

M&A activities in a heavily regulated environment: Evidence from China

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Abstract

The dramatic growth of China's economy in recent years makes China a potentially significant mergers and acquisitions (M&A) market. The rise in M&A activity in China can be measured not only in the number of deals done, but in their size, the number of foreign firms involved, the acquisition methods, the complexity of the deals, and the range of industries involved. Foreign investors are provided with opportunities to acquire assets and/or shares in state-owned enterprises (SOEs), domestic firms, and state-owned and legal person shares in listed companies. Government agencies play an important role in Chinese M&A transactions, and there is no unified code in regard to them. Foreign investments in China are thus subject to restrictive rules and burdensome procedures.

Du et al. (2007) show that in China's state-dominated financial system, a stock market listing is a channel to help SOEs raise external financing. Many enterprises, especially non-state-owned or private firms, face serious restrictions in gaining access to equity markets. This type of highly discriminatory financial repression policy nurtures financing-motivated M&As in which non-listed companies, especially private ones, make use of the acquisition of block shares in listed companies as a means to gain access to equity markets.

Choi et al. (2007) analyze the value of corporate control in China by examining 95 block transfers that were made from 1999 to 2004. Similar to the findings of previous research, they find that there is a positive premium on corporate control in China. Control block transactions in China are priced 14% higher on average than are non-control block transfers. This control premium is negatively associated with corporate governance measures.

1. Overview of merger and acquisition activities in China

Merger and acquisition (M&A) activity has increased dramatically in China over the past several years. Figure 1 shows announced M&A activities in China. The number of announced M&A deals with a value of US\$1 million or greater increased from four in 1990 to more than 2000 in 2006. The announced M&A transaction value for China increased steadily from US\$48

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million in 1990 and reached a peak of US\$47.6 billion in 2000. This value dropped by 70% to \$14.1 billion in 2001 due to global economic recession. From 2002 to 2004, M&A transactions in China averaged about US\$30 billion per year and recovered to the 2000 level in 2006. The announced M&A deals in the first half of 2007 climbed 58.3% to US\$39.1 billion, which is slightly higher than in the second half of 2006, according to Thomson Financial.² Although M&A activities in China have experienced a very fast rate of growth, Table 1 shows that M&As in China account for only 2.7% of global M&A activity. It is forecast that M&As in China will grow at 27% and 19% in 2007 and 2008, respectively.³ It is also generally accepted that the clarification of a legal framework, economic reforms, China's accession to the World Trade Organization (WTO), and its restructuring of state-owned enterprises (SOEs) are all attributable to the growth of M&As in the country.

Figure 1 and Table 1 here

In 2006, 579 M&A deals were completed in China with a total disclosed value of US\$25.8 billion, a 40% increase over 2005. Of these, 297 were cross-border deals, with a total disclosed value of US\$15.4 billion, a 16% increase over 2005. The average size of the disclosed cross-border deals rose to US\$93 million, up 51% over 2005, which is partially due to the expanding role of financial investors in China.⁴

Table 2 displays the 20 largest announced M&A deals in China from 1990 to 2004, of which the largest was the US\$34 billion acquisition of Beijing Mobile by China Telecom. These top 20 deals have a total value of US\$88 billion and account for 43% of the total M&A value related to China from 1990 to 2004. Seven of the 20 acquirers were Hong Kong companies or

²South China Morning Post, June 15, 2007.

³Economic Outlook published by Oxford Economic, May 2007.

⁴M&A in China – deal breakers and pricing challenges, Deloitte, April 2007.

subsidiaries of mainland Chinese companies that are listed in Hong Kong. Procter & Gamble Co. (U.S.) was involved in the US\$2 billion acquisition of Procter & Gamble-Hutchison Ltd. in 2004; HSBC was involved in the US\$1.7 billion acquisition of BoComm in 2004; and Nissan Motero was involved in the US\$1 billion acquisition of Dong Feng Motor in 2004.

Table 2 here

The rise in M&A activity in China can be measured not only in terms of the number of deals done, but in their size, the number of foreign firms involved, the acquisition methods, the complexity of the deals, and the range of industries involved. Figure 2 shows the M&A transaction value in China by the nationality or region of the target firm. From 1990 to 2004, there were 4,487 deals with a total value of US\$203.4 billion and an average value per deal of US\$45.3 million. The M&A value subtotal for target firms from mainland China amounted to US\$186.3 billion, which accounts for 92%, whereas the subtotal for target firms from other countries and regions was US\$17 billion and accounts for the remaining 8%. There were 197 deals that involved acquisitions of target firms in Hong Kong, with an M&A value of US\$5.3 billion. In the same period, mainland Chinese firms acquired two companies in the U.K., 18 in the U.S., 14 in Australia, and 23 in Singapore. Figure 3 shows the M&A transaction value in China by nationality or region of the acquiring firm. Of the 4,477 deals, 2,933 were deals in which the acquiring firms were Chinese. These deals accounted for 44% of the total M&A value. In the remaining 1,554 deals, the acquirers were from Hong Kong or other countries. More recently, however, foreign companies have been struggling to complete takeovers in China and are being forced to pay more than local bidders. This leaves Chinese buyers to drive the growth in the country's M&A activity, according to a report. The latest data, collated by PwC, indicate

that M&A transactions in China over the past year have gone from being almost equally split between domestic and foreign buyers to being two-thirds domestic. David Brown, a partner at PwC, said: “We have seen more problems with large transactions when control is going to a foreign investor. There is a lot of petrol in the tank on the domestic front. On the foreign investor side, valuations are going to have to become more realistic if we are going to see growth in this area.”⁵

Figures 2 and 3 here

Figure 4 summarizes the M&A transaction value in China by acquisition method. Two-thirds of the cases involved asset acquisition, and 15% involved the acquisition of partial interests. Acquisitions of majority interests were involved in 10% of the deals, and mergers were used in 5% of the cases. It appears that mergers had the largest value per deal (US\$96.1 million), whereas acquisitions of remaining interest had the lowest value per deal, at US\$16.1 million.

Figure 4 here

Figure 5 shows the industry sectors of the target firms in China from 1990 to 2004. Only 19% of the M&A value was related to manufacturing industries in mainland China. Service industries accounted for 61%, and financial industries for 10%.

Figure 5 here

The financial service industry played an increasingly important role during the period, as it not only provided financial support for M&A activities, but itself experienced a period of reconstruction and consolidation. Many foreign financial institutions have intensified their M&As in the Chinese financial market, especially after the country entered the WTO. By the end

⁵Minder, Raphael, 2007. Foreign buyers squeezed out of China deals, *The Financial Times*, July 19, 2007.

of 2005, foreign financial institutions had made direct investments in the Chinese insurance, banking, securities, and trust industries through cross-border M&As. Financial services are the sector in which M&A activities have taken place most frequently in China, and this trend will continue, according to a report issued by PriceWaterhouseCoopers in 2006.⁶ Table 3 provides a list of the significant cross-border M&A deals in the Chinese financial sector. These include HSBC's acquisition of 19.9% of the Bank of Communications and the Royal Bank of Scotland's acquisition of 10% of the Bank of China.

Table 3 here

2. M&A legislation and regulations in China

Government agencies play an important role in Chinese M&A transactions. There is a higher level of government participation in the country's M&A transactions than is typical in other jurisdictions. The government agencies that have primary responsibility for supervising foreign related M&A transactions are the Ministry of Commerce (MOFCOM) and the State Development and Reform Commission (SDRC). The MOFCOM is the principal foreign investment regulator and has general supervisory and approval authority over M&A transactions. The SDRC is responsible both for approving foreign investment project applications and for supervising the restructuring of SOEs. These two agencies are involved in most M&A transactions.⁷

The involvement of other regulators depends on the nature of the target firm. The State-Owned Assets Supervision and Administration Commission (SASAC), which has

⁶ Going for growth: The outlook for M&A in the financial services sectors in Asia, published by PriceWaterhouseCoopers in 2006

⁷Webre, E.F. (2006), Merger & Acquisition Practice in China, *The Metropolitan Corporate Counsel*, 68-69, December 2006.

supervisory authority over state-owned assets, plays a significant role in transactions in which the targets are SOEs. The SASAC participates in approving the transactions and may also act as the vendor through one of its designated agencies or companies. The China Securities Regulatory Commission (CSRC) is responsible for monitoring and regulating China's capital markets. Thus, the CSRC will be involved in transactions if the target firms are listed companies.

Other industry specific and specialized administrative agencies may be involved, depending on the nature of the transaction and the targeted industry sector. For example, the approval of the Ministry of Information Industry (MII) may be required for certain acquisitions that target the consumer electronics sector, and the approval of the State Administration of Foreign Exchange (SAFE) may be required for certain types of consideration. A variety of government agencies may be involved in this process. In general, Chinese government is heavily involved in the M&A process. Different agencies have different concerns and agendas, and the approval of one agency may have little bearing on another agency's approval. Social concerns may also have a great impact. Obtaining approvals costs significant amounts of time and effort, and even after approvals are obtained, various registrations are still required.

Another unique feature in China is that there is no unified code on M&As. The various laws and regulations that govern these transactions have been issued piecemeal over the years. As a result, a patchwork of laws and regulations apply to each transaction, largely dependent on the type of target entity involved. Broadly speaking, the legal framework for M&As in China comprises four pillars, as follows.

- (1) The laws of general application in China, such as the General Principles of Civil Law of the People's Republic of China (PRC), the Contract Law of the Civil Law of the PRC, the Company Law of the PRC, and the Securities Law of the Civil Law of the PRC.

- (2) Specific laws that relate to the various forms of foreign-invested entities, such as the Equity Joint Venture (EJV) Law and the Law on Wholly Foreign-owned Enterprises (WFOE). The detailed rules that relate to the implementation of such laws also fall under this pillar.
- (3) The provisions of the numerous measures – including, but not limited to, decrees, orders, directives, administrative guidance, and provisional measures – that are promulgated by the various central and provincial government agencies. The examples include M&A provisions and the Provisional Regulations on the Utilization of Foreign Investment to Reorganize State-Owned Enterprises.
- (4) The judicial interpretations of the Supreme Court of China, for example, the Provisions Regarding Several Issues on Adjudication of Cases Involving Enterprise Reform.

Table 4 briefly summarizes the laws and regulations that are applicable to M&As in China.

