

# Linklaters



Strategy and opportunity.  
China's growth on the world stage

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*Mahjong is a game of strategy and opportunity. Originating in China, it is now played all over the world. The four playing tiles shown are the wind tiles, one for each direction. These carry special significance as they can provide an opportunity for players to win additional points.*

*As China reaches out to the rest of the world – and the world increasingly interacts with China – agile, imaginative organisations that combine strategy with emerging opportunities will achieve the most success.*

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# Executive summary

**China is at a turning point.** Propelled to be the world's second largest economy by thirty years of exponential GDP growth, China now faces a slowdown and significant macro-economic questions. Compounding this is the constant, and dramatic, evolution of the global economic landscape. China's response will determine its own role on the world stage for at least the next thirty years and significantly impact the rest of the world.

That response, outlined in China's 12th Five Year Plan, is being implemented in three linked developments. Increased domestic consumption, not the export-led strategy of the past, must drive economic growth. Re-denominating trade flows into China's currency, the RMB, will mitigate the inflationary pressure of a trade surplus paid for primarily in US dollars at a pegged exchange rate. China's vast foreign exchange reserves will increasingly be invested in real overseas assets rather than Western government bonds. Internationalising the RMB is the vehicle for greater capital account liberalisation and increasing outbound investment.

These macro-economic drivers underpin China's 12th Five Year Plan, which was launched in 2011 – before the 2012/2013 leadership changes – so emphasising the collective commitment of China's leadership to economic continuity amid political change.

China's aim to re-balance its growth by boosting domestic consumption will enhance China's stability as its economic structure becomes large, open and more like the US, the only economy larger than it. To achieve this, China needs widespread reform. It must improve its efficiency and innovation. Its financial system requires reform, to strengthen and widen funding sources and financial institutions, and its capital account requires further liberalisation.

China's project to internationalise use of the RMB is key. Driven by cross-border RMB trade settlement, China has already taken significant strides towards making this vision a reality. Since launching a 2009 pilot scheme, the proportion of China's worldwide trade settled in RMB has ballooned from less than 0.5% in 2009 to 10-15% for 2012. China's counterparties are increasingly choosing to transact in RMB because this is to their advantage.

RMB-denominated trade fuels expansion of an offshore pool of RMB liquidity, available globally. The range of RMB financial products is steadily increasing – from dim sum bonds to loans and letters of credit. Offshore hubs outside mainland China, focused on Hong Kong, London, Singapore and Taipei, act as China's bridges to the rest of the world for RMB currency settlement and RMB financial products.

And a quiet revolution is brewing. China's April 2012 announcement of a forthcoming new payment system (China International Payments System) heralds a major change in RMB clearance and settlement. For the first time allowing international banks a direct relationship with China's central bank, the People's Bank of China, this advance – expected by mid-2013/2014 – could truly globalise the RMB.

Simultaneously and related to the moves to increase more flexible use of the RMB, China recognises the strategic imperatives to increase its outbound foreign direct investment and attract targeted foreign investment into China. Whilst inbound investment into China remains important and increasingly targets Chinese priority sectors and regions, so focusing on quality not quantity of foreign investment, it is outbound investment that will be China's focus in the next thirty years. China aims to use this to move up the value chain, away from low-cost manufacturing, towards

output driven by innovation, and so avoid the so-called “middle income country trap” at which GDP growth plateaus.

This will require Chinese companies to “go global”. Increasing outbound M&A will develop internationally competitive companies and integrate China deeper into the global economy. Investing over \$327bn in outbound M&A since 2005 and growing its share of global outbound M&A from 0.8% in 2005 to 5.5% in 2011, China has signalled its intent.

Driven by diverse factors, from pure financial investment to foreign brand/ know-how acquisition, securing natural resources and strengthening ties with key markets, China is conducting its M&A in a changing global landscape. This presents unforeseen opportunities, for example emanating from the Eurozone debt crisis, and the challenges of a recessionary environment and stalling demand in certain sectors. A nimble response, coupled with more transparent outbound policy and decision-making, will facilitate China's outward growth strategy. Equally crucial to success are practical strategies to execute transactions, from targeted government support to suitable deal structures – minority stake or outright acquisition – given potential regulatory and commercial hurdles.

For today's non-Chinese market participant, whether corporate or financial institution, this means deciding how and when to engage with China. Given the complexity, and often lack of visibility, of the challenges and opportunities ahead, it is key to have a detailed understanding of the full picture. For China, constant extension of its international capabilities will enable it to implement its growth plan for the next thirty years, so developing a more sustainable path for itself and the world economy.

# 1. China's macroeconomic trends

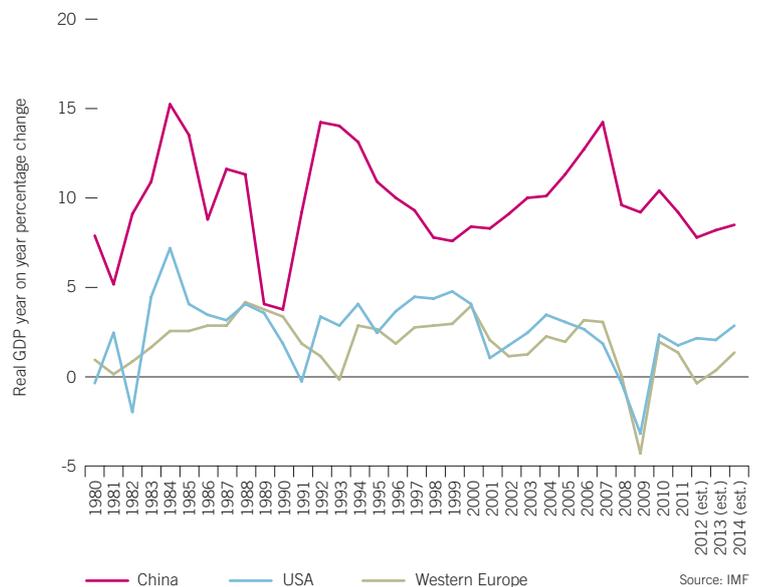
## > 1.1

### Key steps in China's growth to 2030

Over the last thirty years since the start of market-oriented reforms, China has successfully used inbound foreign direct investment (FDI) to expand its manufacturing and export capacity and so fast-track its GDP growth. Since 1980 China has consistently posted GDP growth figures exceeding those of the mature US/Western European economies and frequently revealing exponential economic growth (graph 1). But with growth levelling, the next thirty years require a fresh approach.

