DE BRAUW BLACKSTONE WESTBROEK

China's stricter capital controls limit outbound investment and remittance of capital

February 13, 2017

Since November 2016, additional levels of control have been put into place to curb the flow of funds out of China. With Chinese foreign exchange reserves dropping, Chinese authorities have implemented new policies restricting outbound investments and the outbound remittance of both RMB and foreign currency. These policies have had a significant impact on the M&A landscape and on foreign businesses active in China, which now have more cash trapped in the country. We recommend that parties contemplating selling to Chinese investors take into account the uncertainty and longer execution times caused by the new policies. At the same time, Chinese investments with lower deal values and a genuine business rationale that are aligned with China's economic policies will remain possible.

The new developments relating to stricter capital controls are solely based on announcements (the first of which arrived on 28 November 2016) and changes in the working practices of Chinese authorities. The new policies have not yet been laid down in new regulations. As a result, the specifics of the new policies are unclear, and this has caused confusion and uncertainty among parties, both Chinese and overseas.

New policies for outbound investments

The few official announcements published so far provide some guidance as to the sectors and types of investment which are under stricter scrutiny.

The following types of outbound investments are prohibited, unless approved by various Chinese authorities:

- investments of USD 10 billion or more
- investments in real estate of USD 1 billion or more by SOEs
- investments of USD 1 billion or more if these fall outside the core business of a Chinese buyer
- investments by limited partnerships
- investments involving the acquisition of 10% or less of the shares in an overseas listed company
- investments where the Chinese parent is smaller than the overseas target or where the Chinese parent was established less than a year ago
- delisting of Chinese companies from overseas exchanges
- investments in an overseas target resulting in a debt-to-asset ratio of 70% or higher or a return on equity of 5% or less

In addition to the prohibited investments listed above, the following sectors have been mentioned by authorities as sectors which will receive greater scrutiny:

- real estate
- hospitality
- cinemas
- entertainment
- sport clubs

The authorities will closely look at the commercial and strategic rationale for as well as the deal value for an outbound investment in any of the abovementioned sectors.

On 18 January 2017, the State-owned Assets Supervision and Administration Commission (SASAC) announced a "negative list" of sectors in which China's 102 centrally-governed state-owned enterprises (SOEs) will not be allowed to invest. SASAC did not publish the negative list, but CCTV, China's foremost state media organisation, has reported that the negative list includes real estate, iron ore, petroleum and nonferrous metal.

At the same time, Chinese authorities have been careful to emphasise that the Chinese government continues to support the Going Out Policy and the One Belt, One Road Initiative. SASAC has encouraged SOEs to invest in sectors such as high-speed railway, nuclear power and high-voltage projects, as well as infrastructure and manufacturing.

New policies for outbound remittance

In addition to restrictions on outbound investments to curb capital outflows, capital account transactions in general have seen increased scrutiny since the end of 2016. Any overseas transfer of RMB or foreign currency worth USD 5 million or more for a capital account transaction (including for payment of dividends to foreign shareholders) now requires a re-examination of the underlying transaction by various Chinese authorities to verify its authenticity and compliance with relevant regulations. Each transfer of USD 50 million or more will be supervised by the central SAFE, China's State Administration of Foreign Exchange, instead of a local branch of SAFE.

Also, cross-border lending in RMB by Chinese companies has been restricted. This type of loan now needs to comply with requirements that previously only applied to foreign currency lending. These requirements include registering the loan with SAFE, having a cap on the loan amount of 30% of the lender's total equity, and proving the existence of a shareholding relationship between the lender and the borrower.

Implications and recommendations

While the new policies have only been in effect for a short time, they have already had a significant impact on the volume and value of outbound investments by Chinese companies. It seems that Chinese authorities in most instances are allowing deals which were announced prior to the new policies to proceed with closing. But there remains a risk that, based on the new policies, certain authorities will decide to re-examine the deal, even if all filings have been completed and approvals have been obtained. For investments which have not yet been announced, Chinese authorities will closely look at the rationale for the investment, the industry sector of the target company, and the deal value. Most

transactions with Chinese buyers, including those which have already been announced as well as new investments, will experience delays in closing as Chinese parties are faced with longer procedures to allow outbound remittance of the purchase price.

Foreign sellers have responded to the new developments by requesting more protection from Chinese buyers, such as higher termination fees and placement of those fees in escrow in an offshore account, or a higher premium reflecting the uncertainty. Foreign sellers can, however, best protect themselves by getting to know the Chinese party first and understanding its reasons for the takeover. A Chinese party with a proven track record, sound financial position, and strategic fit will be a safer choice than a party which has just been established or is acting outside its core business.

The general consensus is that the new policies are only a temporary restriction to curb the outflow of funds from China and that China's strategy to encourage its enterprises to invest overseas has not changed. Rumours are that the restrictions on outbound investments will be lifted in September 2017, while the restrictions on outbound capital account transactions might be lifted as early as February 2017. We expect that by that time, new and hopefully less drastic regulations will be implemented. We will continue to monitor developments and update you on any changes.