Table 4 here

3. Practical issues for foreign-related M&A transactions in China

China has attracted substantial foreign direct investment (FDI) since the early 1990s. The country became the largest host of FDI in 2002 and now accounts for about 10% of total global FDI and 40% of total FDI to developing economies. However, only about 6% of FDI into China takes place in the form of foreign M&As. This can be partially explained by the country's strict laws on cross-border M&As. The general regulatory framework that is applicable to foreign investment in China is also applicable to foreign-related M&A transactions. The MOFCOM, joined by the SASAC of the State Council, the State Administration of Taxation (SAT), the State Administration for Industry and Commerce (SAIC), the CSRC, and the SAFE, amended and released the Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises (the

“M&A Rules”) on August 8, 2006. These M&A Rules, which took effect on September 8, 2006, supersede the M&A rules that had been in place in China since April 12, 2003 – the Interim Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises (the “Interim Provisions”). The M&A Rules govern the acquisition of assets and or shares of domestic firms by foreign investors and provide detailed regulatory guidance on anti-trust and foreign exchange issues, employee protection, national economic security concerns, restrictions on round-tripping investments, and conformance with other laws.

A foreign company is not permitted to operate a business in China directly. It must instead do so through a foreign investment enterprise (FIE). There are currently four types of FIE in China: Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures, wholly foreign-owned enterprises, and FIEs limited by shares. Although each type of FIE has its own distinctive features, they all share many common characteristics and are generally limited liabilities companies. Under current Chinese law, cross-border M&As between foreign companies and Chinese targets are not allowed. The only permissible mergers are between FIEs and FIEs or between FIEs and domestic companies. In November 2005, there were about 280,000 FIEs in China. Figure 6 shows that wholly foreign-owned enterprises accounted for 66.3% of FDI in 2004.

Figure 6 here

Investment projects are classified by industry sector in the Catalogue for the Guidance of Foreign Investment as “Encouraged,”⁸ “Permitted,”⁹ “Restricted,” or “Prohibited.”¹⁰ The

⁸ The encouraged items include: (1) specified agricultural items using new technology; (2) defined high-tech items; (3) items that meet the needs of the market; (4) items using new energy conserving technology; (5) items that benefit the development of the central and western areas of China; and (6) other kinds of items stipulated by laws and administrative regulations.

⁹ The restricted category includes those: (1) using outdated technology; (2) detrimental to energy conservation and

catalogue classification affects both the investment approval process and the permissible level of foreign equity holding. Majority Chinese equity is required in certain restricted industry sectors, whereas in others, wholly foreign-owned enterprises are prohibited. Table 5 shows the relevant level of government approval that is needed to set up an FEI.

Table 5 here

The specific approvals that are required for an M&A transaction depend on the deal structure, the target type, and the transaction value. The approval matrix is shown in Table 5. For example, under the categories of “Encouraged” and “Permitted,” approval by the MOFCOM and the SDRC at the national level is required for any deal that exceeds US\$100 million, whereas approval by the MOFCOM and the SDRC at the provincial or lower-level branches is required for any deal that is under US\$100 million.

The M&A Rules establish a basis for using conventional acquisition methods to acquire most types of enterprise in China. These regulations permit foreign investors to engage in the asset or equity acquisitions of FIEs, domestic enterprises, SOEs, and listed companies. According to the Baker and McKenzie (2005) Guide to M&As in China, there are six ways for a foreign investor to acquire or increase an equity interest in a Chinese target company:

- (1) direct acquisition of all or part of the non-listed equity interest of a Chinese target company;
- (2) acquisition of a Chinese target company through the offshore purchase of some or all of the shares of its foreign parents;
- (3) direct purchase of some or all of the business and assets of the Chinese target company

environmental improvement; (3) engaging in specified mining items; and (4) other items stipulated as restricted by laws and administrative regulations.

¹⁰ The prohibited category include: (1) those jeopardizing national security or harming the public interest; (2) those damaging the environment; (3) those disadvantageous to the protection and development of land resources; (4) those applying techniques or technologies that are unique to China; and (5) those stipulated as prohibited by laws and administrative regulations.

- through an existing or new FIE;
- (4) acquisition of an SOE or a state-owned interest in a company;
 - (5) merger by absorption when the absorbed company is dissolved, and its registered capital and assets are merged into the surviving company; and
 - (6) merger by a new establishment in which the pre-merger companies are dissolved, and a new company is established to control the capital and assets.

The items that influence structure include the required government approvals, the target (structure, finances, etc.), third-party consents, tax consequences, and asset transferability. The documentation required for an M&A transaction in China that involves foreign investors varies according to the structure of the deal. It is also dependent on the type of target investment vehicle selected for the purpose of the transaction. Table 6 summarizes the general guidance on the key acquisition documentation.

Table 6 here

Concurrently with market reform, China has been restructuring its state-owned asset holdings. In a few industrial sectors, the state is encouraging SOEs to consolidate into large integrated conglomerates, which are intended to be global leaders in their fields. However, the state is actively seeking to reduce the level of its equity holdings in other sectors. Consequently, a large number of SOEs are being made available for restructuring or partnering with foreign firms. The regulations suggest the following five methods of restructuring SOEs using foreign capital¹¹:

- (1) foreign investors may restructure an SOE into an FIE by acquiring all or part of the state interest in it;

¹¹New M&A Rules for Foreign Investors in China, *China Legal News*, November 2003.

- (2) foreign investors may restructure a “company with state interests” into an FIE by acquiring all or part of the state shares in it;
- (3) foreign investors may acquire from domestic creditors the debt that is owed to them by the SOE and restructure the enterprise into an FIE;
- (4) foreign investors may acquire all or the majority of the assets of an SOE and subsequently establish an FIE; or
- (5) foreign investors may purchase an equity stake, become shareholders in an SOE, and convert it into an FIE.

In terms of anti-trust, the M&A Rules state that M&A transactions must not “cause excessive concentration, eliminate or restrict competition, disrupt the social and economic order or damage the interests of society and the public.” In addition to the standard examination and approval procedures for all M&A transactions, the M&A Rules further require a foreign investor to report to the MOFCOM and the SAIC if a proposed transaction may involve or result in any of the following circumstances:

- (1) the China market share of any party has reached 20% or will reach 25% as a result of the transaction;
- (2) the current year China market turnover of any party exceeds RMB1.5 billion (approximately US\$181 million);
- (3) for onshore deals, the foreign investor has merged with or acquired more than 10 domestic enterprises in related industries within one year;
- (4) for offshore deals, any party will have direct or indirect equity interest in more than 15 FIEs in a corresponding industry; or
- (5) for offshore deals, any party holds assets in China worth more than RMB3 billion

(approximately US\$362 million).

M&A transactions in China may create foreign exchange transactions that involve RMBs and a foreign currency. All types of foreign exchange transactions are subject to government control, and the RMB is not freely convertible in the international market. The following four types of transaction are regulated by the SAFE: (1) inward remittance; (2) settlement of foreign exchange; (3) sale of foreign exchange; and (4) outward remittance. Table 7 provides a summary of the relevant restrictions that the Chinese authorities have placed on foreign exchange transactions.

Table 7 here

In terms of employee protection, the State Restructuring Regulations specifically impose requirements that ensure the welfare of SOE employees. Specifically, these regulations require that the SOE to be reorganized first seek the opinions of the staff and the worker's congress. Also, if the controlling interest in the SOE will pass to the foreign investor upon acquisition or if all of the main business assets of the SOE will be sold to the foreign investor, then the SOE reorganizing party must formulate a plan for settling the staff, and that plan is subject to staff approval. Although these specific employee protection requirements are new to foreign investors, the absorption of, and responsibility for, the staff of their Chinese partners is not. The effect of these new requirements, however, may be that SOEs will have more leverage in negotiations with foreign investors over the number of employees that are to be absorbed by the FIE after completion of the acquisition.

Regarding national economic security concerns, the M&A Rules stress the necessity of protecting national economic security in the context of foreign acquisitions of domestic enterprises. Foreign investors must comply with MOFCOM reporting requirements in

connection with the acquisition of domestic targets that are engaged in key industrial sectors that affect (or may affect) the security of the “national economy” or the acquisition of domestic targets that hold well-known trademarks or traditional brands in China. If the parties fail to declare that an acquisition has, or may have, a significant impact on national economic security, then MOFCOM has the discretion to join with other relevant ministries to order the termination of the transaction or to take other measures that are deemed necessary to mitigate the adverse impact.

As to restrictions on round-tripping investments, the M&A Rules include new provisions that are geared to deter “false” foreign investments. One provision prohibits the use of trusts or other arrangements in the control of offshore or domestic entities. If any of the parties to an M&A transaction are under common control by the same controlling entities, then the ultimate controlling parties must be disclosed to the approval authorities, together with an explanation of the purpose of the M&A transaction and whether or not the acquisition appraisal was conducted on an “arm’s length” basis. The other provision requires that if a Chinese entity establishes an offshore company for the purpose of acquiring a related domestic company, then the post-acquisition company will not enjoy FIE treatment unless (1) foreign investors – other than the Chinese-controlled entity – hold 25% or more of the post-acquisition company, or (2) the offshore company invests additional capital that accounts for at least 25% of the post-acquisition company’s total capital.

With respect to conformance with other laws, the M&A Rules emphasize that a basic principle of any acquisition activity is compliance with the regulations that govern the acquisition of domestic entities that have state-owned assets. The M&A Rules also incorporate certain changes that conform to the recently amended Company Law. The most substantive of

these changes is the requirement that if foreign investors will be investing additional registered capital in a domestic company, then no less than 20% of that increased registered capital must be contributed upon registration of the new business license. This effectively requires that any increase in registered capital must include a cash component of no less than 20%. The M&A Rules also state that the parties to an M&A transaction shall pay taxes in accordance with Chinese tax law and accept the supervision of the Chinese tax authority. Table 8 summarizes the key taxes that relate to the transactional analysis of acquisitions in China. The tax law is complex, and taxes are imposed on transactions at several levels. For example, the transfer of assets by Chinese companies may be subject not only to income taxes on any gains realized, but also to turnover taxes, such as VAT and business tax, and various transfer taxes, such as deed taxes, land value-added tax, and others.

Table 8 here

The public records of many aspects of a Chinese company's business, such as its legal title to land-use rights, the existence of pending litigation, and priority security interests over assets, are often either unavailable or unreliable. Corporate accounting is also frequently lax by foreign standards, and Chinese companies, particularly SOEs, are accustomed to rigid secrecy policies and may be uncooperative in disclosing their records. As a result, conducting satisfactory due diligence can be difficult. Under these circumstances, most foreign investors want comprehensive representations and warranties, indemnities for breach, and security for those indemnities.¹² However, China plans to adopt many international accounting standards beginning in 2007. This development should facilitate due diligence and valuations for cross-border M&As in China.

¹²Merton and Chao (2003), Mergers and Acquisition in China, Topics in Chinese Law: An O'Melveny & Myers LLP research report, April 2003.

