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China M&A Round-Up

Cross-border investment trends

What's the Deal?

The US-China tech tug-of-war and its potential impact on M&A

In the current discussions between the world's two largest economies, trading partners and investment players, headline attention is often focused on trade deficits and proposed tariffs. But right behind is a very complex set of issues about technology, tech transfer, tech-related M&A, and technology appropriation. Some recent government studies in the US have raised the claim that China has unfairly demanded technology transfer from US companies as a cost of accessing the China market, has appropriated technology from US companies without appropriate compensation, and has consistently not protected intellectual property against pirates and counterfeiters.[1,2] China, on the other hand, has commonly voiced that the US has blocked channels of technology acquisition as part of an effort to contain China's growth.

Why is technology currently a major focus of political leaders?

The merits of these arguments will likely be explored and determined over time, but it may be worth asking why the issue of technology transfer has lately been rising to the highest levels of government leadership in major economies. What are the stakes?

There are three potential impacts of national importance: technology as a driver of national competitiveness and growth, technology as a core component of national security, and, less discussed, technology as a tool in diplomacy and the projection of geo-political influence.

Economic growth: Technology and innovation capability are well-established as keys to national competitiveness. At the core, integrative technologies, including essentially all of IT, are commonly fundamental enablers of smart manufacturing and eco-systems that characterize the next industrial revolution, often called "Industry 4.0." Even as a great deal of manufacturing is outsourced, to electronics manufacturing services (EMS) companies and across borders to low labor-cost countries, control of the technology in products such as smart phones, industrial internet equipment, and servers can be tantamount to control of the profit pools. Differentiating technology can secure the sustainability, growth, and profitability of major industrial and consumer brands and will likely play a major role in the expected transformation and reshoring of manufacturing. Profitable growth of enterprises, based on technology and implemented by everything from legal agreements to protective control of core, high value electronic components (like chip sets), typically roll up into key political leadership goals, like national GDP growth.

National security: The direct national security implications are clear. In fact, the interaction of government-sponsored research in the US, defense and space oriented, and commercially-sponsored research is a long-established example of public-private partnership that has contributed enormously to technology growth. Integrated circuits, LEDs, sensors and imaging devices, and high-tech materials like memory foam all can be traced back to NASA. Just as the origin of many technology innovations is from the intersection of national security and commercial activity, the application of many technologies can be classified as "dual-use," i.e. commercially valuable but also useful and important for military applications.

There is a long history of concerns between the US and China about dual use technology, including such things as digital switches, important for public service but also military communication; super computers, important for meteorology but also missile guidance; and, of course, nuclear power programs, important for power generation but also production of nuclear weaponry.

Diplomacy and geo-political projection: Sanctions are a measure of choice in addressing international frictions and disputes short of outright military engagement, and the US has in place many sanction programs that use financial constraints and technology constraints to influence the behavior of other countries. US technology sanctions are intended to prevent the sale to targeted countries of products like core telecommunications components required to build out infrastructure for modernization and growth.

This is a very important component of US clout globally because US companies are often far ahead in technologies that enable capabilities in mobile internet, low-power long-distance wireless connectivity, artificial intelligence and high-speed analytics.

US sanctions can impact not only targeted countries but also potential intermediaries, and this is at the heart of one of the most thorny issues in US-China relations at the moment. Intermediaries might simply transship restricted products to sanctioned countries or they might use US controlled components in manufactured devices ultimately sold to sanctioned countries. This is one reason why US regulators are interested in major Chinese electronics manufacturers and the extent to which they are government or military entities, the extent to which they are using US technology, and their level of compliance with US sanctions. The story recently broke in the media of a seven-year suspension by the Department of Commerce of US IT component sales to a large Chinese electronics manufacturer whom US regulators have accused of multiple sanction violations.[3]

The evolution of regulation

Recent developments and US government studies have triggered a review of relevant regulators and regulations.[4] The direction of these discussions is often of great importance to C-suite executives. Many federal agencies are involved in control of technology transfer and diffusion, including the Departments of Defense, State, Commerce, and Treasury. We have seen evolve over the last decade a wide variety of export controls and an expanding list of barriers to acquisition of some US tech companies. A more and more commodious view of national security issues related to technology—really propelled by the three areas of concern above—could lead to an increase of the scope and powers of US tech regulators.

