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# China: Branching Out

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**Xiaoming Li**

White & Case Partner, Beijing

# China: Branching Out

China is experiencing an upsurge in outbound investment activity as growing domestic needs coincide with weakened and more accommodating M&A markets in Europe and the US.

Changing government policy is enabling domestic companies to upskill and acquire assets overseas to boost China's stature in world markets. Meanwhile, western businesses and institutions are tapping into the opportunity to offload non-core assets or to acquire growth capital from cash-rich Chinese buyers and investors.

In the current financial environment, it is an all-round win-win. But how long can it last?

## Chinese powerhouse eyes external market

Western companies have long looked to China for an entry route into an ever-expanding Asian market. Now, however, roles are reversed. China is increasingly looking westwards, as well as to the rest of the world, as it seeks to morph from export-dependent to consumer-driven economy.

While China gets to grips with its new-found status as an acquirer, western companies are seizing the opportunity to divest non-core assets and to take-up much needed investment finance that may secure their future growth and survival.

Of course, China has the one thing that much of the rest of the world lacks right now: access to capital. This is funding its acquisition drive, leaving western businesses more cognizant of the commercial benefits of East-West alliances.

This article follows a White & Case China seminar held in October 2012 in London and includes quotes from panellists on the day:

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## Rising tide of capital outfllows

China first opened its door to foreign investment in 1978. Now, helped by changing government policies and plentiful liquidity, outbound investment is rapidly increasing.

Outbound investment figures speak for the scale of the upsurge in activity. In 2007, China's aggregate outbound direct investment in the non-financial sector stood at US$117.91 billion. In scarcely four years, the figure has almost quadrupled to US$424.78 billion. Meanwhile, China's outbound direct investment to Europe tripled from 2004 to 2008, and tripled again in 2011 to US$10 billion.

Companies in France, the UK and Germany are China's principle targets, notably those in the manufacturing and services sectors. Many acquisitive Chinese companies are also setting their sights on technology and R&D investments as a means of future-proofing their domestic operations. These European companies, which suffered with the worldwide debt crisis, are becoming increasingly receptive to a Chinese stake in their businesses.

At an institutional level, the increase in outbound investment has seen massive growth in loan portfolios too. China's largest outbound investment bank is the China Development Bank (CDB). Though only established in 1994, today it is central to most outbound investment deals. At the end of 2011, its outstanding foreign currency loan portfolio stood at US$210 billion.

So what makes Chinese buyers so keen to acquire western assets? The reality is that China has depleted many of its own resources as its economy and population grow. It is now seeking to secure staples—energy and natural resources—for domestic use. Moreover, it has long lagged behind the rest of the world. Now that the tables are turned, it has a pressing need to upgrade its commercial capabilities by acquiring foreign technologies, talent and other assets in manufacturing and service industries to enable it to emerge as a truly international player.

As a consequence, acquisitive Chinese businesses are seeking:

- New markets: Domestic competition in China is increasingly cut-throat. The country is struggling with over capacity in many of its core sectors. When big players cannot grow from within, they seek new opportunities outside the country's borders. And so, many national industries—including construction, equipment manufacturing, financial services and energy—are looking beyond China not simply for economic returns and international recognition, but for continuing business survival.

- Technology upgrades: China's technology sector is concentrated in low-margin manufacturing. If it is to compete on a world stage, the sector needs to upgrade its capabilities and climb the production chain to where the value is. As a consequence, many Chinese technology companies are seeking high-tech assets overseas to strengthen the core base.

- Higher returns: Many Chinese companies simply seek higher returns. These are available overseas, where prices are depressed by the economic crisis.

## Government delivers boost to domestic policy

China's government is boosting the surge in outbound investment. Its state-owned enterprises (SOEs) have access to cheap financing, while foreign acquisition deals are fast-tracked for government approval.

Though they accounted for just one-third of deals, SOEs were responsible for 72 percent of total transaction value between 2000 and 2011. This is largely due to a handful of large-scale acquisitions in capital-intensive sectors such as mining and natural resources.

However, such fast-growth by SOEs in foreign countries has sparked concerns in government about increased business risks. It has stepped in with a new directive that prevents SOEs from entering into deals outside their core sectors.

"The focus has to be on what the company is good at," explains Alex Zhang, partner at White & Case in Shanghai. "The regulation requires parties to identify business synergies and opportunities for fundamental strategic value before signing up to outbound deals. It provides comfort to western targets too. The Chinese company that acquires a stake in a western business where there is an identified synergy, is more likely to invest in and nurture the asset on an ongoing basis."

Cash-rich smaller private Chinese companies also have the green light from government to invest overseas. Most notably, they are acquiring relatively inexpensive assets that will complement their core competencies. Deals to secure raw material supply; R&D; distribution networks and brands are especially commonplace.

In particular, the government is endorsing sectors such as high-tech and advanced manufacturing, infrastructure, agriculture, finance and service industries to seek out investment opportunities abroad.

## Liquidity fuels buying spree

Critically important is China's access to investment capital right now. With reserves of more than US$3 trillion, the country is propelling itself into markets all over the world.

By some twist of chance, just as China embarks on its buying spree, the EU and US economies are decidedly weak. In these countries, an abundance of technology assets and skills, which could steer China into its next phase of growth, are available at relatively cheap prices. China is therefore seeking to boost its domestic manufacturing capabilities with acquisitions of western intellectual capital, know-how and expertise.