This discussion indicates that the legal system governing domestic and cross-border M & A has undergone drastic change in China, a country that is undergoing a transition from a planned economy to a market-oriented economy. The conflict of interests and ambiguous identity that is caused by the multiple roles of the regulators, in conjunction with a lack of experience, has led to both under- and over-regulation and to ambiguous laws in China. Whether the country's current reform efforts can work will depend on the government's ability to exert the will that is necessary to relinquish political control and allow the market to function.

4. Financing-motivated mergers and acquisitions: Evidence from corporate China¹³

China has maintained a state-dominated financial system in which the government at various levels controls the allocation of financial resources in both the banking sector and the securities market. China's banking system comprises the central bank, four large state-owned commercial banks, three policy banks,¹⁴ 10 national joint-stock commercial banks, about 90 regional commercial banks, and about 3,000 urban and 42,000 rural credit cooperatives. There are also branches or representative offices of foreign banks with limited activities. Overall, the four state-owned commercial banks dominate the market.¹⁵ China's stock market is also controlled by the government. Its IPO quota system was first adopted in 1993. The State Planning Commission determined the quantity of equity to be issued each year, and the CSRC

¹³This section summarizes the major findings of the following working paper. Du, J.L., O.M. Rui, S. Wong, and X. Li, 2007, Financing-motivated mergers and acquisitions: Evidence from Corporate Finance, Working paper, Chinese University of Hong Kong.

¹⁴The three policy banks were established during the reform of the financial system in 1994 to take over the responsibilities of making policy loans from the four state commercial banks. Their mandates include making policy or low-interest loans to large government infrastructure investment projects specified by government policies, providing agricultural financial services and subsidiary financing for the acquisition and storage of agricultural products, and supporting import and export credit for electronic and machinery equipment systems.

¹⁵The four state-owned banks are the Industrial and Commercial Bank of China (ICBC), the Agriculture Bank of China (ABC), the Bank of China (BOC), and the China Construction Bank (CCB). As of late 2001, they accounted for 63% of outstanding loans and 62% of deposits. With 103,000 branches among them, they are the only financial institutions that cover virtually every location in China.

would then divide this quota up among the provinces and ministries. A company seeking to list would have to be selected by a provincial government or ministry with a quota before asking the CSRC for approval. Local authorities often cut down the issuing proceeds for each firm to allow more firms to list within the quota limit. In 1996, the quota was changed from restricting the quantity of equity to be issued to restricting the number of firms to be listed. Government-guided financial resource allocation usually favors large-scale SOEs that are important to the economic development of the country or the specific region. Smaller SOEs and most non-state enterprises find it difficult to secure financing from the state-controlled financial system. Thus, they suffer serious financial discrimination.

Because listed companies have many privileges, including the ability to raise external finance from the capital market, it is valuable to secure controlling shares in listed companies. This prompts outside entities, especially cash-trapped companies such as non-state enterprises, to acquire block shares in listed companies. Once they become controlling shareholders, the acquirers can enjoy these privileges, including gaining access to the capital market to raise external financing.

This nurtures M&As for the purpose of seeking external financing, which is a unique feature of acquisitions in the highly state-dominated Chinese financial system. Du et al. (2007) provide evidence to show that acquired companies, especially privately acquired firms, truly exhibit a stronger tendency to conduct seasoned equity offerings in the post-acquisition stage. However, they find that these post-acquisition financing activities do not help to improve the operational performance of the target companies. On the contrary, these activities, especially those of privately acquired companies, significantly lower the earnings of the target companies. They argue that the cash-trapped acquirers probably take away the raised funds to inject into

their own businesses or misuse them so that the post-acquisition financing activities do not improve corporate operational performance.

Du et al. (2007) also detect a striking pattern of the clustering of the earnings of target companies with financing activities around the seasoned equity offering qualifying as threshold earnings levels in response to regulatory changes.¹⁶ This gives some support to the conjecture that acquirers are purposely targeting potentially qualified listed companies for acquisition, and there may be earnings management to boost corporate earnings to secure the right to conduct seasoned equity offerings.

5. The value of corporate control in China¹⁷

Studies show that some controlling shareholders are willing to pay a control premium for controlling power. It is generally accepted in the literature that the control premium is associated with the private benefits of control. Various studies discuss the private benefits of control and identify different forms of it. Jensen and Meckling (1976) link these private benefits with the perquisites enjoyed by top executives. Harris and Raviv (1988) and Aghion and Bolton (1992) reveal that some shareholders achieve private benefits of control because they enjoy the pleasure of building a corporate empire. Johnson et al. (2000) provide empirical evidence that controlling shareholders can extract private benefits by tunneling the diversion of corporate resources from the corporation (or its minority shareholders) to the controlling shareholder. However, controlling power also comes with private costs, and in some cases, these can make the net

¹⁶The earnings targets for new issues have changed over the years. Between 1996 and 1998, the rule was three consecutive years of return on equity (ROE) of at least 10%. For 1999 and 2000, the rule was three consecutive years of ROE of at least 6% per year, with a minimum three-year average ROE at 10%. Since 2000, the target has been a minimum three-year average ROE at 6%, which is calculated based on net income excluding extraordinary items.

¹⁷This section summarizes the major findings of the following working paper. Choi, C.K., J.L., Du and O.M. Rui, 2007, The value of corporate control in China, Working paper, Chinese University of Hong Kong.

private benefits negative (Barclay and Holderness, 1989). One of the major sources of these private costs is an under-diversified portfolio. The largest shareholder often holds a controlling block of shares, but has an under-diversified portfolio. The liquidity cost of holding block shares can also decrease the control premium that is observed, as block shares are often less liquid. The existence of this liquidity effect can produce misleading estimations of the value of corporate control. Other private costs include the potential legal liability that is incurred and the risk of a loss of reputation.

The private benefits of control are difficult to observe and measure directly. A controlling party will extract private benefits from corporate resources if and only if this is difficult to verify and prove (Dyck and Zingales, 2004). Two major methods have been widely employed to quantify the value of control. The first method uses firms with multiple classes of shares in which each class has different voting rights. The value of control can then be easily quantified by observing the market price differences between the shares with different voting rights (Lease et al., 1983; Zingales, 1994; Nenova, 2003). The second method, introduced by Barclay and Holderness (1989), measures the value of corporate control as the difference between the price of controlling block share transfers and the market stock price, and infers this as the private benefits of control. The magnitude of the value of corporate control varies among studies. Barclay and Holderness (1989) analyze the pricing of 63 block trades between 1978 and 1982 and find that block trades are priced, on average, 20% higher than the post-announcement stock price. Nenova (2003) uses a sample of 661 dual-class firms in 18 countries in 1997 and documents that the premium of a control block varies from around 0% in Finland to around 50% in South Korea. Dyck and Zingales (2004) use 393 control transactions in 39 countries between 1990 and 2000 and find that the average value of control is 14%, with a range from -4% in Japan to 65% in

Brazil.

One institutional characteristic of Chinese stock markets is that listed companies are sponsored and controlled by government-related entities. Most listed companies are business units carved out of SOEs.¹⁸ Stocks in China are typically dichotomized into tradable liquid shares and non-tradable shares.¹⁹ The two types are identical in every aspect, except that non-tradable shares cannot be sold in the secondary market. Because the majority of shares in China's listed companies have been non-tradable state and legal person shares, acquisitions have typically taken the form of negotiation-based block-share transfers in which the incumbent state or legal person block shareholder negotiates with a potential acquirer about transferring part or all of the shares held by the former to the latter. Once they have reached an agreement, the acquirer becomes a new large shareholder and, in many cases, serves as the new largest shareholder controlling the corporate business. This special feature of the Chinese stock market provides a unique opportunity to study the value of corporate control without the contamination of the liquidity effect. Choi et al. (2007) estimate the value of corporate control in China by analyzing block-share transfers among Chinese firms between 1999 and 2004. To compute the value of corporate control in China, they make use of two block-share transfers within the same company, one of which leads to controlling shareholder change (referred to as control block transfer) and the other does not (referred to as non-control block transfer). As block shares are

¹⁸There are concerns, however, about the potential loss of state assets if all of the shares of SOEs are freely-traded. As a result, the ownership structure of a typical listed company in China is separated into three classes: state-owned shares, restricted institutional shares, and common shares. Both state-owned shares and restricted institutional shares are non-tradable in the market, and the general public can only trade common A and B shares on the stock exchange. Among the three classes of shares, holders are entitled to the same cash flow and voting power. The only difference between the different classes of shares is transferability. Both state-owned shares and restricted institutional shares can only be transferred through private placement and auction between corporate and legal-entity institutions.

¹⁹After 17 years of development, there are 1472 listed companies on the Shanghai and Shenzhen Stock Exchange. The market capitalization reached a total of RMB16 trillion (about US\$2.1 trillion) in April 2007. Of this RMB16 trillion market capitalization, however, tradable shares were valued at only RMB5.2 trillion, which accounts for around one-third of the total market capitalization.

illiquid and not publicly transferable, the liquidity cost problem encountered by previous studies is minimized, and a clean measure of the control premium is provided.²⁰ During the five-year period, 95 block transfer pairs involving 76 companies are identified. Choi et al. (2007) follow the rationale of Barclay and Holderness (1989) to test the existence and magnitude of the control premium in China. It is observed that a controlling block (a block transfer that is associated with a control transfer) in China is, on average, priced 14% higher than is a non-controlling block (a block transfer that does not involve a control transaction).

Multivariate regression analysis reveals that the value of corporate control increases with the controlling power of the block acquirer and decreases with the profitability of the target firm. The control premium increases if the target company has poor corporate governance practices. One outstanding characteristic of China's reforms is the very uneven distribution of economic and legal development across the country. Natural resources and human capital resources account for some of these regional differences, but political connections with the country's leadership elite are also very important. Great variations in regional per capita income and education levels are one manifestation of the vast differences in development across the country. Choi et al. (2007) believe these differences in regional development have a profound effect on the corporate control premium. To examine this, they explicitly account for market development, using a set of indexes that are designed to capture differences in economic, political, legal, and institutional factors across regions. They find that the control premium also decreases if the

²⁰As time differences often exist between control block transfers and non-control block transfers, we normalize the observed block exchange prices by the post-announcement market exchange prices for the comparison so as to control other time-varying variables. We call this measure of the value of corporate control the normalized control premium.

$$\text{Normalized control premium} = \left(\frac{P_{t1}^C}{P_{t1}^M} - \frac{P_{t2}^{NC}}{P_{t2}^M} \right) / \frac{P_{t2}^{NC}}{P_{t2}^M},$$

where P^C is the control-block exchange price, P^{NC} is the non-control block transfer price, and P^M is the market price of tradable shares. The under-script represents the time.

target company is located in regions with better regional governance. Therefore, poor shareholder protection at the firm or market level could increase the likelihood of tunneling, which leads to a higher control premium.

