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China M&A Round-Up

Keeping pace, marking milestones

Issue Updates

The China M&A Round-Up newsletter is moving to a bi-monthly distribution beginning in November 2017. Please note that this September edition will be the final newsletter that you receive on a monthly basis.

What's the Deal?

China M&A Round-Up's "What's the Deal?" series continues with the latest column from US CSG Senior Advisor Ken DeWoskin. The following article examines the M&A and related business implications of China's efforts to become a global leader in Industry 4.0.

China's March to Industry 4.0

China's leaders are on a march to sustain China's manufacturing competitiveness with a focused program aimed at becoming a global leader in Industry 4.0. They are well-versed in the history of Asia's economic development, the first wave that brought prominence and prosperity to Japan, and the second wave that did the same for the "Four Tigers," South Korea, Taiwan, Hong Kong, and Singapore.

While the development and current situation of each of these other Asian nations differ, they all went through early stages when cheap labor drove growth along with low cost capital. Their fates diverged when the labor advantage shrank and the debt incurred in fueling rapid growth became unsustainable. In recent decades, Japan, South Korea, and Taiwan have all moved labor intensive manufacturing to China, while working to maintain control of branding and technology. China does not have that option of moving their massive manufacturing activity to another nearby, less developed economy.

China's approach to its future is somewhat different. While Chinese traders and manufacturing enterprises have moved some labor-intensive manufacturing toward lower cost labor in Southeast Asia, the main thrust is not to move manufacturing activity to lower cost countries. A key strategy from the top leadership is to accelerate the ascent of Chinese enterprises up the technology and value ladder, to take a global leadership role in the new manufacturing frontier, what is broadly captured under the scope of Industry 4.0.

Made in China 2025

The blueprint for "Made in China 2025" (MIC2025) was introduced in May 2015 with a focus on making China a dominant global high tech manufacturer by promoting innovation, building Chinese enterprises and brands, and enhancing service-oriented manufacturing (**China Daily, April 20, 2017**). Since its introduction, the 10 year plan has constantly been promoted by the government, with important channels like the State Council website continuously quoting Premier Li Keqiang's public comments on all essential aspects of the program (**The State Council of the People's Republic of China, "Made in China 2025"**). There has been some evolution of focal points, but the ten key sectors that the government has committed to support include information technology, numerical controls and robotics, aerospace, ocean engineering and high tech ships, railway equipment, new energy vehicles, power equipment, new materials, biological medicine and medical devices, and agricultural technology and machinery. This list covers both what are perceived not only to be the most valuable high tech products in future global markets, but also the key technologies and competencies needed to develop and manufacture them. These ten sectors represent 40% of China's total industrial value-add (**US Chamber of Commerce, "Made in China 2025, Global Ambitions Built on Local Protections"**).

MIC2025 has been studied by numerous media and research organizations, including the EU Chamber of Commerce in China, the US Chamber of Commerce, and the Mercator Institute for Chinese Studies. Reports express various views of the undertaking, but they generally agree on three important points. First, the plan represents a very strong industrial policy, with the government taking a lead in guiding the economy for the next decade. Secondly, they underscore the committed support for domestic companies and suggest disadvantages and some potential risks to the future of MNCs in the China market. Finally, acquisition of technology as well as direction of investment capital, infrastructure support, and regulatory reform are core enabling process that the government will undertake directly or support indirectly for success in the MIC2025 plan.

In the pursuits detailed in Made in China 2025, technology plays a key role. Some of it might be developed domestically. There has been broad stress on the importance of innovation by Chinese enterprises for many years, under the general rubric of "indigenous innovation," and top leaders stress the importance of innovation in every published statement on MIC2025. But there is also a recognition that no one country, much less one company, can create and own all of the complex technologies that will support the future commercialization of land, sea, and air mobility, energy, healthcare, high productivity agriculture, and other tech driven sectors.

Acquiring Technology

New Challenges

Strategic technology acquisition has shaped a significant portion of China's outbound M&A activity from before 2015, and it has sharpened since the promotion of the MIC2025 plan. **As discussed in an earlier article**, as part of its intensified effort to manage foreign exchange, China has significantly reduced approvals of large ODI into real estate and other areas that do not relate directly to the core businesses of the Chinese enterprise applying. The one outbound target area that is still given very high priority is the acquisition of technology assets that contribute to the "Made in China 2025" development goals. Some of the largest acquisition initiatives undertaken have been for technologies that are central to these goals. Chinese buyers have parked wallets in high tech areas like Silicon Valley in search of start-ups developing tech critical for Industry 4.0.

But the global investment environment today is not what it was in 2015. Cross-border investment flows are being impacted by current changes in sentiment about globalization, and there is a particular history in investment supervision involving China and the US that amplifies the impact of the broader changes. That is not deterring anyone from pursuing opportunities in new manufacturing, but it is changing game plans. It is certainly reshaping approaches both Chinese enterprises and MNCs are taking in future growth strategies.