Characterised by a shift in China's growth paradigm, the next phase requires technological progress and so necessitates increasing outbound FDI. China's "going global" policy, launched in 2000, now supplements its "open door" policy by encouraging its firms to "go out" as well as to "pull in" FDI. Relying on this key strategy for future growth, China will increasingly depend on its ability to produce globally competitive companies to help it move up the value chain and overcome the "middle income country trap" – the point where a country's growth slows after reaching about \$14,000 of income per capita (adjusted for purchasing power parity), which China is forecast to reach by 2020. The new phase is therefore likely to centre on global integration and outbound investment.

Graph 1: China, USA and Western Europe GDP growth, 1980 - 2014





**Simon Davies**  
Firmwide Managing Partner

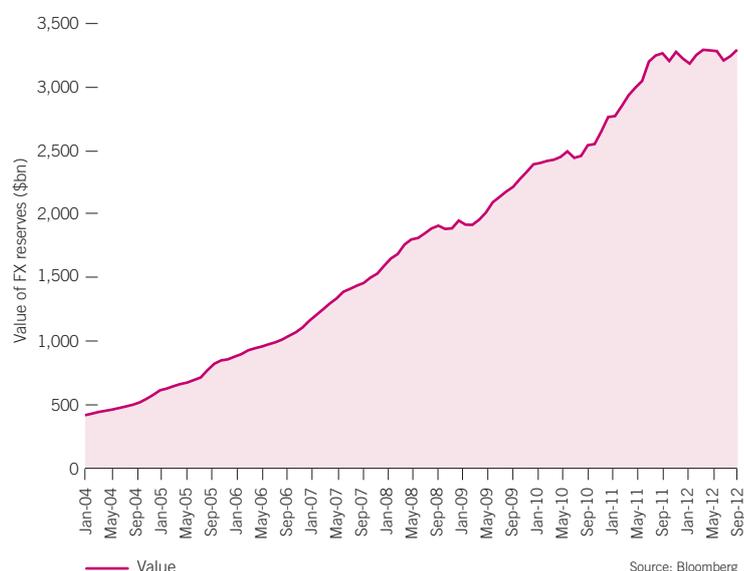
“ Focused on ensuring sustainable growth - and targeting the right quality of growth, China is moving from a manufacturing economy to a highly productive, innovation-driven economy. This will have profound implications worldwide. ”

This approach brings additional macroeconomic benefits. Buying real assets instead of government bonds will reduce China's foreign exchange reserves from its record \$3.3trn (graph 2) and help to balance its current account surplus with its capital account. China has a net US dollar inflow on its current account as its exports exceed its imports, but can counter this on its capital account by spending US dollar reserves on real assets. This also allows China, concerned about the US fiscal position, to diversify out of US Treasury bonds passively, not selling its holdings but also not accumulating more US government debt.

As part of its new global economic policy, China has launched a policy to internationalise use of the RMB via offshore centres. This strategy permits offshore RMB to be used internationally without opening access to the Chinese domestic market. Gradual capital account liberalisation allows China to reap the benefits of wider use of its currency but not unleash potential domestic difficulties in its developing financial system. Improving the flexibility of the pegged RMB exchange rate that is closely aligned with the US dollar is important as historically-low US interest rates, expected to be held near zero until at least mid 2015, are anticipated to boost capital inflows to the higher interest rate Chinese economy. This has the potential to lead to asset bubbles and increase inflation. Internationalising the RMB and increasing the RMB exchange rate's flexibility will therefore be central in the new phase in helping China to manage these issues and keep its economy on a stable footing.

Highlighting this structural shift in the major policy document of its 12th Five Year Plan (2011-2015) and the World Bank and China's State Council Development Research Centre's "China 2030" report, China is carefully planning the key steps to reform its economy internally and externally and so set itself on an assured path to continued growth.

Graph 2: China's foreign exchange reserves, 2004 - 2011





**Fang Jian**  
National Managing Partner – China

“China is increasingly affecting the global terms of trade as it promotes domestic consumption, internationalisation of the RMB, targeted foreign investment into China and significantly escalating outbound Chinese M&A.”

## > 1.2 Re-balancing the economy

Internally, a key step is re-balancing the areas of growth in its economy. Increasing China's stability, this will allow it to develop an economic structure closer to that of the only world economy larger than it – the US. Despite the US being one of the world's top three traders, its economy is largely driven by domestic demand.

China started to plan for this in earnest in its 12th Five Year Plan. This joins structural reforms to re-balance consumption and investment with a focus on efficiency, requiring China to innovate more and develop seven so-called strategic emerging industries, listed in Section 3.1, to form China's new economic backbone. The disruption of the 2008 international financial crisis and its impact on China's Western markets increased the impetus behind re-balancing. China's overall objective in making this adjustment is to transform its economy into a more sustainable model, becoming large and open like the US and avoiding the volatility plaguing small, open economies such as those in developing Asia.

To re-orient towards domestic demand means, in practice, boosting consumption in China and reducing the savings tendencies of Chinese households and companies. Chinese consumption fell from around 50% of GDP in the 1980s and early 1990s to nearly one-third by the late 2000s. Simultaneously, total savings rose. In contrast, developed economies' consumption is typically above this, at between 50% and two-thirds of GDP.

To change Chinese household and company saving habits requires changes to China's financial system, including facilitating bank/capital market credit for private companies. At present, an under-developed financial system and scarcity of funding sources means that Chinese banks rely heavily on deposits. Consequent concern over banks and their legacy of non-performing loans indicates the need for reform and dictates the gradual approach to opening China's capital account and RMB internationalisation. To move faster is to risk imploding the domestic economy as money may leave China's financial system.



### > 1.3 Internationalising the RMB

Externally, key areas of focus are internationalising the RMB and reforming China's capital account. Fundamental in achieving this is increasing the RMB's use in cross-border trade settlement by using it as an invoicing currency and promoting currency swaps which use the RMB as the payment currency. As noted in Section 2.1, the proportion of China's worldwide trade settled in RMB has grown significantly since 2009. Simultaneously, China has agreed an increasing number of bilateral currency swaps with its trading partners. By 2020, China aims to have developed RMB use in trade finance, project finance and FDI, and expanded the RMB bond and derivatives markets to support this.

Capital flows, outward and inward, have grown steadily since China acceded to the World Trade Organisation in December 2001. As shown in Section 2.3 and "China's relaxation of capital controls", China is increasingly liberalising its capital account. This supports its policy to promote outbound FDI in order to overcome the "middle income country trap". But much more remains to be done and how far to open the capital account is undecided as China worries about the potentially destabilising effects of short-term portfolio capital or "hot money" flows seen in the 1998 Asian financial crisis. But, for longer-term investment such as FDI and M&A, subject to state approval, the capital account is gradually opening and supported by the move to internationalise the RMB. China will use its foreign exchange reserves to finance overseas M&A deals, which also helps to reduce its accumulation of reserves in Western government debt.