6. Conclusion

The dramatic growth of China's economy in recent years makes China a potentially significant M&A market. The rise in M&A activity in China can be measured not only by the number of deals carried out, but by their size, the level of foreign firms involved, the acquisition methods, the complexity of the deals, and the range of industries involved. Foreign investors have opportunities to acquire assets and/or shares in SOEs, domestic firms, and the state-owned and legal person shares of listed companies. Government agencies play an important role in Chinese M&As transactions, and there is no unified code on M&As in the country. Foreign investments in China are thus subject to restrictive rules and burdensome procedures.

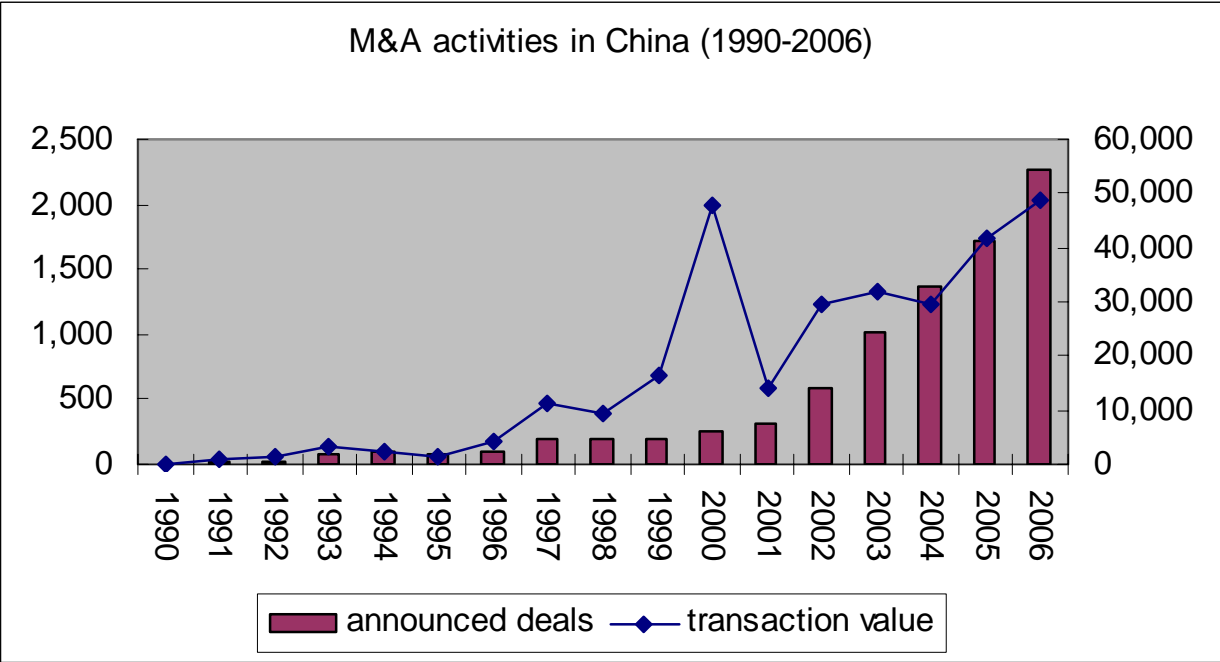
Du et al. (2007) show that in China's state-dominated financial system, stock market listing is a channel to help SOEs to raise external financing. Many enterprises, especially non-state-owned or private firms, face serious restrictions in gaining access to equity markets. This highly discriminatory financial repression policy nurtures financing-motivated M&As in which non-listed companies, especially private ones, make use of the acquisition of block shares in listed companies as a means to gain access to equity markets. These firms tend to rush to conduct rights offerings immediately after being listed. However, the rights offerings in the post-acquisition stage do not seem to improve the corporate operational performance of the target companies. This suggests that fund-seeking acquirers in China either take funds away from the target company or misuse them.

Choi et al. (2007) analyze the value of corporate control in China by using 95 block transfers from 1999 to 2004. Similarly to previous research, they find that there is a positive premium on corporate control in China. Control block transactions in China are priced 14% higher on average than are non-control block transfers. Cross-sectional regression analysis shows that the value of corporate control in China varies positively with the largest shareholder's controlling power. Block acquirers also pay a higher price for companies that are located in poorly governed regions or that have poor corporate governance practices. Choi et al. (2007) also show that the control premium in China is higher in companies with relatively poor performance prior to block transfers.

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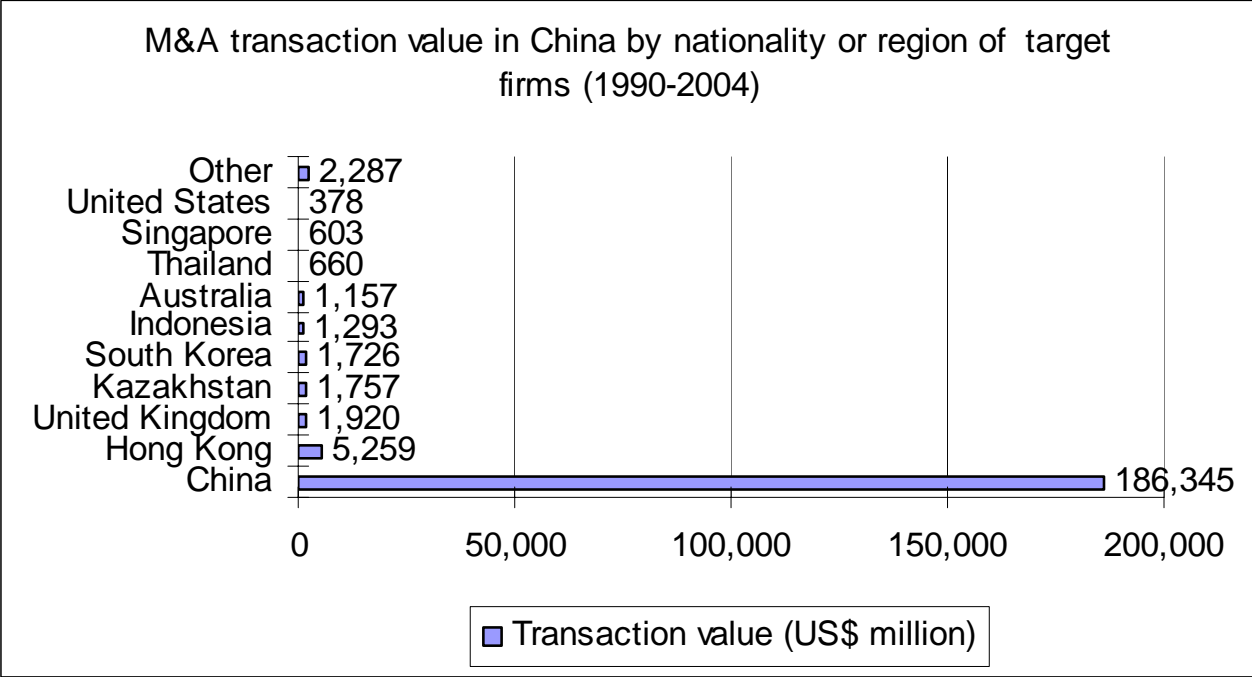
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Figure 1 M&A activities in China (1990-2006)



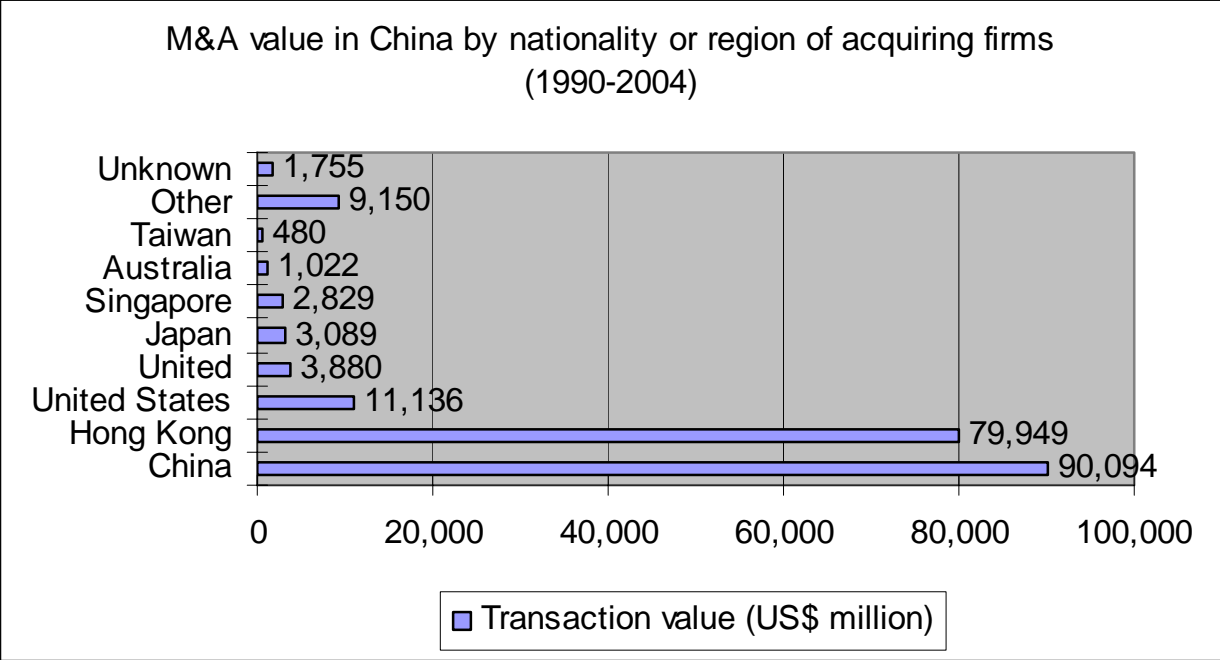
Source: Thomson Financial

Figure 2 M&A transaction value in China by nationality or region of target firms (1990-2004)



