp.com/news/china/economy/article/2136939/china-unveils-sweeping-governmental-changes-cut-bureaucracy-and
[6] http://www.chinadaily.com.cn/a/201803/14/WS5aa85af7a3106e7dcc1416dc.html
[7] Wang Huning, Political Life, 1995

Trends to watch

China's economy grows faster than expected on strong demand for exports, WSJ, 3/14/2018
US pressing China to cut trade surplus by $100 bln: White House, Reuters, 3/14/2018

Outbound M&A from China

Agriculture
Red Sun to acquire 60% stake in Ruralco, moving to market terminal, AgroPages, 2/2/2018

Consumer business
China furniture maker Kuka Home pays $51 mln for Germany’s Rolf Benz, Yicai Global, 3/1/2018

Energy and resources
OMV to Divest Upstream Business in Pakistan, Rigzone, 3/1/2018

Financial services

Ant Financial, Telenor partner to deliver financial services in Pakistan, Xinhua, 3/14/2018

Manufacturing
MayAir takeover by Poly Glorious complete, Alliance News, 3/20/2018
China's Doublestar takes control of South Korea's Kumho Tire in $597 mln deal, Reuters, 3/4/2018
China's Suzhou Victory Precision acquires Finnish company to improve intelligent manufacturing, Yicai Global, 2/7/2018

Technology, media & telecommunications
China's Tencent to take stake in Ubisoft games maker, Channel NewsAsia, 3/21/2018
Tencent leads $115 mln round in music streaming service Gaana, VCCircle, 2/28/2018
Zomato raises $200 mln from Ant Financial, The Economic Times, 2/1/2018

Inbound M&A into China

Energy and resources
Huan Hsin to acquire mining company stake for S$1.06 bln in reverse takeover, The Business Times, 3/6/2018

Life sciences & healthcare
GNC enters China through joint venture with Hayao, Drug Store News, 2/13/2018

China domestic M&A and industry consolidation

Consumer business
Tencent leads $5.4 bln investment in Wanda Commercial, Bloomberg, 1/29/2018

Manufacturing
China's Beijing Electric Vehicle plans to reverse into $4.5 billion listing, Reuters, 12/7/2017

Real estate
Freeing up liquidity: HNA sells Hong Kong site to Wheelock for $811 mln, Reuters, 12/8/2017

Technology, media & telecommunications

Chinese bike-sharing startup Ofo raises $866 mln in new financing led by Alibaba Group, TechCrunch, 3/13/2018
Enlight Media transfers New Classics Media stake to Tencent, 4-Traders, 3/12/2018
Chehaoduo, formerly Guazi, raises $818 mln Series C Round led by Tencent, China Money Network, 3/1/2018

Travel, hospitality & leisure
China Lodging Group announces acquisition of Beijing Novotel Sanyuan and Ibis Beijing Sanyuan with TPG Capital, Reuters, 1/29/2018

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