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Establishing Presence in China through Merger and Acquisition

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> ***"In China, investment projects are classified by industry sector based on the Catalogue for the Guidance of Foreign Investment, they are "encouraged', 'permitted', 'restricted', or 'prohibited …"***

On a global basis, mergers and acquisitions (M&A) were the prevalent method through which multinationals conducted foreign investment, previously, 'green field' investments were virtually the only option available to foreign investors in China. However, this appears to have changed dramatically over the last several years, with the Chinese Government having introduced and consolidated various laws and regulations since 2002, with the intention of stimulating M&A related activity.

The robust growth of China's economy and its further liberalization of the domestic market after its accession to the World Trade Organization have worked together to fuel the accelerated pace of M&A activity in recent years. Statistics shows that China-related M&A transactions rose 50% in 2004 over the previous year. High profile foreign acquisitions include HSBC's US $1.74 billion acquisition of a 19.9% stake in the Bank of Communications and Anheuser-Busch's US $600 million acquisition of Harbin Brewery Group. It is foreseeable that M&A activity, which offers foreign investors a more immediate method of entering the China market as opposed to 'green field' investment, will continue to boom in China in the years to come.

This article will seek to provide a clear-cut overview of the current status of M&A practice in China so that foreign investors unfamiliar with China's investment environment and legal framework may obtain a basic understanding of how to establish a presence in China through M&A.

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Points of Note

Suppose a US-based company 'ABC Co.' has preliminarily identified an ideal target company in China, which it intends to acquire. Before proceeding to conduct an in-depth financial assessment and structure the prospective acquisition, it is advisable to take the following into consideration:

1. M&A transactions in China require examination and approval by Chinese government agencies.

Unlike in many other jurisdictions, the Chinese government agencies play a greater role in M&A transactions. The completion of a specific M&A transaction may require approval by several different Chinese government agencies, depending on factors such as the industry sector, the intended target, the ownership structure of the acquired target (for instance, State-owned vs. privately owned) and the size of the investment. Such approvals are not only a matter of formality, but may take considerable efforts and time to obtain.

Below are several key Chinese government agencies which may be involved in an M&A transaction:

● Ministry of Commerce ("MOFCOM"):

The MOFCOM is the principal foreign investment examination and approval authority, and is entitled to generally supervise and approve M&A transactions.

● State Development and Reform Commission ("SDRC"):

The SDRC is responsible for both approving the foreign investment project application and supervising the restructuring of state-owned enterprises.

● State-Owned Assets Supervision and Administration Commission ("SASAC"):

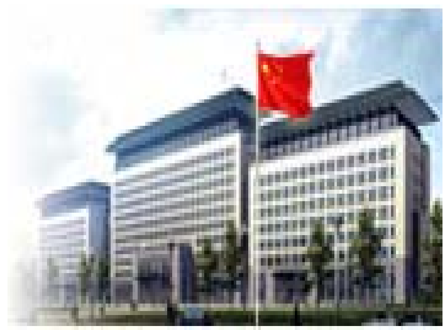
If the target enterprise is state-owned, approval of SASAC is required.

● China Securities Regulatory Commission ("CSRC"):

If the target enterprise is listed on China's stock market, CSRC approval is required.

● other industry-specific regulators

If the target enterprise is in a regulated industry sector, approval of the industry-specific regulator will be required. For example, if the target is a Chinese bank, the approval of China Banking Regulatory Commission will be required.



(picture of MOFCOM office, source: MOFCOM official website)

2. The sectoral restrictions applicable to 'green field' investment in China are also applicable to foreign-related M&A transactions.

In China, investment projects are classified by industry sector based on the *Catalogue for the Guidance of Foreign Investment* ("The Catalogue"), as 'encouraged', 'permitted', 'restricted', or 'prohibited'. The Catalogue's classification impacts both the investment approval process and the maximum foreign shareholding permissible under Chinese law. Majority Chinese shareholding is mandated in several restricted industry sectors, while in other sectors, 100% foreign shareholding is not permitted. These restrictions are not only applicable to 'green field' investments; nor can they be circumvented by entering the market through M&A.

Therefore, if the target of the abovementioned 'ABC Co.' is in an industry sector forbidden for foreign investment, the acquisition plan should not be pursued.

3. Ascertaining the nature and desirable businesses of the target is essential to structuring the M&A transaction.

Is 'ABC Co.' interested in acquiring only some business departments of the target or the target as a whole? What is the nature of the target? Is it a State-owned enterprise, foreign-invested enterprise ("FIE"), domestic unlisted company or listed company? Different answers to these questions may lead to the application of different regulations and, therefore, different approval processes.

Therefore, before moving forward in structuring the M&A, it is our recommendation that 'ABC Co.' first answers these questions.

Structuring & Implementing a M&A Transaction

1. Offshore transaction - the most effective method

If an investment in China is held through a special purpose offshore company (SPOC), the most effective way is to keep the whole transaction offshore. That is, a second SPOC can simply purchase the shares of the first company under the laws of the applicable foreign jurisdiction. This will not trigger any approval requirement within China, unless any item (for example, the name of the shareholder) under the Articles of Association of the FIE needs to be changed and the approval for the change of such items is much more straightforward, as opposed to that for an onshore M&A transaction.

2. Transaction with China - three general methods available

It is sometimes impossible to keep the transaction offshore, and therefore a M&A transaction within China (onshore) is unavoidable. A typical M&A within China may generally be consummated through three ways: (i) equity acquisition, (ii) asset purchase and (iii) statutory merger.