This too explains China's preference for a gradual approach, leading it to create offshore RMB centres, first in Hong Kong from July 2010 and subsequently in London, Singapore and, most recently, Taipei, rather than undertaking a greater, immediate loosening of capital controls. Gradual capital account liberalisation should also impact China's exchange and interest rates, moving towards these being market, not government, set. Feeding back into China's domestic economy, rates in the offshore pool and the domestic economy should move ever closer.

The RMB's increasing prominence may ultimately propel it to be a global reserve currency. Even if not a key Chinese objective, despite the attendant benefits such as lower borrowing costs, this may be an inevitable consequence of the RMB's globalisation and potential to rival the US dollar. Some central banks, for example in Africa, already hold RMB reserves. For China, reform of its financial and monetary policy and institutions, which may contribute to the RMB attaining reserve currency status, is necessary first and foremost to benefit the Chinese economy.



### > 1.4 China inbound investment

China's continuing drive to pull in foreign investment is key. By opening sectors strategically important to it to foreign ownership, China aims to gain overseas expertise, upgrade its economy and so move up the value chain. This also helps China to maintain its employment rate in the face of low-cost manufacturing transferring from it to economies with lower labour costs. Favoured sectors include the seven strategic emerging industries identified in China's 12th Five Year Plan and others expected to boost domestic consumption, so re-balancing its economy, and help China meet its social goals, such as increasing urbanisation and improved public healthcare and pensions. Inbound investment in other sectors will continue, but may in practice be relatively more challenging.

China needs to foster conditions to support this policy's practical requirements. Continuing to develop the Chinese legal system to increase its transparency and meet foreign investors' expectations is fundamental. New M&A and anti-monopoly laws go some way to address this, but work remains to be done.

An integral part of China's growth over the last thirty years, inbound FDI remains important for China to shape its economic development over the next thirty years. In the last decade inbound FDI has risen from \$72bn in 2005 to over \$123bn in 2011. This signals the importance to China of securing targeted inbound foreign investment and expertise as it strives to move away from its role as the world's manufacturer to a globally competitive, balanced economy.

### > 1.5 China outbound investment

China's successful outbound implementation of its "going global" policy is key. Recognising that its growth will slow in the coming decades, and wary of falling into the "middle income country trap", China aims to upgrade technologically, develop globally competitive firms and produce innovation. In practice, this means having companies that can learn, operate and compete in developed markets and companies that acquire internationally recognised brands, bring them back to China and develop the domestic market. Countries that have joined the ranks of rich nations, such as Japan and South Korea, share this trait. China is keen to emulate them and do the same.

A continuing staple ingredient in achieving continued growth including re-industrialisation and upgrading existing productive capacity is China's need to secure commodities. But China is increasingly reaching beyond this, acquiring a broader range of assets in line with its 12th Five Year Plan. This includes buying more global brands and overseas technology and promoting Chinese service industries such as banking. The dawn of a second Chinese industrialisation, focused on upgrading and development, will have far-reaching global consequences.

Outbound FDI has increased dramatically since the mid 2000s when the first commercial investment by a Chinese firm was permitted with TCL's 2004 purchase of France's Thomson. Subsequent outbound FDI has increased from \$12.3bn in 2005 to over \$65bn in 2011, representing a 428% increase over this six year period. China could be on track to demonstrate that its industrial capacity is not only a function of foreign companies purchasing its exports, but also indicates more widespread upgrading of its industry. China's companies increasingly "going global" points to a policy aim being realised.



## 2. Internationalising the RMB

An internationalised RMB – the currency of the world's second largest economy and largest trading nation – has the potential to reshape the global financial landscape.

For CFOs and corporate strategists, this means deciding when and how to engage with the RMB, decisions complicated by the absence of a published Chinese roadmap and China's unique position. Chinese capital and currency controls protect a developing domestic economy not yet ready for international exposure. Driving creation of offshore RMB financial centres and impacting the development of RMB financial products, the challenges ahead are complex and distinctive.

### > 2.1 Increasing trade settlement in RMB

China's unprecedented move to internationalise its currency started to gain traction in 2009 as China concentrated on redenominating its trade flows into RMB. Establishing a limited RMB trade settlement pilot scheme within Asia in June 2009, it quickly expanded this to the rest of the world in June 2010 and finally extended it to all Chinese enterprises in August 2011. As the scheme grew, so did the proportion of China's worldwide trade settled in RMB – from less than 0.5% in 2009 to 8% in 2011, and 10-15% for 2012 (graph 3). Already displaying striking growth, up to one-third of all China's trade and up to half of its trade with developing countries has been predicted to be settled in RMB by 2015.

The advantages to China are clear. Increasing use of its own currency for trade settlement reduces foreign exchange rate risk and transaction costs. More fundamentally, the macro-economic reasons underpinning China's internationalisation of the RMB, outlined in Section 1, reveal the range of benefits anticipated. Taken together with the underlying political drivers, the Chinese authorities cannot allow the RMB's internationalisation to fail or be reversed. This is evidenced in their continuing public commitment, irrespective of changes in the Chinese leadership.

#### China's currency: at a glance

**Overview:** in practice, the terms renminbi, yuan, RMB and CNY interchangeably indicate China's currency. The key distinction is between CNY, denoting currency deliverable onshore, and CNH, denoting currency deliverable offshore. Successful RMB internationalisation is likely to remove this distinction as the onshore and offshore currencies ultimately converge.

**Renminbi:** official currency of China; means "people's currency"; issued by the People's Bank of China (China's central bank).

**Yuan:** primary unit of renminbi; means "round", reflecting the coins' shape.

**RMB:** abbreviation of renminbi.

**¥:** currency symbol for yuan.

**CNY:** code for RMB deliverable onshore mainland China.

**CNH:** code for RMB deliverable offshore in Hong Kong; distinguishes onshore from offshore "currency" in clearing and settlement systems; promotes incorrect perception of separate currency.

