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PRC investors set sights on global companies

Chinese investors are going global. John E Lange of Paul Weiss Rifkind Wharton & Garrison explains how and why Chinese companies are investing overseas

The main focus of M&A activities involving PRC business enterprises has been the inbound acquisition by foreign investors of interests in companies or assets in mainland China. But a big new development is the emergence of PRC companies themselves as acquirors of businesses outside China.

Investment overseas by PRC companies to date has fallen into three broad categories. The first wave of outbound acquisitions focussed on securing supplies of natural resources and other raw materials. The leading players in this activity have been state-owned oil and gas and mining companies, who have acquired oil fields, refineries, petrochemical facilities and mines throughout the developing world. Processed materials in scarce supply in China, such as steel, have also been the objects of overseas investments by PRC companies.

A second type of transaction has involved the acquisition of unprofitable business lines of western multinational companies by PRC companies looking to expand rapidly into the global market. This type of transaction is exemplified by the acquisitions by subsidiaries of TCL Corporation of the global television manufacturing business of Thomson SA of France (a transaction that created the world's largest television manufacturer) and the global mobile telephone handset manufacturing business of Alcatel, and the acquisition by Lenovo of the global personal computer manufacturing business of IBM.

A third category of outbound investment transactions by PRC companies embraces a broad range of strategic or opportunistic acquisitions, driven by a desire to acquire specific technology; to acquire manufacturing capacity closer to principal markets to reduce transportation costs; or to move more manufacturing out of China to circumvent anti-dumping or technology-related import restrictions directed against PRC-source products. One of the early outbound transactions – China Netcom's acquisition of the assets of Asia Global Crossing out of bankruptcy – was an opportunistic move to acquire a regional undersea fibre optic network at a small fraction of its construction cost.

> **The buyer, becoming a global player abruptly and on a large scale, needs an enormous amount of support from the seller for a lengthy transition period**

The globalizing acquisitions

The three globalizing acquisitions to date – the TCL/Thomson, TCL/Alcatel and Lenovo/IBM transactions – have a number of characteristics in common. In each case, the seller was a large multinational company with a number of product lines and was seeking to sell an unprofitable business. The product line to be sold had the benefit of the seller's strong international brand, good technology (including technology available through extensive cross-licensing arrangements and patent pools) and established international distribution channels. However, in each case the seller was operating in a highly competitive market and was under enormous pressure from low cost Asian manufacturers. The seller had begun to outsource much of its manufacturing to try to address this problem, but the business line continued to be a drag on the seller's profits.

The buyer in each of these cases was a PRC-based company that had a strong domestic brand and was looking to expand rapidly in the international arena. The main impediment to that expansion was the lack of an internationally recognized brand, which could take the company many years and billions of dollars of investment to build on its own. Other challenges were lack of an established international distribution network for its branded products and lack of experience in developing and managing international operations. Acquiring control of an international brand and distribution network could jump-start the process of realizing the company's global ambitions.

The makings of a deal in a situation like this can clearly be seen – but not a deal in which the seller would simply dispose of the business line, sever all ties and walk away. The buyer, becoming a global player abruptly and on a large scale, needs an enormous amount of support from the seller for a lengthy transition period. And for the seller, the

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Lange has been active in the fields of mergers and acquisitions and private equity in Asia. He regularly represents private equity funds in connection with investments and corporate restructurings in the Asian region. He has assisted financial and strategic investors in high-profile M&A transactions in mainland China, Hong Kong, Taiwan, Korea, India and elsewhere in Asia.

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biggest asset in the deal would be something that it could not afford to let go of entirely: its brand, which it would retain for a range of other product lines and over which it needed to maintain a degree of control. The seller's brand, technology and distribution network create an opportunity to transform its involvement in the business, rather than exiting from it completely. Instead of hoping for profits to trickle out the bottom of a tough, low-margin manufacturing business, it could shed the manufacturing side of the operations and take a percentage off the top in the form of trade mark royalties, technology royalties and distribution fees. It could follow its management consultants' advice and start to transform from a manufacturing company into something higher up the value chain: an intellectual property company. If it could retain a residual upside interest in a larger, more competitive business platform, so much the better.

