

## REGIONAL FOCUS: ASIA PACIFIC

### Cracking the Great Wall in the Chinese M&A market

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The Chinese M&A market has grown steadily since 2000, when there were 225 completed M&A deals with a total disclosed value of approximately \$42.8bn. At its peak in 2006, approximately 800 deals were completed with a total disclosed value of over \$95bn. According to China Venture investment research, there were 169 M&A deals in China through the second quarter of 2008 with a disclosed value of \$15.5bn. Although we expect deal volume and value to be down in 2008 as a result of ongoing market turmoil, we expect international investors to continue to seek opportunities in China, particularly in energy, mining and manufacturing.

While the M&A route offers foreign investors a feasible method of entering the fast-expanding China market, acquiring a stake in a Chinese company is far from straightforward. Acquirers need a general understanding of the governing corporate regulations in China and should conduct careful and thorough due diligence to avoid common pitfalls.

Three recent regulatory changes have transformed the landscape of China's M&A market. First, in 2006, China's Ministry of Commerce (MOFCOM) issued new Regulations on M&A transactions in China, clarifying ambiguities and uncertainties in the prior rules. All foreign-related M&A transactions in China are subject to the Regulations.

The Regulations permit for the first time non-Chinese companies to acquire Chinese domestic companies using a stock swap. However, entities qualified to use a stock swap are only listed or public companies in jurisdictions with sound regulatory systems, and offshore special purpose vehicles directly or indirectly controlled by Chinese companies or Chinese nationals. Further guidance issued by the State Administration for Foreign Exchange (SAFE)

in 2007 relating to 'roundtripping' have complicated the ability of M&A participants to take advantage of the Regulations. Roundtripping refers to a situation where the ownership of a Chinese company is transferred offshore in order to obtain the benefits of being a foreign-invested enterprise.

As a result of these limitations, few stock swaps have been approved since the Regulations went into effect. Market participants are often reluctant to make enquiries of government officials at the national, provincial and local levels, as answers may vary within the hierarchy and between provinces. With the lack of consistency and certainty, creative legal structures have been developed to minimise the need for governmental approval and registration and to facilitate, among other things, the distribution of income and assets offshore to the non-Chinese shareholders or partners.

Structuring the most suitable entity or vehicle to support the proposed acquisition is key for foreign investors who accept the inherent country-related risks in order to obtain a share of the sizeable Chinese market. Acquisitions today often take the form of a contractual joint venture (CJV), although, where feasible, a wholly foreign-owned enterprise (WFOE) remains the vehicle of choice. Other structures, such as the 'Sina Corp. Model' and the 'Slow Walk,' utilise various contractual arrangements to transfer the equity interests and preserve a suitable economic return, without being subject to regulatory approval.

Second, also adopted in 2006, the Measures for Strategic Investment by Foreign Investors upon Listed Companies (Measures) allowed for the first time foreign persons to invest in the domestic A-Share market for Chinese public companies. Under the Measures, approvals from both MOFCOM and the China Securities

Regulatory Commission are necessary for foreign investors to both invest in and exit from Chinese public companies. A foreign investor that wishes to assign or transfer its holdings must apply for approval to do so from the local SAFE office.

Third, in 2007, the revised Catalogue Guiding Foreign Investment in Industry (Catalogue) opened a number of new areas of the Chinese economy to direct foreign investment. The Catalogue divides China's industry for foreign investment purposes into four categories: encouraged, prohibited, restricted and permitted. Most foreign investors will acquire stakes in industries within the encouraged or permitted categories; the restricted and prohibited categories are subject to strict government scrutiny and approval.

In all potential Chinese transactions, detailed due diligence is required to uncover hidden liabilities and to confirm that the target has clear title to its assets. Record keeping and financial information may not be as extensive or as detailed as in the US or EU. Prospective buyers must drill down to understand the financial position, performance and prospects of a target company. All land in China is state-owned and acquirers can only purchase land-use rights for a limited period of time.

Challenges abound regardless of the industry or the target. Yet, neither strategic investors nor private equity groups can afford to ignore this rich, emerging market, particularly as the current market shake-up continues to present unexpected opportunities. ■

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