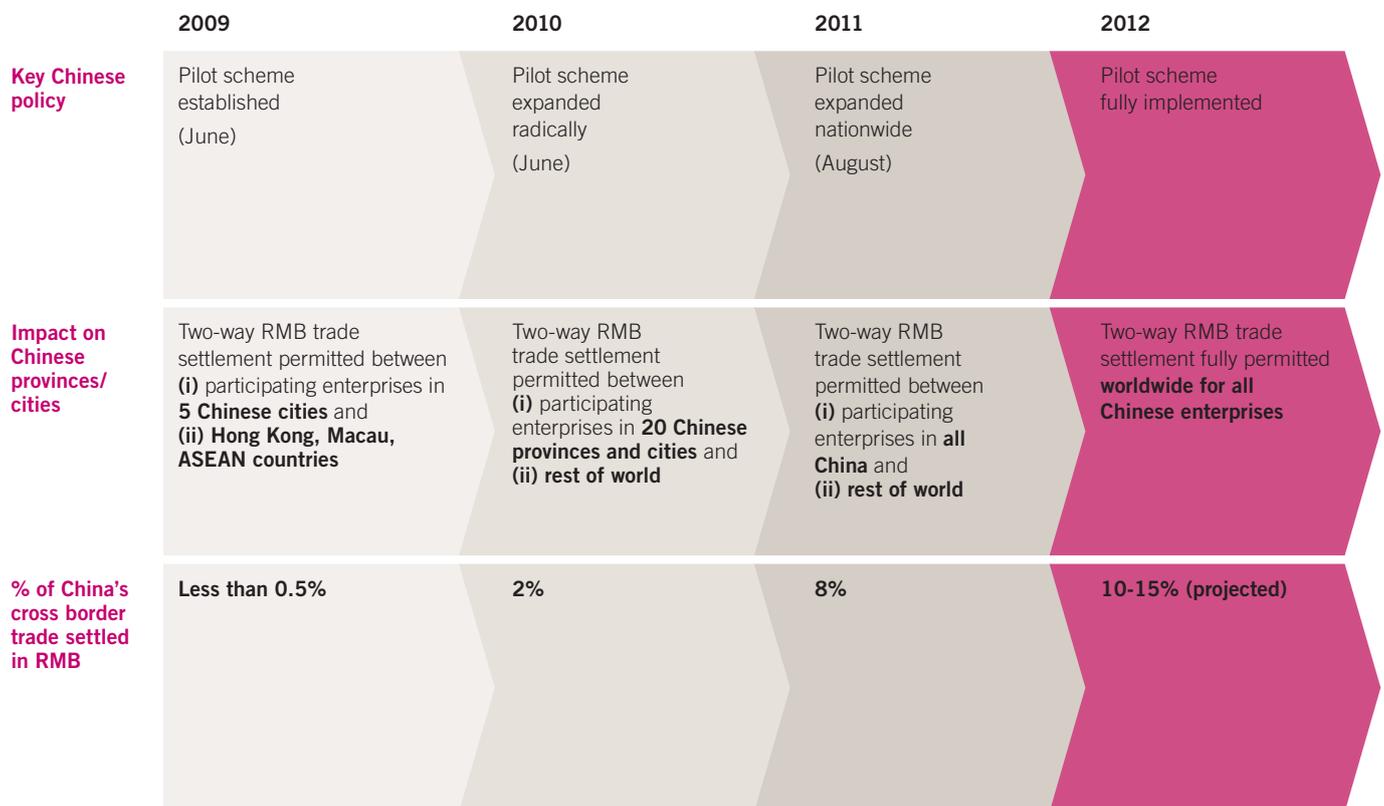


**Andrew Malcolm**  
Partner – Capital Markets

“

Driven by market forces, the RMB is taking off as a major world currency – increasingly used to settle trade, fuelling RMB financial products’ growth and even held in some central bank reserves. ”

Graph 3: RMB trade settlement: key landmarks





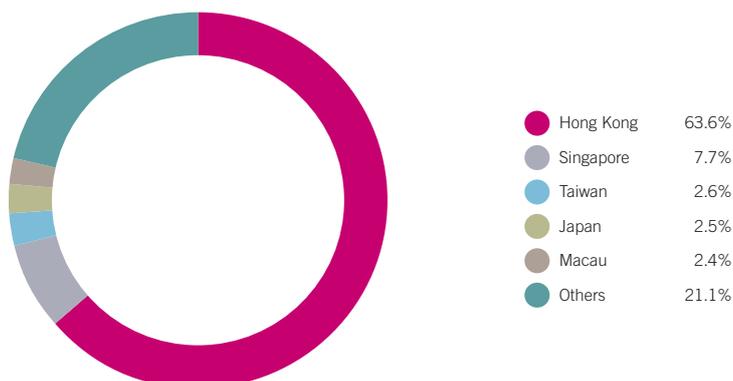
The advantages to China's international trading partners are also clear. An increasingly wide geographical distribution of RMB settled trades shows over 20% of all RMB trades being settled with counterparties mainly beyond Asia (graph 4). This announces a new commercial reality – counterparties are settling trade in RMB because it benefits them. For example, a foreign company asking a Chinese exporter for a RMB quote and a foreign currency quote will often find the RMB quote cheaper. Alternatively, the typically easier and cheaper access to RMB currency swaps in the offshore market attracts foreign companies to hedge their exposures and so improve the transaction's overall pricing.

For Chinese trade to be redenominated successfully and broadly into RMB three key points must be addressed. First, the offshore currency must be available globally: China trades globally. Second, the offshore currency must be the same as the onshore currency. A Chinese exporter receiving RMB in payment from the offshore pool must be able to use those monies onshore to pay wages and buy materials. Third, an offshore RMB capital market and pool of liquidity are needed to facilitate RMB trade flows. This will provide the liquidity, financing, hedging and investment products needed for China's trading partners to use the offshore currency.

Hong Kong currently acts as mainland China's settlement hub and so provides the framework for this. RMB accounts are available worldwide through direct or correspondent bank participation in Hong Kong's RMB Real-Time Gross Settlement System (RTGS). Bank of China (Hong Kong) Limited (BoC HK) is the sole offshore clearing and settlement bank for RMB and controls the flow of RMB into and out of the offshore pool, so preserving a single RMB currency. And Hong Kong's accumulating RMB deposits provide a pool of liquidity and a capital market.

As RMB trade settlement has increased, so RMB deposits in Hong Kong have grown, from only RMB90bn (\$14bn) in June 2010 to RMB627bn (\$99bn) in November 2011. But then they contracted in the next five months by 12%. This has renewed debate about how liquidity in the offshore RMB pool can grow. China's continuing trade surplus may appear to drain the offshore pool as these RMB monies flow back to China, but in fact China looks set to increase this pool via its growing dealings with developing markets, with whom it has a net trade deficit. There is the added potential to increase RMB capital flows through China's increasing outbound investment, as discussed in Section 4, particularly as the regulatory framework for using RMB in outbound investment is already in place. These outbound RMB capital flows, by investment or financings, will grow the offshore pool.

