Trend – Growing Chinese investment in Europe highlights deal challenges

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Chinese outbound M&A activity has reached unprecedented levels, particularly in Europe. The total value of transactions by Chinese investors in Europe announced in the first half of 2016 alone is around USD 79 billion. This accounts for 60% of total Chinese outbound investments in the same period, according to a recent China & Hong Kong Mergermarket trend report. This is almost 50% higher than Chinese investments in Europe in the whole of 2015 (which was already a record year for Chinese outbound investments in Europe). Although Brexit discussions have recently held back some investors, Chinese buyers seem to be picking up speed again and we expect a strong last quarter in 2016.

Even though many Chinese buyers successfully sign and close acquisitions of European companies, some deals have failed due to execution risks that are specific to Chinese buyers. We briefly discuss a number of risks related to regulatory filings and approvals in China and abroad, and we highlight ways to mitigate these risks.

Foreign exchange registration

A Chinese buyer needs to make various regulatory filings in China before it can complete an outbound investment. In general, the Chinese outbound investment rules have relaxed in recent years, changing from a pre-approval regime to a pre-registration one (except for investments in sensitive industries or countries). In line with this overall trend, the State Administration of Foreign Exchange in China (SAFE) delegated the foreign exchange registration process to commercial banks in 2015. This was meant to make the process shorter and simpler, but since early 2016 the main regulatory hurdle in China for Chinese outbound buyers seems to be the foreign exchange registration process for paying the purchase price in foreign currency, especially if the amount is significant. Due to the increased flow of capital out of China, SAFE has implemented measures to slow down the outflow and instructed banks to more closely scrutinise foreign currency conversions. It is now taking much longer than before to convert RMB into foreign currency to pay for investments overseas and it is a much more cumbersome process, causing delays in the closing of transactions.

If a speedy closing is an important consideration for the seller, it is advisable to discuss with the Chinese buyer at an early stage where the funds to pay the purchase price will be coming from. If these funds are still in China, several alternatives can be explored to speed up the transfer of funds out of China. One option may be to remit the RMB-denominated funds to an account with an offshore bank engaged in RMB settlement, instead of first exchanging RMB into foreign currency and then transferring the funds out of China (although RMB exchange rates offshore are usually higher than in China). Another option may be to route the funds through an entity set up in one of the Free Trade Zones, as this may lead to a faster foreign exchange process.

Merger clearance

Even though the deal value of Chinese investments is often significant, merger filings in Europe may not always be required as many Chinese buyers are new entrants to the European market and may not yet have significant assets in Europe. Chinese state-owned entities (SOEs) should, however, be careful in assuming that no filings have to be made. As reported in a previous In context article, a recent European Commission decision about the Chinese-French joint venture for the British Hinkley Point nuclear power plant shows that not only the turnover and market share of the Chinese buyer may be relevant, but also the aggregate turnover and market shares of all Chinese SOEs in the same sector. An acquisition which does not give rise to competition concerns based on market shares of the buyer and target company alone, may be more problematic if market shares of other Chinese SOEs need to be taken into account. Therefore, in the case of a Chinese SOE buyer, the seller should always include appropriate protections in the transaction documentation, such as an obligation for the buyer to offer remedies if the European Commission requires this (a “hell or high water” covenant).

Foreign investment approvals

In addition to Chinese and European regulators, authorities from other countries may also have jurisdiction over the transaction. If the target company has assets or activities in a country which has a foreign investment review regime, such as the US, Canada, Australia or New Zealand, specific attention is required where the potential purchaser comes from China. There are persistent rumours that Chinese buyers are subject to greater scrutiny by foreign investment supervisors. Although very few cross-border deals are actually blocked, there are examples of acquisitions by Chinese buyers that had to be abandoned due to a failure to obtain foreign investment approval. Most of these relate to investments in technology and agricultural sectors.