There are signs that supervision of Chinese M&A activity in the US is changing, as a result of actions taken on both sides. Toward the end of July, it was widely reported that the US is changing the way it views inbound investment from China in a number of respects (**Reuters, July 20, 2017**). While the Committee on Foreign Investment in the United States (CFIUS) is facing a significant backlog and reviewing acquisition initiatives from many countries, their focus on Chinese initiatives is on the same areas that China has prioritized: technology related to enablers of new manufacturing like AI, data, semiconductors, robotics, and networking, as well as insurance and other financial services. CFIUS is on track this year to review a record number of deals. Some potential buyers who have experienced delays in their reviews or specific objection have simply withdrawn them, while others have reapplied after taking specific mitigating steps. Even at the state government level in the US, technology centers on the West and East Coasts are analyzing the impact of China's inbound investment drive. Among current regulator interests are the future roles and commercial potential of technologies sought, the ultimate source of capital for the acquisition, and centrality of the technology to US development interests.

Threats to national security that would ensue from an acquisition have traditionally been the main concern of acquisition rules and reviews around the world. But the scope has now broadened, in the context of country-to-country competition for control of rapidly developing, extremely high value technologies that are increasingly seen as critical for manufacturing growth, job creation, and overall economic development, not to mention cybersecurity and IP protection. Few if any observers see the rules and reviews of inbound acquisitions easing in the foreseeable future for technology and for financial services, especially investment that relocates controlling equity shares.

If government regulators tighten inbound investment controls and impede acquisition of technologies through established M&A activity, what are the options available to enterprises to participate in the fastest growing, tech-driven growth opportunities?

New Solutions

One innovative solution that appears to be increasing in popularity is to reverse the direction of investment. Recently we have seen rapid growth in new kinds of partnerships, based on the mainland and purpose built, in which foreign tech companies cooperate with Chinese counterparties in structures that enable them to bring their technologies and market knowledge into sectors where

China generally restricts foreign investment. These win-win models address the need of Chinese enterprises to play a high-tech role in their home market and provides market access for the MNC that otherwise would be difficult.

The primary step is for the MNC to take a minority equity position so that the jointly owned enterprise is classified as a Chinese company and is therefore not subject to restrictions that apply only to foreign companies. This can be accompanied by side agreements that give disproportional management rights to the foreign party, for example, so that the operating performance of the enterprise, the actual control of IP, the management of R&D activities, and similar critical functions are largely controlled by the foreign company. Some elegant variants of this model parse value chains in unique ways, dividing IP licensing from manufacturing from distribution from enterprise services related to the products and their support. Recent reference examples can be seen in sectors as diverse as animation, server manufacture, 3D printing, cloud services, and semiconductor manufacturing.

China is a top priority market for firms up and down the value chain, from makers of manufacturing systems and machinery to owners of prominent high tech brands. It is not only that the domestic market is huge and growing. China also dominates the manufacture now of most consumer electronics and a large share of industrial electronics. Moreover, a number of factors have positioned China as an important development arena and proving ground for high-value technologies of the future. In addressing China opportunities, MNC executives should take note that not only are technologies and markets changing at unprecedented speed, but adaptive business models and partner relationships and structures that support access and profitable growth are changing as well, at least as fast.

Trends to Watch

China's currency rebounds as economic optimism returns, New York Times, 9/11/2017
Multinationals fight for their margins in China, WSJ, 9/7/2017
In overseas deals, China goes easy only on tech, manufacturing, Caixin, 9/6/2017

Outbound M&A from China

Aviation, Transportation & Logistics
CMP buys into Brazilian terminal, China Daily, 9/5/2017

Consumer Products
Billionaire buys stake in Bindaree Beef, Global Meat News, 9/4/2017

Energy and Resources
Odebrecht to sell 456MW Peruvian hydroelectric plant to CTG-led consortium, Business and Financial Times, 8/29/2017

Financial Services
China's Legend buys Luxembourg's BIL bank for $1.8 bln in landmark European expansion, Reuters, 9/1/2017

Life Sciences
Shanghai Fosun Pharmaceutical Group says unit acquires 3.9 mln shares in Impax Laboratories, Reuters, 8/31/2017

Manufacturing
Permasteelisa to be sold to Chinese company, US Glass News Network, 8/21/2017

Inbound M&A into China

Energy and Resources
JM Global Holding signs share exchange agreement with China Sunlong Environmental Technology, Reuters, 8/28/2017

Manufacturing
Global Logistic Properties's Unit buys Hallmark International Investment for $121.6 mln, Fox Business, 8/22/2017

Technology, Media & Telecommunications
Sequoia Capital China leads $240 mln investment in WuXi NextCode’s AI-powered genomics platform, VentureBeat, 9/7/2017

China Domestic M&A and Industry Consolidation

Manufacturing
China Shenhua, GD Power to create power entity as part of group restructuring, Morningstar, 8/28/2017

Technology, Media & Telecommunications
Private, state investors to acquire 35.19% stake in China Unicom Unit, Lexology, 8/25/2017

Dbriefs China Issues Webcast

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