Graph 4: Geographical distribution of RMB settled trades





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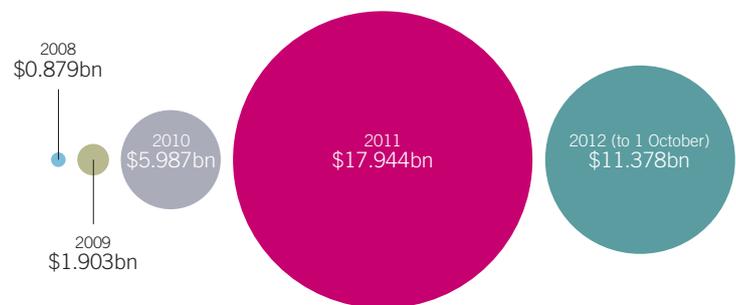
China's Ministry of Finance has shown clear support for the growing offshore RMB bond market with its multi-tranche sovereign RMB bond issues to benchmark the market. ”

## > 2.2 Growth of RMB financial products

With an offshore RMB pool of liquidity a prerequisite to successful internationalisation of China's currency, attention is shifting towards growing this via an increasing range of RMB financial products.

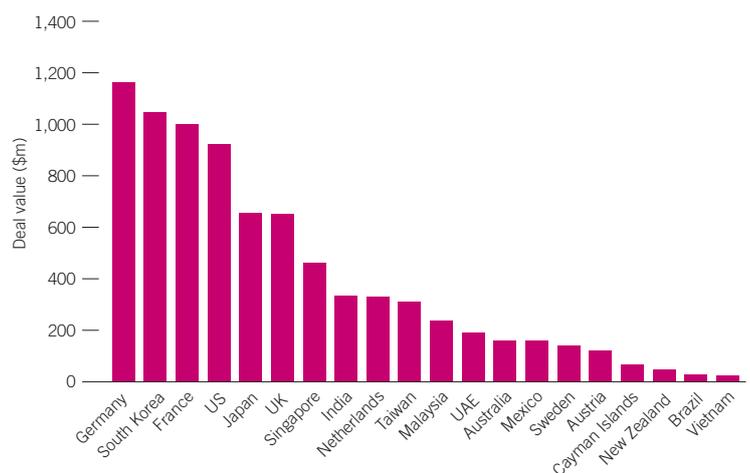
The offshore RMB bond market is flourishing, with strong volumes of RMB denominated bonds issued offshore since 2010 (graph 5) and an increasing geographical spread in issuers (graph 6). So-called “dim sum bonds”, RMB denominated bonds issued by Chinese or non-Chinese companies in offshore markets, have been issued in Hong Kong since 2010 and, more recently, in London. It is now common for issuers in Asia, Europe and the US to add RMB as a drawdown option to their medium term note (MTN) programmes. Trade finance in the form of RMB denominated letters of credit and factoring facilities is available. A market for RMB denominated loans is developing, supported by a maturing interbank rate. Diversification into more structured products continues, for example with a RMB denominated REIT listed in Hong Kong in 2011 and successful RMB denominated Islamic sukus in 2011 and 2012 highlighting interest among Gulf investors.

Graph 5: Dim sum bond issuance, 2008 - 2012 (1 October)



Source: Thomson Reuters

Graph 6: Dim sum bond issuance by issuer, 2011 - 2012 (1 October)



Source: Thomson Reuters





**Chin-Chong Liew**  
Partner – Capital Markets



RMB denominated derivatives as investment products, not just hedging instruments, are a key growth area in the RMB financial product range.”

This expansion has varied implications. First, there is a high level regional/ jurisdictional divergence in approach. Asia leads the pack in product take-up, with some jurisdictions, such as Singapore, Japan and Korea, showing strong RMB deal flow, and others, such as Thailand, Australia and Indonesia, at earlier stages of indicating interest. Europe sees emphasis on RMB drawdown options under existing MTN programmes but a growing number of standalone RMB deals. Second, greater product usage, coupled with changing expectations in relation to slowing RMB appreciation, is moving RMB capital markets to international standards. Exhibited in an increasing investment grade/high yield split, bond issues are now likely to be allocated to the appropriate part of the market and appropriate credit enhancement taken – from onshore guarantees and Chinese bank-issued letters of credit to keepwell agreements and letters of support. Third, market participants increasingly need to develop a practical response to uniquely Chinese issues. A key example is the use of currency fallback clauses, providing that contractual RMB payments can be made in another specified currency, such as Hong Kong or US dollars, if a Chinese currency-related disruption event occurs. With full internationalisation of the RMB, the need for this provision should disappear. In the meantime, parties will need to consider the appropriate approach to such a provision on each transaction.

Hong Kong remains the current world centre for RMB product development, so giving rise to a misplaced perception that the offshore RMB is a Hong Kong-based market. Even market terminology augments this perception, for example with the tag “dim sum” bond referring to a Hong Kong snack and so giving this product a local feel. Yet the reality is of an increasingly global picture.

London is being promoted as a trading centre to harness its financial prowess to make available both the RMB as a currency and RMB financial products in the European time zone. Following the January 2012 announcement by the Hong Kong Monetary Authority and the UK Treasury of a private sector-led forum to develop the offshore RMB market in London, steps have already been taken to substantiate this, for example with a RMB2bn dim sum bond issue by HSBC in April 2012. Offering deep, sophisticated and leading capital markets as well as a bridge to Europe and the US, London is opening a channel for trade settlement in RMB which in turn will promote the RMB’s growth. Other financial centres too play key roles. Paris has seen a spate

of dim sum bond issuance by French issuers. Singapore was picked by China in July 2012 as a new RMB clearing centre, with a Chinese bank authorised to clear RMB there. Expected to offer cost benefits and route more RMB trade flows through Singapore, this has the potential to develop Singapore into the regional hub for RMB services to south-east Asia, so capitalising on Singapore’s existing strong trade links with this region. Most recently, Taiwan has established an agreement for one of China’s banks operating in Taipei to offer RMB there.

Development of the offshore RMB financial markets is gradual. Increasing RMB trade settlement encourages banks to provide RMB financial instruments necessary to underpin wider use of China’s currency. In turn this promotes capital markets growth, and so on. The pace of development over the past two years demonstrates that the RMB’s internationalisation is well under way. While there remains much further to go, the logical conclusion is “convergence” – ultimately the offshore pool and the onshore capital markets will merge, with full convertibility of the RMB.



**Nigel Pridmore**  
Partner – Capital Markets



London offers China numerous advantages – not least a time zone which bridges Asia, Europe and the US and, critically, deep and leading financial markets to develop RMB financial products.”

## China's relaxation of capital controls

	Inbound	Outbound
2006	Qualified Financial Institutional Investors (QFII) regime (introduced 2002) expanded.	Qualified Domestic Institutional Investors (QDII) regime introduced.
2007	QFII quota tripled to \$30bn.	
2010	Limited access to PRC bond markets for designated offshore banks.	
2011	RMB QFII (RQFII) regime introduced.	RMB overseas direct investment regime established.
	No regulatory approval required for cross border RMB loan to foreign invested enterprise (FIE); approvals for RMB capital injection streamlined.	Pilot schemes announced in Shenzhen and Wenzhou for outward remittance of RMB.
2012	QFII quota raised to \$80bn.	
	Qianhai Shenzhen-Hong Kong Modern Service Industries Cooperation Area announced.	Qianhai announcement includes outward remittance of RMB project loans.
	RQFII quota tripled to RMB70bn (\$7.95bn).	