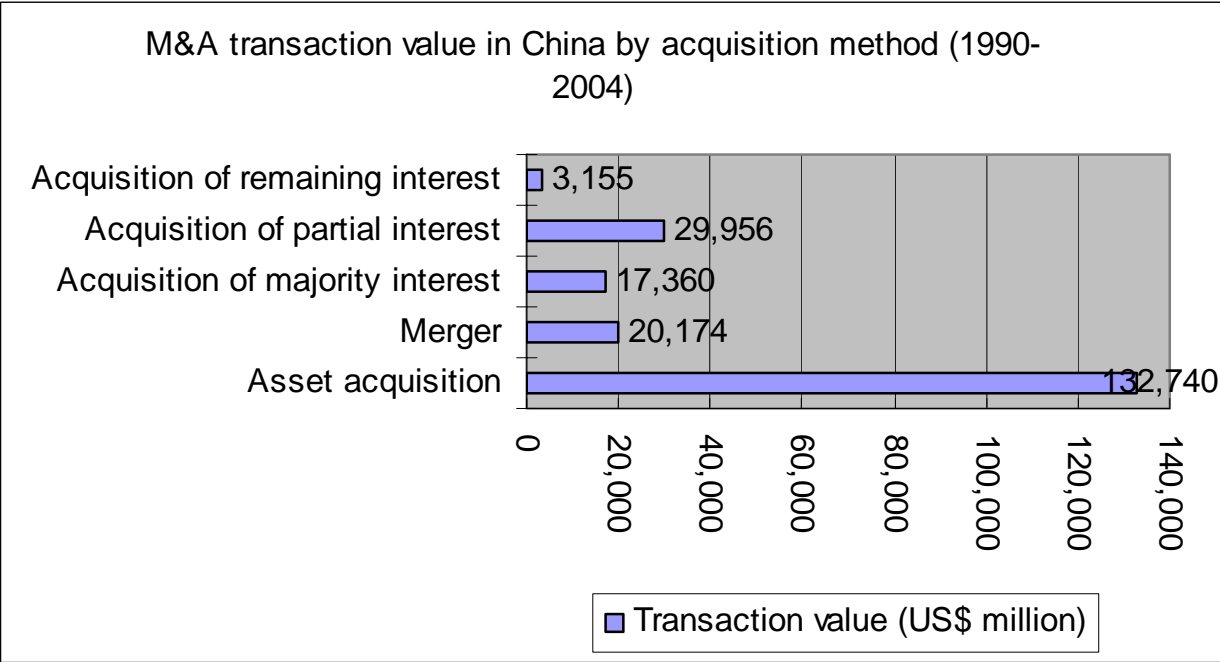
Source: Thomson Financial

Figure 3 M&A transaction value in China by nationality or region of acquiring firms (1990-2004)



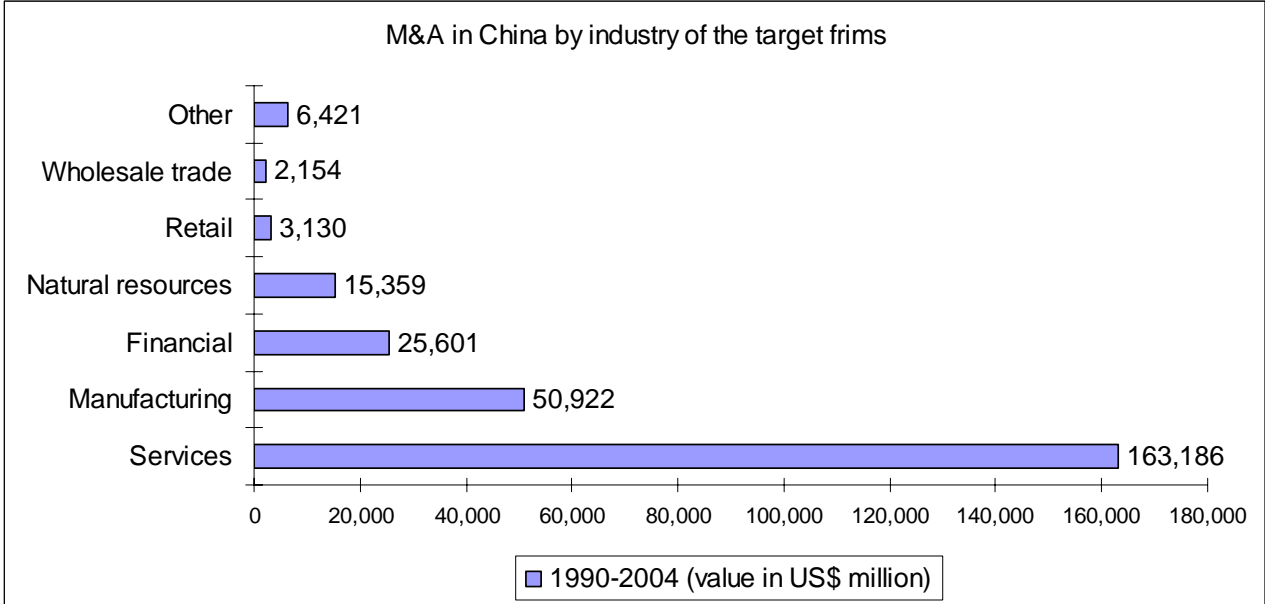
Source: Thomson Financial

Figure 4 M&A transaction value in China by acquisition method (1990-2004)



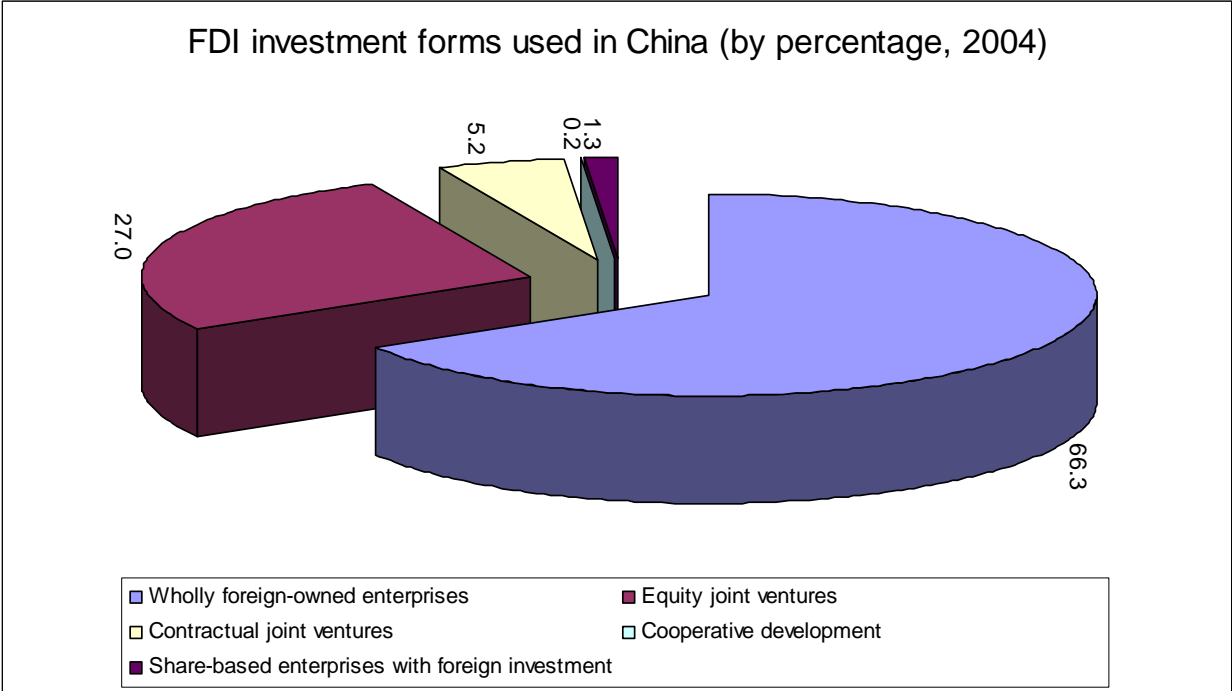
Source: Thomson Financial

Figure 5 M&A in China by industry of the target firm (2000-2004)



Source: Thomson Financial

Figure 6 FDI investment forms used in China



Source: Thomson Financial

Table 1 Global M&A activity (US\$ billion)

	2004	2005	2006	2007	2008	2009	2010
World	2146	2983	4059	4647	5112	5008	4674
United States	872	1183	1543	1698	1861	1806	1662
Europe	730	1101	1593	1833	1998	1950	1799
UK	199	292	367	404	452	443	409
Germany	76	130	158	200	211	205	190
France	135	117	174	196	207	197	179
Italy	71	106	128	134	142	136	124
Asia	274	431	475	571	668	675	658
Japan	144	241	184	206	245	243	226
China	58	65	103	131	156	161	163
Indian	7	24	30	36	40	40	39
Rest of the world	269	267	449	545	585	578	556
Share of China	0.027027	0.02179	0.025376	0.02819	0.030516	0.032149	0.034874
Growth rate of M&A in China		1.12069	1.584615	1.271845	1.19084	1.032051	1.012422

Source: Economic outlook published by Oxford Economics, May 2007

Table 2 Twenty largest announced M&As in China (1990-2004)

Announced date	Effective date	Target name and nationality	Acquirer and nationality	Amount (US\$ million)
2000-4-10	1/13/2000	Beijing Mobile (China)	China Telecom Hong Kong Ltd (HK)	34,008
5/16/2002	2002-1-7	C H Mobile HK (BVI) - Mobile (China)	China Mobile - Hong Kong Ltd (HK)	10,335
7/14/2003	12/31/2003	China Telecom - Fixed Line Asset (China)	China Telecom Corp. Ltd. (China)	9,676
1999-4-10	1999-10-12	Fujian Mobile, Henan Mobile (China)	China Telecom Hong Kong Ltd (HK)	6,398
9/15/2000	2000-1-10	Sinopec Corp. (China)	Investor Group (China)	3,642
4/28/1998	6/15/1998	Jiangsu Mobile Communication (China)	China Telecom Hong Kong Ltd (HK)	2,900
11/21/2002	12/31/2002	Unicom New Century (BVI) Ltd (China)	China Unicom Ltd (HK)	2,721
12/16/1999	12/22/2000	G H Water Supply (Holdings) Ltd (China)	Guangdong Investment Ltd (HK)	2,328
11/16/2001	11/16/2001	Shanghai Baosteel Corp. - Steel (China)	Baoshan Iron & Steel Co. Ltd (China)	2,204
2004-11-5	6/30/2004	Procter & Gamble - Hutchison Ltd (China)	Procter & Gamble Co. (U.S.)	2,000
8/23/2004	2/23/2005	MG Rover Group Ltd (U.K.)	Investor Group (China)	1,908
8/24/2004	8/18/2004	BoCOMM (China)	HSBC Holdings PLC (HSBC) (UK)	1,749
2002-4-11	2002-4-11	China Unicom (BVI) Ltd (China)	China United Telecom Corp. Ltd (China)	1,359
7/20/1999	8/16/1999	Enron Oil & Gas Prop (China)	Enron Corp. (U.S.)	1,230
4/20/2001	12/31/2001	Sinopec Star Petroleum Co. (China)	Sinopec Corp. (China)	1,103
1997-4-8	1997-4-8	Argyle Centre Phase I (China)	Honnex Development (China)	1,070
9/18/2002	2003-9-6	Dong Feng Motor Corp. (China)	Nissan Motor Co. Ltd (Japan)	1,032
1997-2-12	12/31/1997	Shanghai Shidongkou No. 2 - Power (China)	Huaneng Power International Inc. (China)	788
8/15/1997	8/20/1997	Shanghai Investment and Trust (China)	Temasek Holdings (Pte.) Ltd (Singapore)	762
10/22/2001	10/22/2001	Avansys Power Co. Ltd (China)	Emerson Electric Co. (U.S.)	750