"Without the downturn in Europe and the US, it would have taken China much longer to achieve a foothold in the western world," comments Xiaoming Li, White & Case partner in Beijing. "The opportunity presented itself; China took it."

Western enterprises that used to eye China with a degree of suspicion due to its different cultural, political and economic systems, are proving less resistant to acquisition or investment stakes. Though still relatively risk averse, the western attitude to Chinese investment is softening with the recognition that a good deal could help to refinance debts and possibly restore commercial fortunes.

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## Approval procedures face further refinement

China's government recognizes that its existing deal approval procedures, often perceived as opaque and prone to delay, require further streamlining if its companies are to invest successfully overseas.

The National Development and Reform Commission (NDRC) is charged with drawing up policies that will maintain the balance of economic development in China while restructuring economic systems. It has pledged to further simplify existing approval procedures for overseas acquisitions.

Even though China's approval process for outbound investment will probably remain onerous compared with western standards, streamlining will at least ensure that Chinese outbound investment is easier to execute and better tolerated overseas.

On the flip side of the deal equation, would-be Chinese buyers are often equally frustrated by western regulatory conditions, national security clearance, anti-trust procedures and pension and labor laws that can create problems pre- and post-deal. These can be doubly painful where Chinese buyers are regard with suspicion by westerners. Such hurdles and cultural clashes can delay and unsettle deal-making. Chinese buyers, however, are more likely to flex on price if it means that foreign investment can be concluded swiftly, but with certainty.

"Of course," comments Alex Zhang, "as more high-profile deals are sanctioned by the west, the sooner anti-Chinese perceptions will be dismantled, leading to more open-minded and collaborative deal-making."

Right now, there is significant appetite for deals, but there will come a point when the Chinese have to take stock of what they have acquired and do the sums.

Xiaoming Li adds: "There is a wide gap in understanding between China and the rest of the world, due to clashing commercial cultures and language difficulties. Dialogue needs to be open to improve transparency, negotiation and progression towards end goals."

Of course, it is worth remembering that Chinese companies are relative novices at the acquisition game—more accustomed to being acquired by western counterparts than acquiring. It is here where bilingual financial and legal advisers can take the lead, helping buyers and sellers to negotiate the approvals process and achieve successful resolution.

That is not as simple as it sounds. Bilingual and qualified financial and legal resources are hard to come by. As more companies expand outside China, headhunters are increasingly occupied with finding the right blend of skills and linguistic capabilities to translate and execute contracts in Chinese and English. "Don't be afraid to say to your Chinese counterpart, 'let's work together and sort out potential regulatory and administrative hurdles between us'," adds Alex Zhang.

## Not all plain sailing

Life is pretty good for Chinese enterprises right now. The collision of wealth and opportunity in overseas markets is enabling them to make investments that could guarantee their survival and prosperity for the foreseeable future. As long as this continues, they will keep on rising to greater dominance on the world stage.

However, trouble may be ahead. Right now, there is a significant appetite for deals, but there will come a point when the Chinese have to take stock of what they have acquired and do the sums.

Moreover, the failure rate for cross-border acquisitions is high. This is partly because the window of opportunity is currently wide open but cannot stay open forever. It has created a sense of growing urgency among Chinese companies to acquire assets while prices are favorable and to move into higher levels of production in order to drive future growth. This scramble for acquisitions is resulting in hasty due diligence and ill thought-through investment decisions.

"Chinese companies must avoid the mistakes that Japanese and Russian companies made 20 or so years ago," warns Xiaoming Li. "Corners cut on due diligence could prove costly to merged and acquired ventures further down the line. The tendency to quickly inspect an acquisition and to only pull out where there is an obvious problem is short-sighted. Major changes are needed to the way that Chinese companies value assets if they are to remain credible suitors for international businesses." For western targets, this will add further reassurance.

There will also come a time when China's US$3 trillion reserves start to shrink. "Chinese banks may start to experience a round of problems not dissimilar to, but hopefully on a smaller scale than those that European banks are currently attempting to resolve," says Xiaoming Li.

"The speed of outbound lending from China and the often less-than-rigorous approach to due diligence in the lending arena, will inevitably surface as bad debts along the way. Chinese banks that have made long-term commitments to less liquid market segments could be vulnerable in the future."

For now, however, the conditions are right for boosting China's stature within world markets. Western companies, short on capital, are finding that their expertise in sectors such as technology, finance and manufacturing carries a relatively attractive price. Deals are currently being made that could change the commercial status quo as traditional barriers are dismantled.

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## East-West relations: tips for making outbound deals work

1. Start with a sense of trust. A transaction is a business deal. Start out with a sense of trust and a collaborative spirit to make the deal work and benefit both the target and acquirer's commercial motivations.

2. Understand the Chinese mindset. Commercially, China has lagged behind much of the rest of the world in terms of business practices. It has some catching up to do. Some Chinese business practices may seem outdated, but while this may be inexperience or ignorance, it is definitely not insincerity.

3. Make allowances for political change. China's political system and decision-making procedures are very unlike the western world's. Though steps are being taken to overhaul and simplify existing systems, China's legacy may confound and prolong deal execution in the immediate term.

5. Ignore stereotypes. The Chinese treasure their culture and they respect people who respect it. Just learning one or two phrases in Chinese is a good start for indicating your acceptance and respect.

6. Engage advisers who understand east and west. By appointing advisers accustomed to working in both cultures, the learning curve and deal execution can be considerably shortened.

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