### > 2.3 RMB: fully and freely convertible?

The inconvertibility of the RMB is probably the single most significant obstacle to its continuing internationalisation. The fact that it is not freely convertible means, to many, that liquidity must be a problem, that capital controls bar access to RMB denominated assets, that the offshore RMB is not “real” Chinese currency and that internationalisation cannot succeed until the capital account is opened. The safer course, runs this school of thought, is to await free convertibility before engaging with the Chinese currency.

The reality is significantly more nuanced. Since August 2011, the RMB is effectively already convertible on the current account, albeit at the official exchange rate. This is the result of expanding the trade settlement scheme to cover the whole of China and trading counterparties worldwide. In the offshore market, the RMB is freely convertible for any purpose as settlement through Hong Kong falls outside the jurisdiction of Chinese currency controls. China does, however, maintain capital controls and these remain a constraint on convertibility. Yet even here, with China wary of opening its capital account for the reasons discussed in Section 1.3, the pace of liberalisation has picked up considerably, as “China's relaxation of capital controls” shows.

Although references to China's “tightly controlled” capital account are common, channels for capital to enter and leave China are, in fact, actively promoted, with those for RMB denominated capital receiving particular attention. For example, 2012 has seen increasing activity in RMB denominated exchange-traded funds (ETFs). The first to be listed in Hong Kong provided for direct investment in mainland China stock markets and attracted a market capitalisation of RMB4bn, and two subsequent ETFs received approval for RMB7bn. Although the focus to date has been on the capital markets, this shifts attention to the onshore equity markets, and in sizeable amounts.

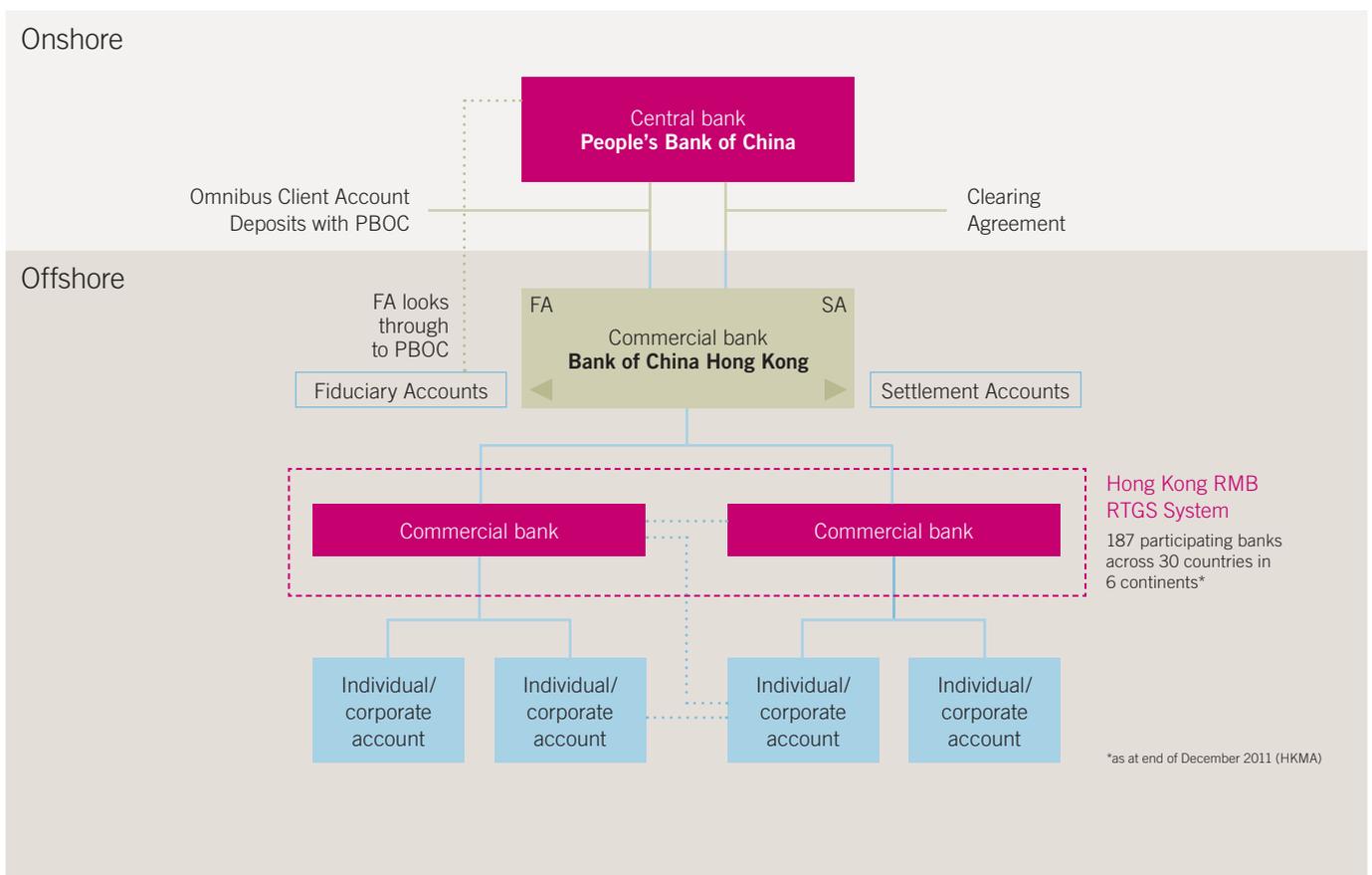
Two points are worth emphasising. First, a key priority since the 2011 expansion of the trade settlement scheme has been fixing the ability of offshore RMB bond issuers to bring the proceeds onshore for investment. This resulted in flows out of the offshore pool. Subsequent capital account reform has laid the framework for RMB to exit China in order to swell the offshore pool. Second, the Chinese authorities are taking a careful, gradual approach both to the RMB's internationalisation and the associated loosening of initially current account and now capital account controls. The likely result of these reforms is full, but not free, convertibility of the RMB. In contrast to a freely convertible currency, such as the US dollar, which is convertible without any regulatory restraint whatsoever, a currency may be fully, but not freely, convertible in the sense of convertible on every item of the capital account, but still subject to a quota, reporting, filing or

similar. This is clearly the direction being followed for the RMB and fits with the need of the Chinese authorities to protect the developing domestic markets from “hot money” or short-term portfolio flows thought to be de-stabilising for an under-developed financial system.

