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First M&A Loan Activity Under New CBRC Guidelines: What Does the Future Hold?

A number of acquisition loan arrangements have already been inked since the China Bank Regulatory Commission ("CBRC") issued new guidelines (the "Guidelines") on December 6, 2008 allowing commercial banks to provide loans to domestic enterprises conducting acquisitions within China and abroad.

In this legal update, we report on new merger and acquisition ("M&A") lending activity, describe the substance of the new Guidelines and what changes they bring, and offer an outlook on the effects the Guidelines will have.

M&A LOAN ACTIVITY SINCE THE NEW GUIDELINES WERE ISSUED

Two banks in China are reported to have taken advantage of the new Guidelines already, and another two are in negotiations to do so.

Most recently, on January 20, 2009, the China Development Bank signed a contract for a CNY 1.63 billion (USD 240 million) acquisition loan to the CITIC Guo'an Group. State media reported that this is the first acquisition loan since the Guidelines were promulgated. CITIC Guo'an, a subsidiary of the CITIC Group that invests in the information industry, natural resources development, and real estate development, would use the loan to increase its shareholding stake in the Baiyin Group, a non-ferrous metal processing company in northwest China.

The Industrial and Commercial Bank of China ("ICBC") has been actively signing agreements establishing cooperative arrangements and lines of credit for M&A lending. On January 22, 2009, ICBC's Guangdong branch signed a strategic cooperation agreement with China's Southern United Assets and Equity Exchange ("CSUAEE") whereby ICBC would extend a CNY 20 billion line of credit for future M&A transactions by local companies. ICBC claims that this is China's largest-ever credit line for enterprise M&A. The loans will be extended to enterprises focusing on infrastructure construction, environmental protection, and high technology. On January 16, 2009, ICBC's Shenzhen branch signed a strategic cooperation agreement with China Hi-Tech Property Exchange and Shenzhen Assets & Equity Exchange. The agreement would provide a CNY

10 billion line of credit to support the M&A transactions of local Shenzhen enterprises. On January 6, 2009, ICBC signed a cooperation framework agreement on M&A loans with Beijing Capital Co., Ltd., a Chinese company listed on the Shanghai Stock Exchange, engaging in infrastructure investment and operation management (particularly with respect to urban water supply and sewage disposal), and the China Beijing Equity Exchange. ICBC also granted a CNY 10 billion credit line for enterprise M&A transactions on December 25, 2008, in partnership with the Bank of Shanghai and the Shanghai United Assets and Equity Exchange. Under this latter arrangement, the Shanghai United Assets and Equity Exchange will be responsible for recommending well-performing, non-real estate projects to ICBC and the Bank of Shanghai to be the subject of acquisition loans.

China Construction Bank ("CCB"), like ICBC one of China's "Big Four" state-owned commercial banks, is reportedly in talks with Baosteel Group Corp. Ltd. ("Baosteel"), China's largest steelmaker, about making acquisition loans available to Baosteel. The Bank of Communications is also reportedly negotiating acquisition loans with steel manufacturing and shipbuilding companies.

THE SUBSTANCE OF THE NEW GUIDELINES

What are the new Guidelines?

The Guidelines are essentially risk management guidelines that permit commercial banks to make M&A loans, reversing a previous policy prohibiting such loans, and that set parameters for such loans. As the requirements described below make clear, the Guidelines establish a clear principle that management of M&A loans by commercial banks in China must be stronger than that for other loans.

Generally speaking, prior to issuance of the Guidelines, M&A loans were prohibited by the General Rules on Lending ("General Rules") issued in 1996 by the People's Bank of China. Exceptions were limited to specifically approved M&A loans extended to state-owned enterprises ("SOEs") for policy-driven purposes, such as M&A loans provided by ICBC to PetroChina and other large SOEs with special approval from the State Council for each loan. Although various approaches have been used by enterprises to obtain loans from banks in order to facilitate their merger transactions, direct loans for M&A were always treated as illegal.

Things began to change when the State Council stated its intention to stimulate the domestic economy by issuing statements known as the *Ten measures to stimulate the economy* (the "Ten Measures") and the *Nine financial measures* (the "Nine Measures") in December 2008. The Ten Measures are designed to increase investment in China by addressing goals such as improving infrastructure and enhancing financial support for economic growth. One of the goals of the Nine Measures is to boost new financing channels, including loans for mergers and acquisitions, real estate investment trusts, private equity funds, and private lending. The Guidelines, issued one week after the Nine Measures, are the embodiment of this goal with respect to M&A, effectively lifting the ban on M&A loans.

Who can lend?

The Guidelines apply only to commercial banks incorporated in China (including locally incorporated subsidiaries of foreign banks, but not Chinese branches of a foreign bank).

Qualifying banks must meet specified risk management requirements and capital adequacy tests on an ongoing basis in order to extend M&A loans. The key requirements and tests include having strong risk management and effective internal control systems, a loan loss reserve adequacy rate of no less than 100%, a capital adequacy rate of no less than 10%, a general reserve balance of no less than 1% of the loan balance for the same period, and established M&A risk assessment and due diligence teams.