Belonging to the Treasury with broad inter-agency participation, the Committee on Foreign Investment in the United States (CFIUS) is an example of an agency that has chosen to expand its own range of activities and has also been under review for a major legislative expansion of its mandate for several years.[5] CFIUS has been in existence since 1975 with historically little change in its scope and powers. Companies with plans to acquire a commercial asset in the US are not required to submit to CFIUS review, but CFIUS can initiate a review on a project if it wishes. For the last two years, CFIUS has become more active, recently ending a potential acquisition of a financial service company. It is estimated that about 20 percent of CFIUS reviews over the last five or six years have involved Chinese buyers.[6]

Legislation is pending regarding proposed expansion of CFIUS called the Foreign Investment Risk Review Modernization Act of 2017 (FIRRMA). FIRRMA proposes to change CFIUS in several ways. It extends allowable review time and makes an abbreviated filing mandatory, termed a "declaration process." It broadens the list of security concerns CFIUS must consider, and it broadens the remedies at the disposal of CFIUS and the President in the wake a CFIUS determination. Beyond these operational updates, FIRRMA makes three other changes for CFIUS. It extends the scope of review beyond traditional M&A to include joint ventures, property leases, or any other arrangement that involves critical technology, infrastructure, or even proximity to a sensitive US facility, where foreign parties are not passive participants. It relates review content to countries of "special concern" and could enable CFIUS to review transactions of interest even if no US company were involved. And finally, FIRRMA expands CFIUS reach geographically to reviews of transactions that do not take place in the US but are related to the CFIUS national security agenda. This final expansion of reach is likely in response to topics already widely discussed in the media, including the accusation that China requires technology transfers for joint ventures set up in the Chinese Mainland as a condition of approval of those ventures and for MNC access to China's consumer and industrial markets.

While FIRRMA extends the reach of US regulators, an additional piece of legislation just introduced, the Fair Trade with China Enforcement Act, provides more detail on targets and remedies, including the idea of imposing a special tax on US companies that enter into JVs with China companies with vulnerable technologies. A common theme appears to be the expansion of the definition of national security these proposals imply, essentially encompassing technology assets that are commercially valuable to the US, even if not obviously dual use or of military importance.

The potential impact on C-suite priorities

FIRRMA and the Enforcement Act remain in the legislative process, so the final form of the bills is not yet known. But it is reasonable to expect something close to the current, published version will become law, because there is bipartisan consensus on the national security and competitiveness concerns FIRRMA and the Enforcement Act address.

Powerful and profitable US MNCs in tech sectors may not be active in cross-border M&A, and they are unlikely to be targets for acquisition by foreign companies, some exceptions noted. Yet tech sectors and leading enterprises are notable for structural innovations and new forms of partnerships, cross-investment, and cooperation, including patent portfolio sharing, standards co-development, and co-invested R&D. If CFIUS' scope expands to include any form of cooperation that encompasses technology sharing or exposure, new disclosure requirements related to IP exposures, IP protection plans, and IP valuation could be forthcoming.

Given the new geographic reach, it is also possible that arrangements outside the US that encompass IP exposure might also be subject to CFIUS review, and in particular workable, contractual arrangements binding parties from on-selling technology and equipment might become more subject to regulation than has previously been the case. There are examples of M&A deals involving tech assets in the US that were discouraged by CFIUS, but the same technologies were later transferred via joint venture projects domiciled outside the US.[7]

It should be clear from these developments that the scope of what are considered critical technology assets is being expanded, and governments are increasingly seeing differentiating technologies belonging to their enterprises as national assets deserving of thoughtful protection. This policy trend appears to be on a path that will likely increase reporting and compliance demands on companies reliant on cutting edge technologies as they seek to strengthen their global brand mindshare and market revenues.