Convertibility of the RMB will not be a “big bang” event which precedes and enables the RMB's internationalisation. Instead, internationalising the RMB is proceeding in tandem with reform of China's capital account. To wait for free convertibility will be to miss the boat. Full convertibility is the key landmark and will indicate that the offshore and onshore markets have converged, for example in offshore RMB exchange and interest rates providing a reliable guide and match for onshore rates. This will signal that China's domestic markets are in line with international markets and ready to open fully to international participation. The consequences of this process for capital flows, particularly the flow of capital out of China, are discussed in Section 4.



Graph 7: The present: offshore RMB settled indirectly via BoC HK



## > 2.4 Potential revolution in RMB settlement systems

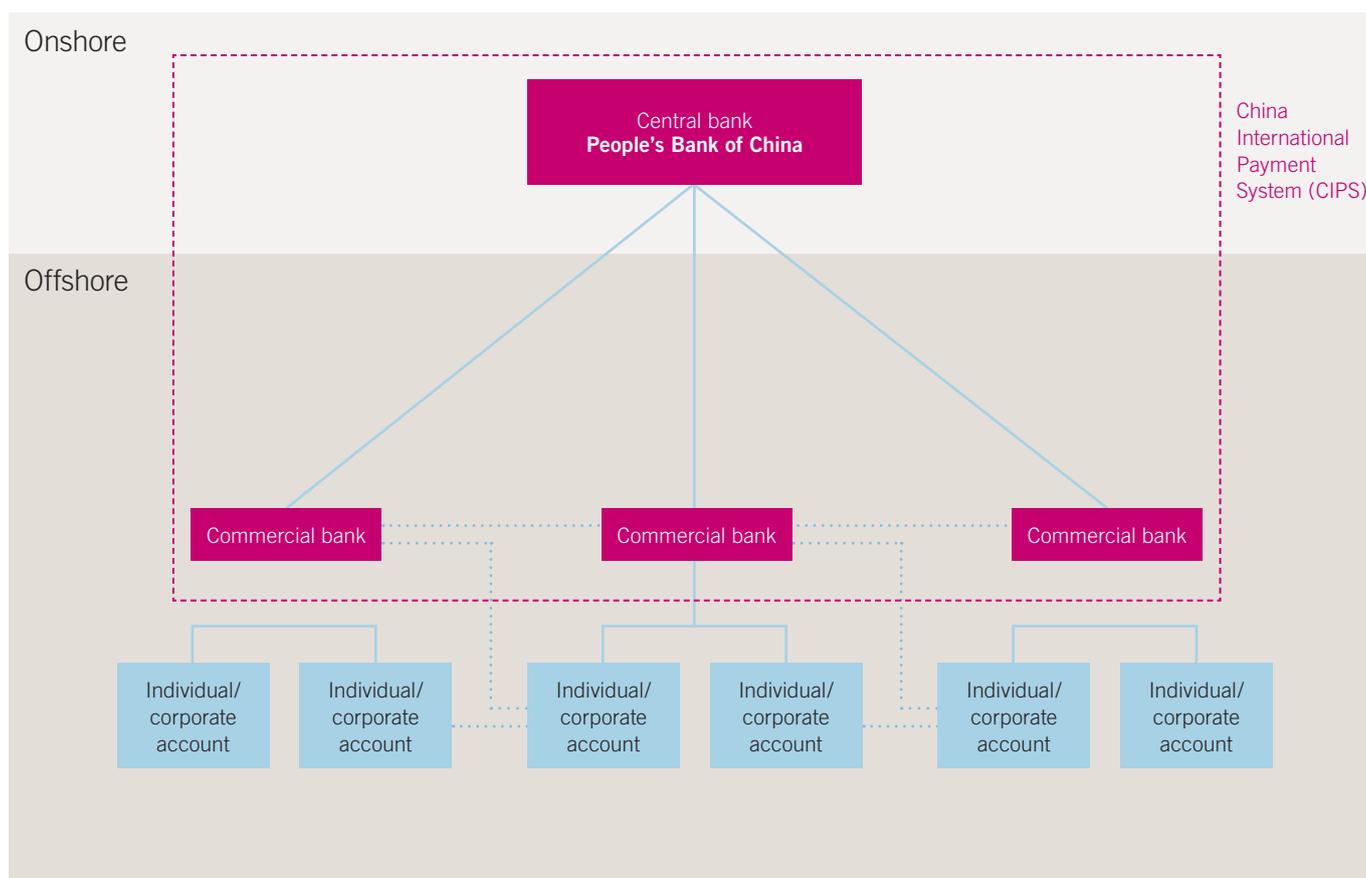
Another practical factor drives China's capital controls and currency strategy – the need to keep distinct currency which is offshore and currency which is part of China's domestic money supply.

Currently managed by BoC HK acting as sole clearing and settlement bank for offshore RMB, the system allows offshore RMB to be truly offshore mainland China and free of all onshore controls. Other currencies which have attempted a measure of offshore use, such as the Japanese yen and the new Taiwanese dollar, have created a rule-bound system of offshore accounts which are part of the domestic settlement system. As shown in graph 7, China's use of Hong Kong means that offshore RMB is identifiable because it settles in Hong Kong's RMB RTGS, outside the Chinese domestic system – CNAPS. An electronic link between these two systems allows a regulated passage for funds to pass into and out of the offshore pool.

This settlement system has worked well. Its flexibility was confirmed when London took on a new role as an offshore RMB trading centre in early 2012. Access to the offshore pool is provided simply through the existing infrastructure in Hong Kong, with the system staying open until 11.30pm local time from July 2012 to provide real time access during London's trading day.

But the current set-up presents bottlenecks. Offshore settlement is done outside the purview of Chinese foreign exchange and capital controls on the books of BoC HK. Concerns about credit concentration risk were addressed by introducing a nightly sweep for unused funds to a fiduciary account maintained with PBOC, giving access to central bank credit. But this lacks transparency and is operationally cumbersome. All transactions in the offshore currency must also be settled with commercial bank money (a claim on BoC HK) rather than with central bank money. This feature alone disbars the RMB from eligibility for settlement through the CLS system which handles the majority of international settlement in eligible currencies in central bank money.

Graph 8: The future: offshore RMB settled directly with PBOC



In April 2012, PBOC announced its intention to create a new China International Payments System (CIPS). This could prove to be a decisive catalyst for acceptance of the offshore RMB as a major world currency. Details are scant, but the system's announced features are that it will be a modern electronic system operated by PBOC, separate from the domestic CNAPS but linked to this to permit transfers between the two and reserved for the offshore currency, with access limited to international banks. Most importantly, it will allow settlement of transactions in the offshore currency backed directly by central bank money. Graph 8 indicates how it is likely to operate.