The preferred acquisition form would depend on many factors. For example, if a foreign investor already has a reliable business associate in China, the foreign investor may wish to consider entering into an equity acquisition with the existing entity. The advantages of an equity acquisition with a local counterpart are, among others, ready local knowledge and channels to penetrate the local market and the comfort of having one less competitor. Of course, consideration should also be given to factors such as the reliability of available information regarding the financial and legal status of the target, the required governmental approvals, the transferability of assets, and the tax consequence of the structure.

Equity Acquisition

In an equity acquisition, the foreign investor acquires equity in an existing FIE or domestic enterprise from its foreign or Chinese shareholders. In either case, an equity acquisition agreement or new equity subscription agreement will be negotiated and concluded. An equity acquisition in a FIE requires the discretionary approval of the Chinese examination and approval authority that originally approved the formation of the FIE (i.e., MOFCOM or its local branch). Any other investors in the FIE will have a statutory pre-emptive right to acquire the interest being transferred.

If the target is a purely domestic company, after the equity purchase, the target will be converted into a FIE, and the approval process for the establishment of a FIE would be applicable.

Generally speaking, purchasing equity is the quickest and cheapest method currently available, as the legal structure of the company usually remains unchanged, with only the equity ownership being transferred, allowing a continuation of the target's current business. However, it should be noted that the FIE, after the acquisition, shall assume the targets rights and liabilities. The Foreign investor, the target, creditors and other parties may reach separate agreements regarding the disposition of the creditor's rights and liabilities of the target, provided that the agreement shall not result in any damage to any third party's interest or societal public interest. Any agreement on the disposition of creditor's rights and liabilities shall be submitted to the examination and approval authority.

Therefore, if the target has very complex and heavy debts, or cannot provide sufficient information about its indebtedness, this option of equity acquisition will be subject to considerable risks, and therefore become less appealing to a foreign investor.

Asset Purchase

A foreign investor may also acquire select assets of the target. In this case, the acquirer may 'peel off' unwanted assets and liabilities. There is no change of equity ownership in an asset purchase, and the target shall retain all of its original creditor's rights and liabilities. While time-consuming, this method may be attractive as the foreign investor will not need to worry about the uncertainty of the liabilities of PRC entities, which it will assume in the case of equity acquisitions.

As a foreign company is not allowed to directly operate any assets in China without the establishment of a PRC presence, the foreign investor shall establish an FIE to purchase the assets or use the purchased assets as the registered capital to establish a new FIE.

Statutory Merger

Statutory mergers are also sanctioned under PRC law. However, it should be noted that if a foreign investor has not established an FIE in China, it is not possible to conduct a merger.

In accordance with the Regulations on Mergers and Divisions of FIEs, statutory merger is defined as the combination of not less than two companies into one company through the conclusion of an agreement. There are two types of mergers: (i) merger by absorption and (ii) merger by new establishment. Merger by absorption means the absorption by one company of another, and the company absorbing the other company will survive, while the absorbed company will be dissolved. Merger by new establishment means the combination of not less than two companies into a new company, with the combined companies being dissolved.

A merger is subject to a multistep approval process. Preliminary approvals must be obtained from both the surviving and the dissolving entities' approval authorities. A final approval is required from the surviving entity's approval authority.

Some Practical Issues

Is it necessary to conduct a legal due-diligence exercise in a merger and acquisition transaction in China?

CERTAINLY! Due to the general lack of transparency or proper regulations in China, many Chinese companies may have certain irregularities incurred somewhere / sometime in the course of its business.

For example, the director of a company may deliberately fail to file the registration of title to a property in order to save costs. It is imperative that a foreign investor resolve any irregularities before entering into the transaction. Therefore, conducting a legal due diligence exercise is often just as important as conducting a financial due diligence to determine the viability of the target company in a merger and acquisition deal.

How do you determine an accurate value of the company?

The following components should be considered: legal due diligence, financial due diligence, and commercial due diligence. Furthermore, it is suggested that looking at the company from three different angles will also enhance the probability of obtaining the most accurate results. These three angles are: (i) the internal current performance of the target itself; (ii) external current factors; and (iii) future strategy of target and network, which may include structure, sales, organization, marketing and human resources.

What are the tax consequences of a M&A transaction?

China offers various tax subsidies and incentives to attract foreign investment. For example, acquisitions that result in foreign equity holdings of 25% or more qualify for FIE tax benefits. In addition, foreign manufacturing facilities are, generally, entitled to an income tax exemption for the first two profit-making years, and a 50% deduction for the three years thereafter.

Taxes that apply to an M&A transaction may include: (i) 0.05% stamp tax on the value of the transaction, applicable to both the seller and the buyer on equity and asset acquisition; (ii) 10% withholding tax on capital gains applicable to sellers of equity in existing FIEs; (iii) 5% business tax on transferring property and intangible assets, applicable to sellers in an asset acquisition; (iv) 3-5% deed tax on land and buildings, applicable to buyers in an asset acquisition; (v) 30-60% real estate capital gains tax, applicable to sellers on the basis of capital gains from the resale of granted land; and (vi) 2% value-added tax (VAT) on machinery and equipment, applicable to sellers on the basis of certain equipment. It is also important for companies considering equity acquisitions to exercise particular care regarding contingent tax liabilities.

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