Deal structure

The deal structures dictated by the respective interests described above have involved the creation of a new entity (the JV company) into which the relevant assets, or shares of the relevant subsidiaries, of the buyer and the seller are contributed. The buyer receives a majority of the shares in the JV company. The seller also receives shares, constituting a percentage of total shares low enough to permit deconsolidation under applicable accounting principles, in either the JV company (as was the case in the TCL/Thomson and TCL/Alcatel transactions) or in a listed holding company within the buyer's group (as was the case in the Lenovo/IBM transaction). Where the seller receives shares in the JV company, it will typically have the right, exercisable after an agreed transition period if the JV company is not listed in the meantime, to exchange the JV company shares for shares of a listed company in the buyer's group. Charts 1 and 2 show the structure used for the TCL/Thomson transaction.

The seller might also receive cash. The consideration for the Lenovo acquisition of IBM's personal computer business, for example, included $650 million in cash. However, if the target business is losing large amounts of money, the consideration might consist primarily of assumption of liabilities of the target business by the JV company, shares in the JV company and the anticipated stream of royalties and distribution fees to be received by the seller.

Intellectual property arrangements

The JV company typically enters into a series of agreements with the seller relating to operations of the JV company going forward. Among the most important of these are trade mark licence agreements and technology licence agreements.

The licensing of the brand for use in connection with the relevant product line is accomplished through the trade mark licence agreement. This agreement will have provisions governing the products for which the licence is granted; royalty payments; the term of the licence; minimum performance requirements; quality control; and brand support and marketing. If the relevant products and product categories are evolving rapidly (as in the consumer electronics industry) and the seller is retaining business operations in closely adjacent product lines, negotiating the scope of the trade mark licence might be difficult.

PRC companies that acquire foreign brands to get a head start in globalizing their operations generally already have brands that are well established within the PRC and to which the companies are heavily committed. In addition, the trade mark licences, while sometimes long-term (20 years in the case of TCL/Thomson, for example) are not perpetual. The trade mark licence agreement must give the buyer the flexibility to manage its portfolio of brands so as to take full advantage of the value of the acquired brands, while building up the international value of the home-grown ones.

Technology licence arrangements are often complex. Literally thousands of patents might be implicated in some way by a single product, such as a colour television. Manufacturers with strong patent portfolios often share among themselves through bilateral cross-licence agreements or multilateral patent pools. For a PRC company, one benefit of a foreign acquisition might be to reduce its exposure to patent infringement claims as it expands its international sales. However, although cross-licence and patent pool arrangements usually allow benefits under them to be assigned to controlled subsidiaries of the parties, it might be impossible for the seller to pass on all of these benefits to a joint venture company in which it holds only a minority interest.

Seller support

A PRC company leaping headfirst into international operations through the acquisition of a large, money-losing business might need substantial support from the seller for a lengthy transition period. On the other hand, although the seller might be looking forward to a long and meaningful relationship in terms of collecting royalties and fees, it will not be at all eager to retain any material risks or burdens relating to the business. This divergence of interests often generates some difficult negotiating points.

The support sought by the buyer could be both operational and financial. Operational support could include provision of marketing, distribution, information technology, human resources or other corporate services on a transitional basis. It could also involve managing, and bearing the costs of, a restructuring of the operations, perhaps including the closure or downsizing of manufacturing facilities.

Financial support required by the buyer usually relates to working capital needs of the target business. Particularly if the business is running