[1] https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/march/section-301-report-chinas-acts
[2] https://www.uscc.gov/Research/supply-chain-vulnerabilities-china-us-federal-information-and-communications-technology
[2] https://www.reuters.com/article/usa-china-zte/update-7-u-s-bans-american-companies-from-selling-to-chinese-phone-maker-zte-idUSL1N1RT0IX
[4] https://www.wired.com/story/a-trade-war-with-china-could-catch-tech-in-the-crossfire/
[5] https://www.nytimes.com/2017/11/08/us/politics/china-foreign-investments.html
[6] https://www.nytimes.com/2018/03/05/business/what-is-cfius.html
[7] Deloitte analysis.

Trends to watch

China foreign direct investment up 1.9% to $9.09 bln, MarketWatch, 5/17/2018
China sets new restrictions on companies' foreign debt to curb risks, Reuters, 5/17/2018

Outbound M&A from China

Consumer business
Hisense offers best bid for Slovenia's Gorenje, China Daily, 5/11/2018
UK's House of Fraser to close stores, secures C.banner investment, Reuters, 5/2/2018
Galaxy Entertainment buys 4.9pc stake in Wynn Resorts for $927.5 mln, SCMP, 3/23/2018
Alibaba doubles Lazada investment to $4 billion in aggressive Southeast Asian expansion, Reuters, 3/19/2018

Life sciences & healthcare
China's CDH Investments makes $1.4 bln offer for Australia's Sirtex, DealStreetAsia, 5/4/2018

Financial services
Zhejiang Semir Garment's unit to buy France's Sofiza SAS in order to acquire Kidiliz's assets, Reuters, 5/2/2018

Technology, media & telecommunications
Invengo's unit to acquire Dutch digital library management system provider for $203 mln, YiCai Global, 5/9/2018
Malaysian Newsprint stakeholders to sell stake to HK's Asia Honour, DealStreetAsia, 5/4/2018
Weifu High-Technology will invest in US electric drive system developer, set up China JV, YiCai Global, 3/28/2018
Vivendi selling Ubisoft stake for $2.45 bln to investors led by China's Tencent, SCMP, 3/22/2018

Travel, hospitality & leisure
Star to raise $450 mln from Hong Kong partners, Australia China Business Review, 3/29/2018

Inbound M&A into China

Financial services
China's Baidu to sell majority of financial services unit for $1.9 bln, Reuters, 4/29/2018

Life sciences & healthcare
Capital Group Private Markets leads $150 mln round in China's Innovent Biologics, China Money Network, 4/27/2018
Chinese biotech firm Hua Medicine raises $117 mln to go toward clinical trials for diabetes drug, SCMP, 3/29/2018

China domestic M&A and industry consolidation

Consumer Business
HNA's Tianjin Tianhai plans to buy Dangdang's e-commerce assets, Reuters, 4/11/2018
Shenbao to acquire Shenzhen Cereals for CNY 6 bln, Zephyr, 3/23/2018

Energy & resources

Meijin Energy plans to acquire 60% equity of Shanxi Luhe Coal and Chemical Group, Asian Metal, 3/27/2018

Financial services
Zhongyuan Special Steel to acquire stake in COFCO investment firm via assets swap, share issue, Reuters, 4/24/2018

Life sciences & healthcare
WeDoctor and AIA announce healthcare tie-up, China Daily, 5/12/2018

Manufacturing
Wanhua Chemical signed a restructuring framework agreement, Oriental Wealth, 3/5/2018

Technology, media & telecommunications
Shanghai bourse questions pesticide maker's plan to enter internet ads sector, YiCai Global, 5/14/2018

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