Table 3 A list of significant cross-border M&As in the Chinese financial sector

Chinese Financial firms	Foreign investor(s)	% shares held	Date
New China Life Insurance Co., Led.	Zurich Insurance/IFC/Meiji Yasude Life Insurance Company		
Bank of Shanghai	HSBC/IFC/Shanghai Comm. Bank	8/7/3	Dec. 2001
Nanjing Comm. Bank	IFC	15	Feb. 2002
Shanghai Pudong Dev. Bank	Citigroup	4.6	Dec. 2003
Fujian Asia Bank	HSBC/Ping An Insurance	50/50	Dec. 2003
Bank of Communications	HSBC	19.9	Jun. 2004
Industrial Bank	Hang Seng Bank/GIC/IFC	16/5/4	Apr. 2004
Minsheng Bank	IFC/Asia Financial Holding	1.08/4.55	Jan. 2005
Xi'an City Comm. Bank	IFC/Scotia Bank	12.5/12.4	Oct. 2004
Shenzhen Dev. Bank	Newbridge Capital	17.9	Dec. 2004
China Minsheng Bank	Temasek Group of Singapore	5	Jan. 2005
China Construction Bank	Bank of America	9	Jun. 2005
China Construction Bank	Temasek Group of Singapore	5.1	Jul. 2005
Bank of China	Royal Bank of Scotland consortium	10	Aug. 2005
Huaxia Bank	Pangaea Capital (Singapore)		Sept. 2005
Beijing Securities	UBS		Sept. 2005
Jinan City Comm. Bank	Commonwealth Bank of Australia	11	TBA
Bohai Bank	Standard Chartered	19.99	TBA
Bank of Beijing	ING Group/IFC	19.9/5	TBA
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	20	TBA
Industrial and Commercial Bank of China	Goldman Sachs, Allianz, Amex and others	10	TBA

Table 4 Summary table of the laws and regulations applicable to M&As

Name of Law	Effective Date	Issuing Authority	Type of Target Covered
Several Provisions on Changes in Equity Interests of Investors in Foreign-Invested Enterprises	May 28, 1997	MOFCOM, SAIC	CJVs, EJVs, WFOEs, FICLS (non-listed shares only)
Regulations on Mergers and Divisions of Foreign-Invested Enterprises	Revised effective November 22, 2001	MOFCOM, SAIC	CJVs, EJVs, WFOEs, FICLS and domestic enterprises
Interim Provisions on Domestic Investment by Foreign-Invested Enterprises	September 1, 2000	MOFCOM, SAIC	LLCs and CLS
Notice on the Relevant Issues concerning the Transfer of State-owned Shares and Corporate Shares of Listed Companies to Foreign Investors	November 1, 2002	CSRC, MOFCOM, SETC	Listed companies (non-listed shares only)
Administrative Measures on the Acquisition of Listed Companies	December 1, 2002	CSRC	Listed companies
Provisional Measures on the Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors	December 1, 2002	CSRC, PBOC	Listed companies
Provisional Regulations on the utilization of Foreign Investment to Reorganize State-Owned Enterprises	January 1, 2003	MOFCOM, SAIC, SAFE, SETC	Stated-owned enterprises (excluding listed companies and financial enterprises)
Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors	April 12, 2003	MOFCOM, SAT, SAIC, SAFE	Domestic Enterprises
Establishment of Companies with an Investment Nature by Foreign Investors Provisions	November 17, 2004	MOFCOM	Domestic Enterprises
Strengthening Foreign Exchange Control in Foreign Acquisitions	January 24, 2005	SAFE	Domestic Enterprises
Circular of the SAFE on Relevant Issues Concerning Foreign Exchange Administration of Financing and Return Investment Undertaken by Domestic Residents through Overseas Special-Purpose Vehicles	November 1, 2005	SAFE	Domestic Enterprises
Provisions for Foreign Investors to Merge and Acquire Domestic	August 8, 2006	MOFCOM,	Domestic Enterprises

Enterprises

SAIC,
SAFE,
SETC
CSRC
SAT

Source: Mergers and Acquisition in China

Key:

CJV: Contractual joint venture

CLS: Companies limited by shares

CSRC: China Securities Regulatory Commission

EJV: Equity joint venture

FICLS: Foreign-invested company limited by shares

LLC: Limited liability companies

MOFCOM: the Ministry of Commerce

PBOC: People's Bank of China

SAFE: State Administration for Foreign Exchange

SAIC: State Administration for Industry and Commerce

SETC: State Economic and Trade Commission

SAT: State Administration of Taxation

WFOE: Wholly Foreign-Owned Enterprise

Table 5 Relevant level of government to approve the setting up of an FEI

Total Investment Amount	Approval Authority	Investment Category
Less than US\$100 million	SDRC and MOFCOM at provincial level or lower	'Encouraged' and 'Permitted' categories
Less than US\$50 million	SDRC and MOFCOM at provincial level only	'Restricted' category
US\$100 million or more but less than US\$500 million	SDRC and MOFCOM	'Encouraged' and 'Permitted' categories
US\$50 million to US\$100 million	SDRC and MOFCOM	'Restricted' category
US\$500 million or more	State Council	'Encouraged' and 'Permitted' categories
US\$100 million or more	State Council	'Restricted' category

Source: Mergers and Acquisition in China

SDRC: the State Development and Reform Commission

MOFCOM: the Ministry of Commerce

Table 6 General guidelines on key acquisition documentation

Type of Transaction	Key acquisition Documentation
Asset acquisition	Sale and purchase agreement (sometimes termed as “asset acquisition agreement”)
Equity interest acquisition (existing equity interest)	Sale and purchase agreement
Equity interest acquisition (new subscription of equity interest)	Subscription agreement
Wholly-owned foreign enterprise	Articles of association
Equity joint venture enterprise	Joint venture contract Articles of association
Co-operation joint venture enterprise	Joint venture contract Articles of association
Joint stock company	Articles of association

Source: Mergers and Acquisition in China

Table 7 Summary of the relevant restrictions that Chinese authorities have placed on foreign exchange transactions

Category	Restrictions
Outward	Approval required by MOFCOM for outward-bound foreign direct investment. SAFE will examine sources of foreign exchange and assess foreign exchange risk. Approval and registration of outward foreign exchange remittance with SAFE are required. SAFE will then monitor the repatriation of profits back into the PRC.
Inward	Non-residents are free to invest in China as long as they meet the relevant requirements under Sino-foreign joint venture laws and other relevant regulations. Approval of MOFCOM is required for all inbound foreign direct investment. No restriction on the inward remittance of funds.
Repatriation	Repatriation of dividends/profits may be arranged with designated foreign exchange banks if supported by documentary evidence (e.g. suitable directors' resolutions of the relevant enterprise). Repatriation of capital is subject to SAFE approval. SAFE verification is required to purchase foreign exchange to remit funds belonging to the foreign investor after liquidation of the enterprise.

Source: Mergers and Acquisition in China

Table 8 Key taxes that relate to the transactional analysis of acquisitions in China

Tax	Tax rate	Scope of charge	Party to pay
		<i>Equity acquisition</i>	
Corporate Income Tax (FEIT or EIT)	10% or 33%	Gain on transfer	Seller
Stamp Duty	0.05%	Execution of contractual document	Seller and buyer
		<i>Asset acquisition</i>	
Value-added tax (VAT)	17%	Transfer of inventory	Seller
	0%-2%	Transfer of used equipment, boats, vehicles, and motorcycles	Seller
Business Tax	5%	Transfer of immovable or intangible assets	Seller
Stamp Duty	0.05%	Execution of contractual document	Seller and buyer
Deed Tax	3%-5%	Purchase of land use rights or real estate property	Buyer
Land value-added tax (LVAT)	30%-60%	Gain on disposal of land-use rights and buildings	Seller
Claw-back of Customs and import VAT	To be determined by Customs	Disposal of imported tax/duty free equipment within the 5-year customs supervision period	Seller

Source: Mergers and Acquisition in China

M&A activities in a heavily regulated environment: Evidence from China

Oliver M. Rui
Chinese University of Hong Kong

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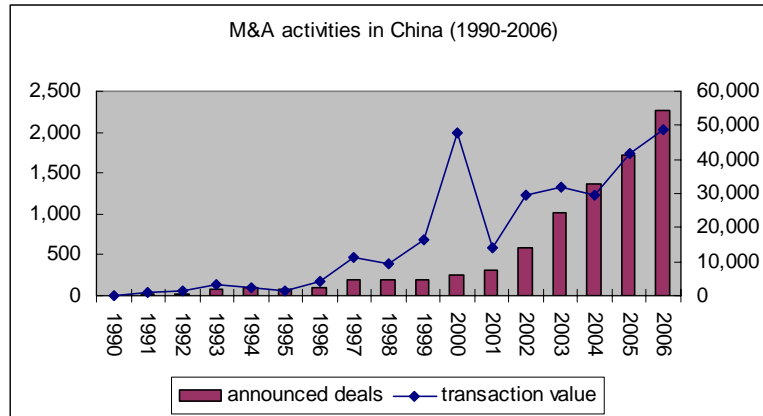
Outline

- Overview of merger and acquisition activities in China
- M&A legislation and regulations in China
- Practical issues for foreign-related M&A transactions in China
- Financing-motivated mergers and acquisitions: Evidence from corporate China
- The value of corporate control in China
- Discussion

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Part I: Overview of merger and acquisition activities in China



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3

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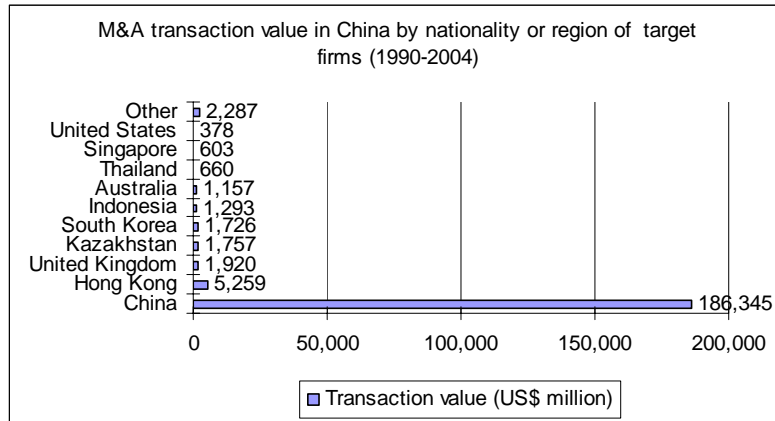
Twenty largest announced M&As in China (1990-2004)

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10/22/2001	10/22/2001	Avansys Power Co. Ltd (China)	Emerson Electric Co. (U.S.)	750

Overview of merger and acquisition activities in China

- It is generally accepted that the following factors attributable to the growth of M&As.
 - the clarification of a legal framework,
 - economic reforms,
 - China's accession to the World Trade Organization (WTO),
 - and the restructuring of state-owned enterprises (SOEs)
- The rise in M&A activity in China can be measured not only in terms of the number of deals done, but in their size, the number of foreign firms involved, the acquisition methods, the complexity of the deals, and the range of industries involved.