Chart 1: before exercise of exchange option

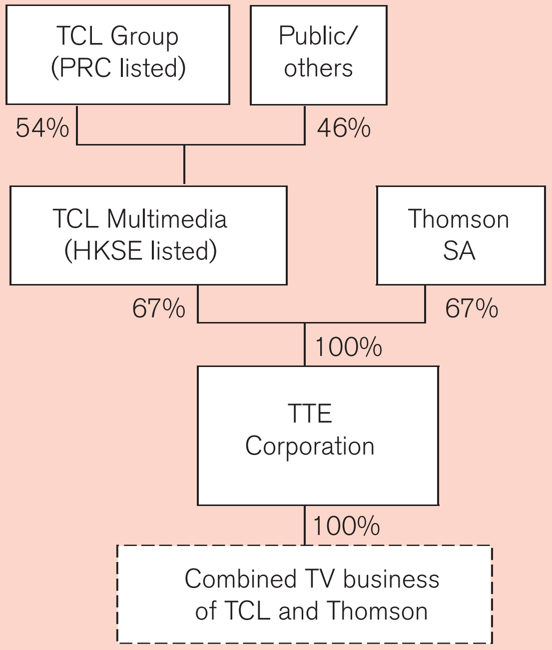
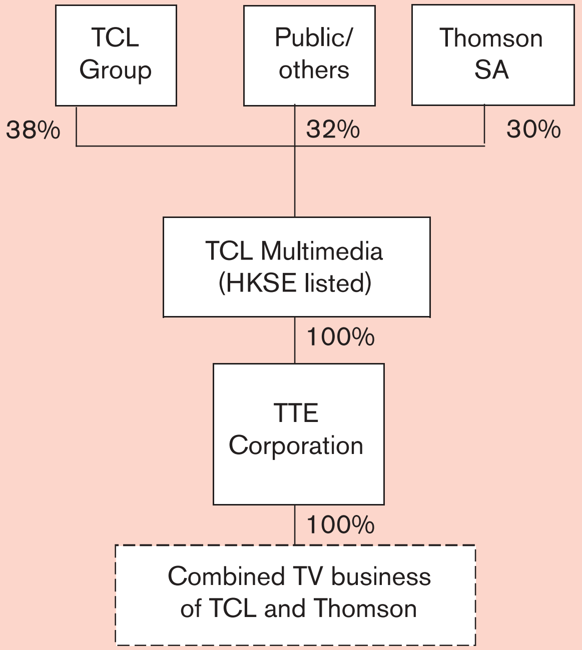


Chart 2: after exercise of exchange option



at a cash-flow deficit, the buyer might insist that the seller guarantee some minimum level of working capital, or provide some other form of working capital financing, for a period of time. In the TCL/Thomson transaction, for example, Thomson undertook to provide a receivables purchase facility to the JV company to help meet working capital needs.

A PRC company is likely to feel the need for more extensive post-acquisition seller support than would a company already experienced in integrating international acquisitions. For the seller, expansive and burdensome post-acquisition support is inconsistent with its basic objective in entering into the transaction. However, such support can usually be accounted for as an investment or, at worst, a one-time charge in connection with disposing of the business. As long as there is a clear limit on the seller's exposure, some level of support will usually be accepted as part of the price of ending the burden placed by the target business on the seller's operating income.

The PRC government has been steadily liberalizing the regulatory regime applicable to investments abroad by PRC companies

Shareholder issues

Establishing the JV company will involve all of the issues typically encountered in negotiating joint venture arrangements, including corporate governance and future transfers of interests in the joint venture company.

The seller will typically have the right to nominate at least one director of the JV company or of the holding company in which it owns shares. Although minority veto rights for the seller might be expected to be a subject of extensive negotiation, accounting considerations can prevent this from becoming a big issue. Under generally accepted accounting principles in France, for example, anything beyond rudimentary veto rights could require even a minority shareholder to consolidate the JV company in its financial statements. As this would have defeated the central purpose of the transaction from the seller's point of view, the negative control rights of both Thomson and Alcatel in their joint ventures with TCL were very limited.

The shareholders' agreement for the JV company will usually provide for a lock-up period during which the seller cannot sell its shares in the JV company or holding company. The purpose of this restriction is to keep the seller involved, and motivated to support the business, during an extended transition period. The shareholders' agreement might contemplate an eventual listing of the JV company, with a transfer of the seller's shares, or an exchange into a listed holding company's shares if that listing is not completed by a specified time.

Approval requirements

The PRC government has been steadily liberalizing the regulatory regime applicable to investments abroad by PRC companies. Under the applicable regulations, a prospective acquiror would have to go through the following verification and approval procedures before completing an overseas acquisition:

- project verification by the State Development and Reform Commission (SDRC);
- company verification by the Ministry of Commerce (MOC); and
- foreign exchange source review by the State Administration of Foreign Exchange (SAFE).