- **Ramifications.** The "Big Four" state-owned banks (Bank of China, ICBC, CCB, and Agriculture Bank of China) will be the major players in M&A lending as a result of the Guidelines. Three other banks have reported meeting the 10% capital adequacy requirement (according to 2008 third-quarter financial statements): China Merchants Bank, CITIC Bank, and Industrial Bank. Most commercial banks, however, do not currently satisfy the capital adequacy requirements.
- **What about foreign banks?** More than 30 foreign banks are incorporated in the PRC and theoretically can take advantage of the Guidelines by extending M&A loans, particularly to their traditional foreign-invested enterprise ("FIE") customers, if the banks otherwise meet the requirements. So far, though, most foreign banks have not shown much interest in taking advantage of the new policy, likely for a couple of reasons. First, foreign banks hold just a small fraction of the total assets in China's banks (about 2%), relying on the interbank market for liquidity. Second, local Chinese banks still hold a significant advantage in information about, and

relationships with, Chinese companies who stand to benefit from the new lending rules.

Who can borrow?

Qualifying M&A loans can only be extended to domestic enterprises bearing industry and strategic relevance to the target of the acquisition. Although the term "domestic enterprises" is not defined in the Guidelines, we understand it to include FIEs that are incorporated in China under PRC law, such as joint ventures and wholly foreign-owned enterprises ("WFOEs"), but not foreign investors themselves.

Qualifying loans

An M&A loan must be extended in connection with acquisitions of new or existing equity interests, purchase of assets, or the undertaking of liabilities resulting in the merger with or the obtaining of *de facto* control over an already established and operating target enterprise. The Guidelines specifically allow for the M&A transactions to be carried out by special purpose vehicles ("SPVs"); that is, by means of a wholly-owned or controlled subsidiary enterprise that has been established especially by the acquiring party and that conducts no other business activities.

- **Ramifications.** First, it appears that the proceeds of M&A loans must be used to acquire a going concern, not for greenfield investments. Second, where a transaction qualifies under the Guidelines because it is designed to result in *de facto* control by the acquiring party (as opposed to a merger), the reference to "*de facto* control" implies that the M&A transaction must give the acquirer a controlling interest in the target company. It is unclear whether a "controlling" interest must be a majority interest, or whether a minority equity stake coupled with preferential board representation or similar mechanisms would qualify. Third, although we understand that FIEs incorporated in China would fall within the ambit of the Guidelines, there are other considerations that may limit the feasibility of FIEs obtaining M&A loans, such as:

- the FIE (or its SPV subsidiary) must still satisfy the other requirements of the Guidelines, including the strategic relevance requirements described below;[1]

- the Guidelines require that the proposed M&A transaction has been approved, or is about to be approved, by relevant authorities (e.g., with respect to national industrial policy, industry access, antitrust, overseas investment, foreign exchange, transfer of state-owned assets, etc.) and complies with existing laws and regulations;

- approval by the Ministry of Commerce ("MOFCOM") or its local branch is required to acquire a domestic business in a restricted industry;

- MOFCOM generally will not grant approval for a foreign investor to set up a special purpose FIE for the purpose of acquiring equity of a domestic target; and

- for FIEs whose business scope does not include investment business, there are restrictions on conversion of an FIE's registered capital for any equity investment.

Notably, the *Several opinions of the General Office of the State Council on providing financial support for economic development*, issued by the State Council on December 13, 2008, refers to the possibility of M&A lending to offshore companies, which may portend a further relaxation of lending rules in the future.

The "strategic relevance" requirements

The Guidelines contain, in Article 22(3), requirements that the borrower/acquiring party and the target enterprise have a relatively high degree of strategic relevance.

- **Ramifications.** The business or strategies of the two parties must correlate so that the acquiring party would obtain a strategic benefit from the transaction (e.g., R&D capacity, key technology, production techniques, trademarks, or supply/distribution networks). Where the acquiring party is an SPV, presumably this requirement would be analyzed by reference to the business or strategies of the domestic parent of the SPV. These requirements make it less likely that M&A loans could be extended solely for private equity investments unless the private equity investors, established in the PRC, partner with other PRC enterprises that already operate in the relevant industry to conduct M&A transactions jointly.

How will the loans be structured?

The Guidelines make it clear that M&A loans will be treated as a special form of financing, subject to special financing terms, stringent risk analysis, and more in-depth due diligence.

The key terms of an M&A loan contemplated by the Guidelines include:

- the loan value should not exceed 50% of the total consideration for the M&A transaction;

- the term of an M&A loan should generally be no longer than 5 years;

- the M&A loan must be secured (such as by way of mortgages, pledges, and third-party guarantees), and on terms more stringent than security generally required by the lender for other types of loans; and

- the loan agreement should contain certain terms and conditions to protect the interests of the lender (e.g., financial covenants, mandatory prepayment out of excess cash flow, account control provisions, restrictions on asset disposal, etc.).