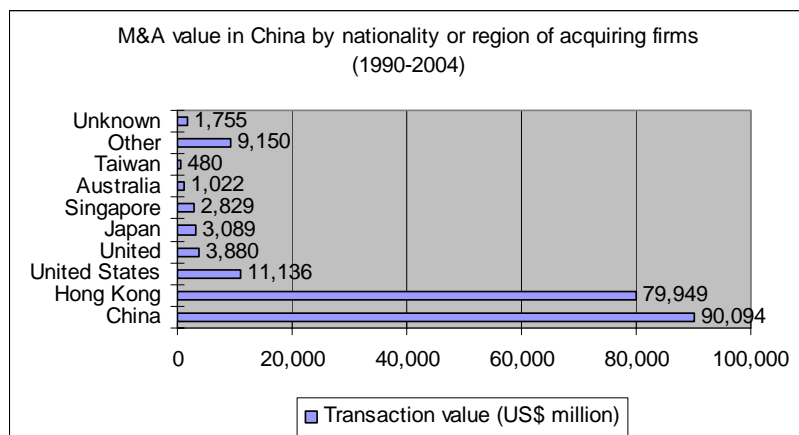
Overview of merger and acquisition activities in China



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Overview of merger and acquisition activities in China



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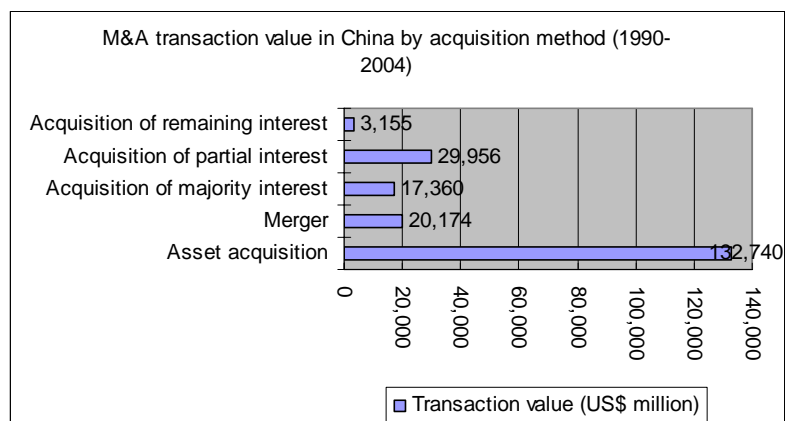
Struggling of foreign acquirer

- More recently foreign companies have been struggling to complete takeovers in China and are being forced to pay more than local bidders.
- The latest data, collated by PwC, indicate that M&A transactions in China over the past year have gone from being almost equally split between domestic and foreign buyers to being two-thirds domestic.
- David Brown, a partner at PwC, said: "We have seen more problems with large transactions when control is going to a foreign investor. There is a lot of petrol in the tank on the domestic front. On the foreign investor side, valuations are going to have to become more realistic if we are going to see growth in this area."

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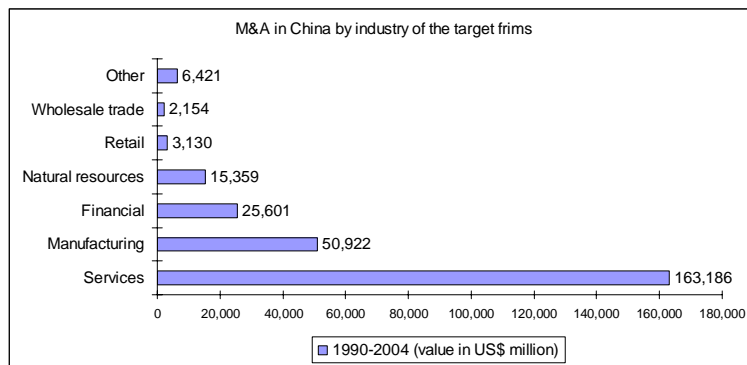
Overview of merger and acquisition activities in China



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10

Overview of merger and acquisition activities in China



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11

A list of significant cross-border M&As in the Chinese financial sector

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Fujian Asia Bank	HSBC/Ping An Insurance	50/50	Dec. 2003
Bank of Communications	HSBC	19.9	Jun. 2004
Industrial Bank	Hang Seng Bank/GIC/IFC	16/5/4	Apr. 2004
Minsheng Bank	IFC/Asia Financial Holding	1.08/4.55	Jan. 2005
Xi'an City Comm. Bank	IFC/Scotia Bank	12.5/12.4	Oct. 2004
Shenzhen Dev. Bank	Newbridge Capital	17.9	Dec. 2004
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China Construction Bank	Bank of America	9	Jun. 2005
China Construction Bank	Temasek Group of Singapore	5.1	Jul. 2005
Bank of China	Royal Bank of Scotland consortium	10	Aug. 2005
Huaxia Bank	Pangaea Capital (Singapore)		Sept. 2005
Beijing Securities	UBS		Sept. 2005
Jinan City Comm. Bank	Commonwealth Bank of Australia	11	TBA
Bohai Bank	Standard Chartered	19.99	TBA
Bank of Beijing	ING Group/IFC	19.9/5	TBA
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	20	TBA
Industrial and Commercial Bank of China	Market of Corporate Control and others	10	TBA

Part II: M&A legislation and regulations in China

- ❑ Government agencies play an **IMPORTANT** role in Chinese M&A transactions.
- ❑ Ministry of Commerce (MOFCOM) is the principal foreign investment regulator and has general supervisory and approval authority over M&A transactions.
- ❑ State Development and Reform Commission (SDRC) is responsible both for approving foreign investment project applications and for supervising the restructuring of SOEs.
- ❑ The State-Owned Assets Supervision and Administration Commission (SASAC), which has supervisory authority over state-owned assets, plays a significant role in transactions in which the targets are SOEs.

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Market For Corporate Control

13

M&A legislation and regulations in China

- ❑ The China Securities Regulatory Commission (CSRC) is responsible for monitoring and regulating capital markets and plays a significant role in transactions in which the targets are listed firms.
- ❑ The approval of the Ministry of Information Industry (MII) may be required for certain acquisitions that target the consumer electronics sector.
- ❑ The approval of the State Administration of Foreign Exchange (SAFE) may be required for certain types of consideration.
- ❑ **Different agencies have different concerns and agendas, and the approval of one agency may have little bearing on another agency's approval.**

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14

M&A legislation and regulations in China

- ❑ **The legal framework for M&As in China comprises four pillars:**
- ❑ The laws of general application in China, such as the General Principles of Civil Law of the People's Republic of China (PRC), the Contract Law, the Company Law, and the Securities Law.
- ❑ Specific laws that relate to the various forms of foreign-invested entities, such as the Equity Joint Venture (EJV) Law and the Law on Wholly Foreign-owned Enterprises (WFOE).

M&A legislation and regulations in China

- ❑ The provisions of the numerous measures – including, but not limited to, decrees, orders, directives, administrative guidance, and provisional measures – that are promulgated by the various central and provincial government agencies. The examples include M&A provisions and the Provisional Regulations on the Utilization of Foreign Investment to Reorganize State-Owned Enterprises.
- ❑ The judicial interpretations of the Supreme Court of China, for example, the Provisions Regarding Several Issues on Adjudication of Cases Involving Enterprise Reform.

Summary table of the laws and regulations applicable to M&As

Name of Law	Effective Date	Issuing Authority	Type of Target Covered
Several Provisions on Changes in Equity Interests of Investors in Foreign-Invested Enterprises	May 28, 1997	MOFCOM, SAIC	CJVs, EJVs, WFOEs, FICLS (non-listed shares only)
Regulations on Mergers and Divisions of Foreign-Invested Enterprises	Revised effective November 22, 2001	MOFCOM, SAIC	CJVs, EJVs, WFOEs, FICLS and domestic enterprises
Interim Provisions on Domestic Investment by Foreign-Invested Enterprises	September 1, 2000	MOFCOM, SAIC	LLCs and CLS
Notice on the Relevant Issues concerning the Transfer of State-owned Shares and Corporate Shares of Listed Companies to Foreign Investors	November 1, 2002	CSRC, MOFCOM, SETC	Listed companies (non-listed shares only)
Administrative Measures on the Acquisition of Listed Companies	December 1, 2002	CSRC	Listed companies
Provisional Measures on the Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors	December 1, 2002	CSRC, PBOC	Listed companies
Provisional Regulations on the utilization of Foreign Investment to Reorganize State-Owned Enterprises	January 1, 2003	MOFCOM, SAIC, SAFE, SETC	State-owned enterprises (excluding listed companies and financial enterprises)
Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors	April 12, 2003	MOFCOM, SAT, SAIC, SAFE	Domestic Enterprises
Establishment of Companies with an Investment Nature by Foreign Investors Provisions	November 17, 2004	MOFCOM	Domestic Enterprises
Strengthening Foreign Exchange Control in Foreign Acquisitions	January 24, 2005	SAFE	Domestic Enterprises
Circular of the SAFE on Relevant Issues Concerning Foreign Exchange Administration of Financing and Return Investment Undertaken by Domestic Residents through Overseas Special-Purpose Vehicles	November 1, 2005	SAFE	Domestic Enterprises
Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises	August 8, 2006	MOFCOM, SAIC, SAFE, SETC, CSRC, SAT	Domestic Enterprises

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17

Part III: Practical issues for foreign-related M&A transactions in China

- ❑ The M&A Rules, which took effect on September 8, 2006
- ❑ Supersede the Interim Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises that had been in place in China since April 12, 2003.
- ❑ The M&A Rules govern the acquisition of assets and or shares of domestic firms by foreign investors and provide detailed regulatory guidance on:
 - anti-trust
 - foreign exchange issues,
 - employee protection,
 - national economic security concerns,
 - restrictions on round-tripping investments,
 - and conformance with other laws.