The total time required for these steps is usually three to five months.

According to the SDRC's Interim Measures on the Review of Overseas Investment Projects, effective from October 2004, project verification is required for all types of M&A and investment transaction outside mainland China by PRC legal persons and their controlled overseas subsidiaries. Proposed projects are reviewed based on macro policies and the applicant's ability to make the investment. For resource development projects, the relevant verification authorities are the provincial development authorities if the amount of investment by the Chinese party is below $30 million; the SDRC if the investment amount is between $30 million and $200 million; and the State Council if the investment amount is $200 million or above. For other types of projects, verification will be done by the provincial development authorities if the amount of foreign exchange to be used for investment by the Chinese party is less than $10 million; by the SDRC if the amount of foreign exchange will be between $10 million and $50 million; and the State Council if the amount of foreign exchange will be $50 million or above.

Most applicants submit their applications to provincial development authorities, which review them and submit them to the SDRC if necessary. There is no time limit specified for this stage of the process. The SDRC may retain qualified consulting organizations to conduct an appraisal or study of the main issues. The SDRC should complete its verification or submit its recommendation to the State

Council within 20 working days, subject to extension.

Before submitting a bid or commencing negotiations, the prospective acquiror should submit an information report to the SDRC or the relevant provincial authorities, which should provide an acknowledgement letter within seven working days. This will be necessary to purchase or remit foreign exchange funds to cover preliminary transaction expenses. The full application materials will include:

- a project application report;
- a letter of intent or framework agreement for the acquisition;
- board resolutions of the Chinese party;
- evidence of assets, operations and credit of the Chinese and foreign parties;
- financing-related letters of intent; and
- asset appraisal reports or other third-party valuation documents, if the Chinese party will make an in-kind contribution.

Verification and approval of overseas investment by PRC enterprises is also required pursuant to the MOC's Regulation Regarding Approval Matters on Investment and Establishment of Enterprises Abroad, effective from October 2004. This process can be handled for enterprises other than central level enterprises (large enterprises under the direct control of the central government) by provincial commerce authorities if the investment will be in one of 133 designated countries. Verification must be made by the MOC at the central government level if the investor/acquiror is a central level enterprise or if the investment will be in the US, Japan, Taiwan, the offshore jurisdictions of Cayman Islands, British Virgin Islands or Bermuda, or any other location not included in the list of 133 designated countries.

Most applicants submit their applications to provincial authorities, which must notify an applicant within five working days whether the application is complete. The provincial authorities should consult the commercial counsellor's office in the relevant PRC embassy or consulate, which should reply within five working days. The provincial authorities must make their decision within 15 working days after start of the review period, or submit its opinion within five working days to MOC, which must make its decision within 15 working days.

Application materials required under the MOC's regulation include:

- application form;
- articles of association of target company and relevant agreements;
- opinion of SAFE from foreign exchange source review, if applicable (see below); and
- business licence of acquiror and relevant qualifications or qualification certificates required by law.

The MOC regulation specifies the following factors to be considered in the approval process:

- investment environment in the target country;
- security of the target country;
- political and economic relationship between the target country and China;
- guiding policies for foreign investment;
- reasonable distribution of countries;
- fulfilment of obligations under relevant international conventions; and
- safeguarding the legitimate rights and interests of enterprises

Lastly, under measures first adopted in 1989 and amended numerous times since then, SAFE source review is required if the PRC acquiror needs to purchase foreign exchange funds, or use foreign exchange held by it in China, for the acquisition. SAFE review is not required if only assets, not cash, are used as consideration. It is unclear whether review is required if only foreign exchange already held outside of China is used.

Review may be conducted at the provincial or local level in most provinces for the use of foreign exchange funds of up to $3 million. Above that level, SAFE review at the central government level is required. The review period is 30 days at the provincial or local level, and most likely another 30 days at the national level if review there is necessary.

The next phase of China's extraordinary economic transformation will surely involve an ever-increasing number of PRC enterprises making the transition from being suppliers to western multinationals to be being global players in their own right. With the approval regime now clearly developed, and strong government encouragement, overseas acquisitions by PRC companies should become an increasing part of the international M&A scene in the years to come.