As for general risk management, a lender must comply with the following requirements:

- the total amount of its M&A loans must not exceed 50% of its net core capital;
- the outstanding amount of M&A loans extended to a single company may not exceed 5% of its net core capital;
- it must have in place a loan concentration control system at the single borrower, borrower group, and industry category levels; and
- it must have a special team for due diligence and risk assessment, and the relevant responsible person must have at least 3 years of experience in acquisition transactions.

As for due diligence, the lender is required to undergo a stringent risk analysis for each M&A loan transaction; the analysis must include examination of strategic risk, legal and compliance risk, integration risk, operation and finance risk, and government approval risk. The Guidelines highlight points of analysis for each such type of risk. In addition, the CBRC has said that where the M&A loans concern cross-border transactions, the lender must evaluate country risk, foreign exchange risk, and transit-of-capital risk.

OUTLOOK

Why issue the Guidelines now?

- The Chinese government has been encouraging consolidation in certain key industries such as steel, energy, real estate, nonferrous metals, and cements, because of inefficiencies and excess capacity.
- The Guidelines provide a new financing option, important in the current economic environment.
- The Chinese government has identified outbound acquisition by domestic companies as an important goal. So far, Chinese banks have not played a key role in outbound acquisition deals; the majority of such deals have used offshore financing via an offshore investment holding structure. The Guidelines are an attempt to "level the playing field" by allowing domestic companies to borrow from qualifying banks for outbound acquisitions.
- Even if demand for M&A loans remains low at first, the new Guidelines will likely help Chinese banks develop more sophisticated M&A lending operations (especially with respect to pricing and risk evaluation), making them more competitive with foreign banks in the long run.

Who will benefit?

- Domestic companies, Chinese entrepreneurs, Sino-foreign joint ventures, and, potentially, wholly foreign-owned enterprises.
- Domestic companies seeking to fund outbound acquisitions.
- Domestic commercial banks, such as the Big Four, that meet the quantitative requirements of the Guidelines (foreign investors can only benefit from the Guidelines through established FIEs or participation in Sino-foreign joint ventures, or possibly through cross-border derivative structures).

Market potential

- Although the Guidelines do not restrict the type of industries for which M&A loans can be provided, the Chinese government's current M&A focus is on long-cycle industries such as steel, energy, real estate, etc.
- The demand for M&A loans will grow as industry consolidation in China and outbound M&A activity increases. The Chinese government's current focus is on domestic consolidation.
- The growth of the M&A loan market will depend on government policies and development of laws and regulations to support M&A lending. A number of the provisions of the Guidelines are subject to further interpretation, such as the strategic relevance requirement.
- The strategic relevance requirement will serve China's larger goal of facilitating the development of large-scale enterprises with global reach.
- It is unclear how the Guidelines will work with respect to M&A loans to investment holding companies or private equity funds with diverse portfolios. Presumably, the strategic correlation requirement would be satisfied if the investor and the target company have some synergistic potential.
- Chinese banks will need time to develop M&A

lending programs, including hiring experts in risk evaluation and management. This, together with a slowing economy and falling asset prices, will slow the growth of M&A lending. According to officials in one of the Big Four state-owned commercial banks, banks for now are more willing to grant loans to some government policy-driven projects in industries such as steel, electricity, transportation, and some other key industries relating to national security and domestic economy. A vibrant commercial market for M&A loans is still not practical in the near future.

- The due diligence and risk assessment requirements will require lending banks to mobilize significant resources, and the negotiation of the financing and M&A documents will require more intense involvement by the bank. Larger banks are naturally better suited to meet these requirements.
- The requirement remains that all other applicable regulations be followed and approvals be obtained before the M&A loan can be extended. Foreign deal-makers may have concerns that bureaucratic obstacles will favor domestic Chinese banks.
- The quantitative restrictions on lenders (such as per-borrower and aggregate percentage of net core capital requirements) may lead banks to syndicate large M&A transactions.
- Where M&A loans succeed, they will be evidenced by more sophisticated financing documents that respond to specific requirements of the Guidelines.

CONCLUSION

The Guidelines represent a significant step away from the prohibition of acquisition finance in China that was previously embodied in the General Rules. Clearly, Chinese policy has moved in favor of strengthening support for M&A lending by commercial banks, including outbound investment. The Guidelines emphasize extensive risk assessment and dictate certain loan terms, but ultimately increase financing options—a welcome development amidst the current economic downturn. The CBRC has stated that it will closely track the M&A lending business and continually improve the supervisory rules and procedures in order to promote the healthy development of M&A lending.

The Guidelines are not expected to create an immediate boom in M&A lending, but they have generated much market interest by providing a regulatory framework for M&A lending. Banks and investors will continue to watch developments in this area with keen interest. ■

The information made available herein is for informational purposes only. While we hope and believe the information will be helpful as a background matter, please note that it is general in nature and does not purport to cover the many issues that can arise in each specific transaction, and may not apply to particular factual or legal circumstances. The information does not constitute legal advice and should not be relied on as such.

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