Many companies with European headquarters have assets in the US. Chinese buyers of these companies may therefore be faced with the US foreign investment regime. Acquisitions of a business involving US assets are supervised by the Committee on Foreign Investment in the United States (CFIUS) based on a national security review, which in many instances is linked to critical technologies and/or critical infrastructure. The number of transactions reviewed by CFIUS is relatively small compared to the overall number of acquisitions involving US assets, but Chinese investments do represent around 20% of the transactions reviewed in recent years (the most of any country).

One of the Chinese investments reviewed by CFIUS was the proposed USD 2.8 billion sale by Philips of its LED business to a consortium led by the Chinese venture-capital firm GO Scale Capital. Concerns voiced by CFIUS during its review led to the termination of this transaction, even though neither of the parties to the deal was a US entity. An acquisition which did not even reach the CFIUS review stage was the takeover bid on Fairchild Semiconductor by China Resources Microelectronics. Although the Chinese bidder offered a “hell or high water” commitment to obtain CFIUS clearance and a break fee of USD 108 million (4.3% of the total offer) if no CFIUS clearance was obtained,

Fairchild rejected the offer and accepted a lower offer by a US bidder. The board of Fairchild explained that, despite the break fee, the Chinese offer posed an unacceptable level of risk of failure to obtain CFIUS approval. There are other examples of deals with Chinese buyers that have been aborted and of offers by Chinese parties that have been declined due to concerns over clearance by CFIUS. And there may be further examples that are not publicly known.

Deal protections

Assessing possible regulatory risks at an early stage and proactively addressing these risks may help the buyer to make its offer more attractive. Likewise, early assessment by the seller of regulatory risks inherent to the Chinese party will help to properly evaluate the offer and, if the seller decides to move forward, to seek protection against these risks from the buyer.

We see a notable trend of sellers demanding that the transaction documents include specific protection against regulatory risks associated with the Chinese buyer. As part of this trend we see sellers increasingly demanding that the buyer pay a break fee if the transaction cannot close due to a failure to obtain certain regulatory clearances, especially a rise in break fees linked to CFIUS clearance. Although “hell or high water” covenants, which are commonly seen in relation to merger clearance, are also regularly agreed for CFIUS approval, the seller may not consider such a covenant sufficient protection against the risk that CFIUS clearance is not obtained. This is because CFIUS – contrary to competition authorities – usually does not provide clear guidance on what mitigation measures may make the transaction more acceptable. The seller will therefore be more comfortable with having a break fee in place in addition to the buyer’s “hell or high water” obligation.

Next to break fees linked to a CFIUS clearance closing condition, we have also seen specific break fees for a failure to obtain certain PRC regulatory approvals or a failure by the buyer to proceed with closing after all closing conditions have been fulfilled. At the moment there does not yet seem to be a standard market practice in Europe for determining the appropriate amount of the break fee. We have seen break fees ranging from 3% to 10% of the deal value.

Sellers are increasingly demanding escrow arrangements, bank guarantees or letters of credit from banks outside China to secure break fee payments and other types of penalties or compensation payments. The additional protection is spurred by the risk of non-enforceability against the Chinese buyer, as well as by the current difficulties Chinese parties face to get money out of China. In certain deals, the seller has required non-refundable payments into a bank account outside China, sometimes even before the Chinese party is allowed to commence due diligence.

A new product that seems to be developing is insurance for payment of break fees, specifically related to break fees for CFIUS risks. Although premiums are still rather high, this may be an interesting alternative to escrow, bank guarantees or letters of credit from non-Chinese banks to secure break fee payments, especially if these instruments are not available to the Chinese buyer due to its inability to transfer funds out of China or its lack of assets outside China that can be used as security for the bank. Insurers will require a “hell or high water” covenant from the buyer to agree to any mitigation measures requested by CFIUS as a condition to providing the insurance.

Even though Chinese buyers are faced with specific challenges in doing investments in Europe, there are ways to navigate these challenges and reach agreement on deal terms acceptable to both seller and buyer. Whether you are on the selling or on the buying side, early engagement of advisors with experience in cross-border M&A involving Chinese buyers will contribute to a successful signing and, ultimately, closing of the deal.