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18

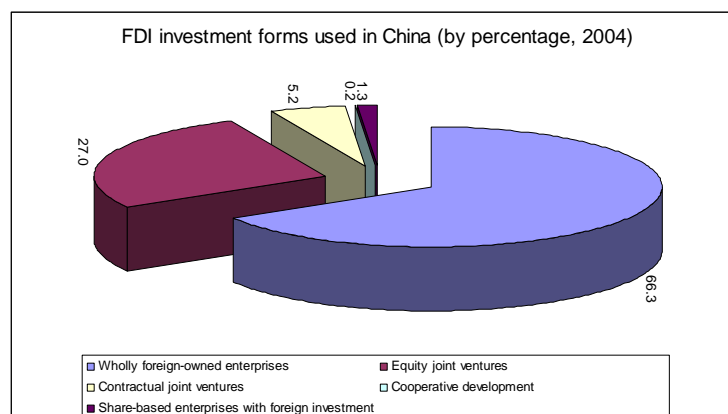
Practical issues for foreign-related M&A transactions in China

- A foreign company is not permitted to operate a business in China directly.
- It must instead do so through a foreign investment enterprise (FIE).
- There are currently four types of FIE in China:
 - Sino-foreign equity joint ventures,
 - Sino-foreign cooperative joint ventures,
 - wholly foreign-owned enterprises,
 - and FIEs limited by shares.

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19

FDI investment form used in China



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20

Practical issues for foreign-related M&A transactions in China

- Foreign investment projects are classified by industry sector in the Catalogue for the Guidance of Foreign Investment as
 - “Encouraged,”
 - “Permitted,”
 - “Restricted,”
 - or “Prohibited.”

Relevant level of government to approve the setting up of an FIE

Total Investment Amount	Approval Authority	Investment Category
Less than US\$100 million	SDRC and MOFCOM at provincial level or lower	'Encouraged' and 'Permitted' categories
Less than US\$50 million	SDRC and MOFCOM at provincial level only	'Restricted' category
US\$100 million or more but less than US\$500 million	SDRC and MOFCOM	'Encouraged' and 'Permitted' categories
US\$50 million to US\$100 million	SDRC and MOFCOM	'Restricted' category
US\$500 million or more	State Council	'Encouraged' and 'Permitted' categories
US\$100 million or more	State Council	'Restricted' category

Practical issues for foreign-related M&A transactions in China

- There are six ways for a foreign investor to acquire or increase an equity interest in a Chinese target company:
 - direct acquisition of all or part of the non-listed equity interest of a firm ;
 - acquisition of a company through the offshore purchase of some or all of the shares of its foreign parents;
 - direct purchase of some or all of the business and assets of a company through an existing or new FIE;
 - acquisition of an SOE or a state-owned interest in a company;
 - merger by absorption; and
 - merger by a new establishment.

Practical issues for foreign-related M&A transactions in China

- The regulations suggest the following five methods of restructuring SOEs using foreign capital:
 - foreign investors may restructure an SOE into an FIE by acquiring all or part of the state interest in it;
 - foreign investors may restructure a “company with state interests” into an FIE by acquiring all or part of the state shares in it;
 - foreign investors may acquire from domestic creditors the debt that is owed to them by the SOE and restructure the enterprise into an FIE;
 - foreign investors may acquire all or the majority of the assets of an SOE and subsequently establish an FIE; or
 - foreign investors may purchase an equity stake, become shareholders in an SOE, and convert it into an FIE.

Practical issues for foreign-related M&A transactions in China

- The M&A Rules require a foreign investor to report to the MOFCOM and the State Administration for industry and commerce (SAIC) if a proposed transaction may involve or result in any of the following circumstances:
 - the China market share of any party has reached 20% or will reach 25% as a result of the transaction;
 - the current year China market turnover of any party exceeds RMB1.5 billion (approximately US\$181 million);
 - for onshore deals, the foreign investor has merged with or acquired more than 10 domestic enterprises in related industries within one year;
 - for offshore deals, any party will have direct or indirect equity interest in more than 15 FIEs in a corresponding industry; or
 - for offshore deals, any party holds assets in China worth more than RMB3 billion (approximately US\$362 million).

Practical issues for foreign-related M&A transactions in China

- In terms of employee protection, the State Restructuring Regulations specifically impose requirements that ensure the welfare of SOE employees.
- Regarding national economic security concerns, the M&A Rules stress the necessity of protecting national economic security in the context of foreign acquisitions of domestic enterprises.
- As to restrictions on round-tripping investments, the M&A Rules include new provisions that are geared to deter “false” foreign investments.
- The public records of many aspects of a Chinese company’s business, such as its legal title to land-use rights, the existence of pending litigation, and priority security interests over assets, are often either unavailable or unreliable.

Part IV: Financing-motivated mergers and acquisitions

- China has maintained a state-dominated financial system in which the government at various levels controls the allocation of financial resources in both the banking sector and the securities market.
 - the four state-owned commercial banks dominate the market.
 - China's stock market is also controlled by the government. Its IPO quota system was first adopted in 1993.

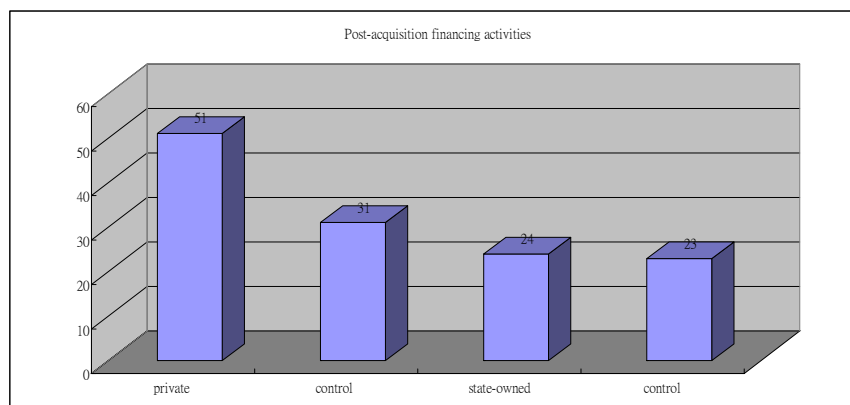
Financing-motivated mergers and acquisitions

- Government-guided financial resource allocation usually favors large-scale SOEs that are important to the economic development of the country or the specific region.
- Smaller SOEs and most non-state enterprises find it difficult to secure financing from the state-controlled financial system.
- Thus, they suffer serious financial discrimination.

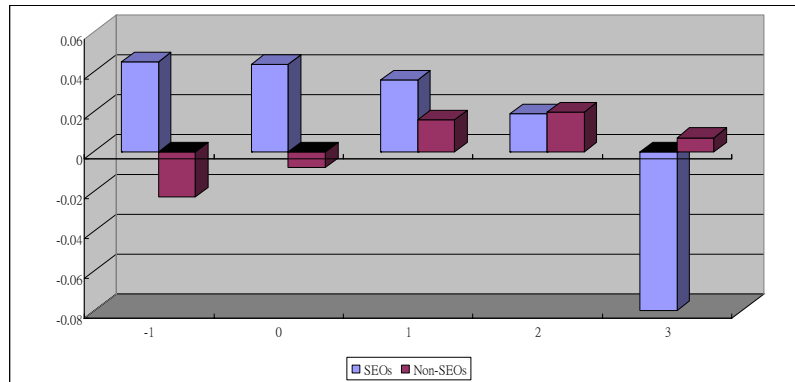
Financing-motivated mergers and acquisitions

- Because listed companies have many privileges, including the ability to raise external finance from the capital market, it is valuable to secure controlling shares in listed companies.
- This prompts outside entities, especially cash-trapped companies such as non-state enterprises, to acquire block shares in listed companies.
- Once they become controlling shareholders, the acquirers can enjoy these privileges, including gaining access to the capital market to raise external financing.

Post-acquisition financing activities



Operating performance



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31

Part V: The value of corporate control in China

- Studies show that some controlling shareholders are willing to pay a control premium for controlling power. It is generally accepted that the control premium is associated with the private benefits of control.
 - Perks
 - Empire building
 - Tunneling

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32

The value of corporate control in China

- Controlling power also comes with private costs
 - the potential legal liability that is incurred
 - the risk of a loss of reputation
 - under-diversified portfolio
 - the liquidity cost of holding block shares
- The existence of this liquidity effect can produce misleading estimations of the value of corporate control.

The value of corporate control in China

- The private benefits of control are difficult to observe and measure directly.
- Two major methods have been widely employed to quantify the value of control.
 - To use firms with multiple classes of shares in which each class has different voting rights. The value of control can then be quantified by observing the market price differences between the shares with different voting rights.
 - To measure the value of corporate control as the difference between the price of controlling block share transfers and the market price, and infers this as the private benefits of control.

The value of corporate control in China

- The majority of shares in China's listed companies have been non-tradable state or legal person shares.
- Acquisitions have typically taken the form of negotiation-based block-share transfers in which the incumbent state or legal person block shareholder negotiates with a potential acquirer about transferring part or all of the shares held by the former to the latter.

The value of corporate control in China

- To compute the value of corporate control in China, we make use of two block-share transfers within the same company,
 - one of which leads to controlling shareholder change (referred to as control block transfer)
 - and the other does not (referred to as non-control block transfer)
- As block shares are illiquid and not publicly transferable, the liquidity cost problem encountered by previous studies is minimized, and a clean measure of the control premium is provided.

The value of corporate control in China

- It is observed that a controlling block in China is, on average, priced 14% higher than is a non-controlling block.
- Multivariate regression analysis reveals that the value of corporate control
 - increases with the controlling power of the block acquirer
 - decreases with the profitability of the target firm
 - increases if the target company has poor corporate governance practices.
 - decreases if the target company is located in regions with better regional governance.
- Therefore, poor shareholder protection at the firm or market level could increase the likelihood of tunneling, which leads to a higher control premium.

Part VI: Discussion

- As has undergone drastic change in China, a country that is undergoing a transition from a planned economy to a market-oriented economy.
- The conflict of interests and ambiguous identity that is caused by the multiple roles of the regulators, in conjunction with a lack of experience, has led to both under- and over-regulation and to ambiguous laws in China.
- Whether the country's current reform efforts can work will depend on the government's ability to exert the will that is necessary to relinquish political control and allow the market to function.

Thank you!

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