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Spotlight: M&A Trends In China

Law360, New York (August 04, 2010) -- Proposed mergers and acquisitions in China need to be structured carefully to take into account government policy priorities. Lack of alignment of deals with government policies can often lead to deals being rejected or subject to onerous conditions under regulations governing mergers and acquisitions and other regulations. Recent examples of attempted acquisitions of Chinese companies by foreign investors, as well as proposed acquisitions by Chinese companies of overseas businesses, reinforce this well-known reality of doing business in China.

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Some of the policy objectives that were put in action in the outcomes of recent transactions include environmental protection, protection of national brands, designation and protection of “pillar industries” and the selection of certain state-owned enterprises as “national champions” to grow into global companies. The unmistakable theme at play is China’s determination to move up the economic development ladder.

In a similar vein, China’s indigenous innovation policy also has a definite bearing on the authorities’ attitude toward a proposed deal. The 2006 Medium- to Long-Term Science and Technology National Plan, which establishes the Chinese government’s strategic role in innovation activities through 2020, explicitly calls for “the country’s reliance on foreign technology [to] decline to 30 percent or below.”

Conversely, Chinese companies’ acquisitions overseas which involve the acquisition of foreign technology and brands are likely to be looked upon favorably. Although the policy is in its relatively early stages of implementation, the themes mentioned above are evident alongside other policy considerations in some of the transactions discussed in this article.

In the Provisions for the Acquisition of Domestic Enterprises by Foreign Investors (amended in 2009) (the “M&A Regulations”), the Chinese government has put in place mechanisms to manage the extent and effects of foreign influence. If a foreign acquirer obtains control of a domestic enterprise in a “key industry,” or there are factors that affect the economic security of the state, the transaction must be reported to the Ministry of Commerce.

MOFCOM could, in concert with other relevant departments, demand that the concerned parties terminate the transaction, transfer relevant equity or assets or take other effective measures to eliminate the impact of the acquisition on the economic security of the state. This economic security review provision codified a long-standing policy of the Chinese government to guard against control of key sectors of the economy by foreign investors.

In October 2005, The Carlyle Group agreed to buy 85 percent of a subsidiary of Xuzhou Construction Machinery Group, which is owned by the Xuzhou local government, for $375 million. At that time, this would have been the biggest acquisition by a foreign investor of a controlling stake in a leading state-owned Chinese company. The Ministry of Commerce refused to approve the transaction on the grounds that it would have given foreigners control over an important asset in China's strategically important manufacturing sector.

Over three years (during which time the M&A Regulations were promulgated, thus formalizing the national economic security review requirement for foreign acquisitions), Carlyle made several concessions in attempts to win approval for its bid for Xugong, cutting its purchase stake from 85 percent to 45 percent.

After three years of waiting, the parties abandoned the transaction as the period of agreed negotiations lapsed. Reportedly, the Chinese government continued to withhold approval for the transaction because to allow the takeover would hurt China's economic security and result in China's selling off its technology to foreign companies, thereby losing its competitive edge.

The M&A Regulations also provide that if a foreign acquisition would result in foreign control of a well-known trademark or an old Chinese trade name, the concerned parties must report the same to the Ministry of Commerce. According to publicly available information, Coca-Cola's proposed acquisition of China Huiyuan Juice Group encountered this issue. The transaction also reportedly met the thresholds for a notifiable concentration under the Anti-Monopoly Law.

The deal did not go through as the Ministry of Commerce cited antitrust grounds for denying approval for the deal. According to reports, MOFCOM's reasoning was that while neither Coca-Cola nor Huiyuan were presently exhibiting anti-competitive behavior, Coca-Cola could in the future take advantage of its dominant position in the soft drinks market to compete unfairly with domestic brands in China.

Many believe nationalistic concerns about a famous local brand being acquired by a foreign firm may have played into the government decision, on top of the antitrust reasons cited. The Chinese public was severely critical of the proposed takeover, as reported in the Chinese media, which portrayed Coca-Cola as a giant swallowing a cherished national brand. While MOFCOM cited grounds under the anti-monopoly law for blocking the acquisition, it is also probable that the strong public criticism made it difficult for MOFCOM to approve the bid without concessions from Coca-Cola (which were proposed by MOFCOM but not accepted by Coca-Cola).

Already the fourth-largest consumer of clean energies in the world, by some accounts, and having invested $34.6 billion into renewable energy and energy-efficiency sectors in 2009, China is forging ahead with economic development plans that contain ambitious environmental targets. With targets to reduce energy consumption per unit of GDP by 20 percent from 2005 levels, China has energy conservation plans that set extensive targets for energy and resource efficiency across two dozen specific industrial sectors and equipment types.

China has also identified 10 priority energy conservation projects in coal, petroleum, buildings, lighting, transportation and other areas. The failed bid by Sichuan Tengzhong Heavy Industrial Machinery, a privately owned manufacturer of heavy equipment, to buy Hummer from GM, is not surprising when considered against China's green energy goals. Tengzhong was unable to obtain clearance of the transaction from the Chinese regulators within the time frame required by the deal.

Xinhua News Agency, the official state news agency in China and government mouthpiece, remarked that Tengzhong's proposed acquisition of the gas-guzzling Hummer contradicted China's goals and the worldwide trend toward decreasing dependence on oil. In contrast, Geely's acquisition of the Volvo car business from Ford was blessed by Beijing as it believed the Volvo brand and technology were highly regarded worldwide, which is in line with China's goals of acquiring premium brands and technology.

The Chinese government has also been encouraging toward overseas acquisitions by energy and resource companies, as such deals are in line with government policy aimed at procuring the materials China needs to feed its economic growth.

Other countries have national security and other noncommercial grounds on which the government may review and if necessary block a deal from proceeding. The United States has the Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee of the United States Government that reviews the national security implications of foreign investments in United States companies or operations.

In 2005, China National Offshore Oil Corporation (CNOOC), China's third-largest national oil company, withdrew its $18.5 billion bid for Unocal, citing political tension inside the United States. CFIUS' review effectively blocked CNOOC's bid because of fears that an acquisition of a U.S. energy resource and development company by a Chinese company would threaten the United States' national security.

However, the M&A Regulations contain many grounds on which approval is required, instituting more regulatory roadblocks than parties to a transaction might encounter in the United States and many other jurisdictions.

M&A continues to increase and remains a viable strategy for expansion or market entry. Before proceeding, it is important to understand China's national policy goals and priorities and carefully evaluate the transaction and business in line with such policy framework. Being aligned with such policies will greatly enhance the prospects of obtaining the blessings of the Chinese government authorities, cooperation from the Chinese seller and, ultimately, completion of the deal.

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