The announced implementation timeline is an ambitious two years. If CIPS is designed to use international SWIFT messaging protocols, to allow CLS eligibility and to provide for finality of settlement, its implementation could be the operational advance which will truly globalise the RMB.

#### Graph 8 notes:

- > **CIPS structure/operation:** to be confirmed – diagram is indicative only
- > **Key features:** (i) link domestic and overseas participants directly, (ii) adopt global standards
- > **Languages:** multiple, including Chinese and English
- > **Time zones:** 17-18 working hours
- > **Announced:** April 2012
- > **Intended operational date:** mid 2013-2014

# 3. China inbound investment

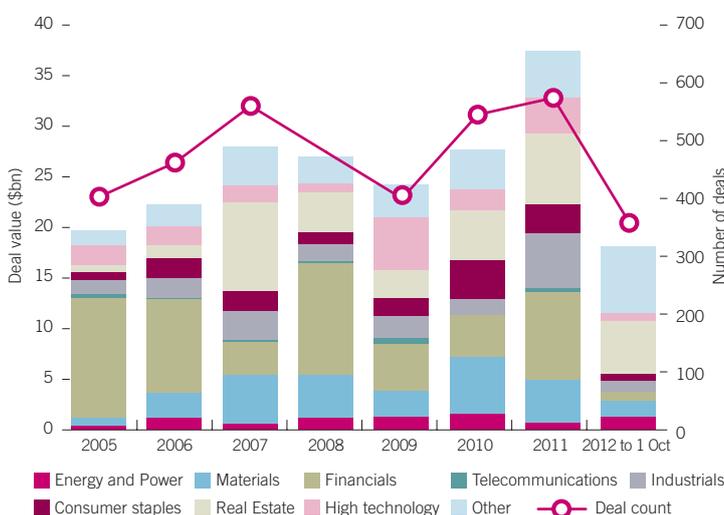
Inbound foreign investment has been a core strategic tool in China's growth over the last thirty years and, as China looks ahead, remains important. But China is now adopting a more targeted approach, prioritising certain sectors and regions. Inbound M&A in preferred areas is facilitated and encouraged. Added to the broader backdrop of a business environment sometimes difficult to navigate, it is key for foreign investors to analyse the changing Chinese landscape.

## > 3.1 China's key inbound regional and sector targets

Inbound M&A into China was relatively consistent between 2005 and 2012, revealing its continuing importance. Never dipping below \$19bn annually, and this during the 2008 global financial crisis, it hit a high of over \$37bn in 2011. But beneath the headline numbers, a pattern of diverse investment is clear.

Sectors prioritised by China for inbound M&A are consistent with the seven strategic emerging industries – biotechnology, new energy, high-end equipment manufacturing, energy conservation/environmental protection, clean-energy vehicles, new materials and information technology – highlighted in its 12th Five Year Plan. Backed by government incentives to invest, and with foreign ownership thresholds progressively relaxed, in these sectors, inbound M&A has steadily increased since 2008 in higher-value added sectors, whilst being comparatively low in energy/power and materials (graph 9). Simultaneously, for the reasons outlined in Section 1.4, opportunities for inbound M&A are increasing in sectors giving access to the services sector, an area promoted by the Chinese government, ranging from consumer staples, cars and pharmaceuticals to financial products. For example, foreign investors have acquired well-known Chinese retail brands, including US Yum!'s 2011 \$566m acquisition of Chinese restaurant chain Little Sheep.

Graph 9: China inbound M&A by target sector, 2005 - 2012



Source: Thomson Reuters



**Betty Yap**  
Partner – Head of China Practice

“ Chinese regulation, foreign ownership rules, regulators’ attitude and government incentives all help steer foreign investment to areas strategically important to China. ”

Where China may once have rejected such transactions, as with Coca-Cola’s 2009 failed \$2.4bn acquisition of Huiyuan Juice, recent strategic foreign M&A investments have been more, if conditionally, accepted. This gradual approach is replicated in China’s incremental lifting of foreign investment restrictions in different sectors, for example in its recent adjustments to its Foreign Investment Industrial Guidance Catalogue. Regulatory changes include initiating practical alternatives to traditional models. For example, new Chinese regulations permit foreign invested limited liability partnerships to be established. Providing a more flexible investment approval process than that of the traditional fixed asset-centred joint venture model, this structure facilitates inbound M&A in the services sector key to China as it seeks to sponsor innovation and move up the value chain.

Internationally, China has signed a network of bilateral trade treaties, including with Brazil, Russia, the US and the UK, and agreements with Hong Kong, Macau and Taiwan, to support inbound M&A. Coupled with international investors’ access on preferential terms to certain sectors, consistent with China’s priorities, in certain areas, such as interior regions away from the developed eastern seaboard, this enables China to direct foreign investment to sectors and geographies important to it. This strategy offers foreign investors clear opportunities for inbound M&A.

### > 3.2 Addressing challenges in inbound M&A

Despite attracting high volumes of inbound FDI, China can be a challenging market for international companies to penetrate. Key to allowing them to exploit the opportunities offered and develop successful Chinese operations, and China to win foreign investment essential for upgrading its economy, is addressing these challenges practically.

First, China is still developing its legal system to meet foreign investors’ expectations of clarity and certainty. With current discretion on applying rules and sometimes opaque decision-making, for example in the Ministry of Commerce’s (MOFCOM) imposition of competition clearance conditions without accompanying analysis, uncertainty often prevails. China’s reforms to date, including modernising the court system, appointing more sophisticated judges and introducing a thirty day minimum consultation period for new legislation, improve the position but work remains to be done.

Second, foreign companies may find it more difficult to invest in sectors not earmarked by the Chinese government. For example, mandatory requirements to form joint ventures with Chinese partners and ownership restrictions in certain sectors, including financial services, may inhibit foreign investment. In response, China needs to continue to re-assess its approach to required approval levels.

Third, China historically does not have a fully robust regime for protecting intellectual property, a key concern for foreign investors required to transfer technology to obtain Chinese market share as part of joint venture agreements, so helping China to upgrade technologically. In reply, China has continued its efforts in enforcing foreign investors’ intellectual property rights particularly after adopting strict WTO standards upon its accession in 2001. For example, Michelin in 2010 and Honda in 2011 scored Chinese court victories in protecting their names, marks and logos. But there remains more to do in this area.



**Simon Poh**  
Partner – Corporate

“ Joint ventures marrying foreign technology and premium products with local Chinese manufacturing knowhow and distribution networks offer potential to innovate and unlock new markets. ”





**Richard Gu**  
Senior Consultant – Corporate

“

As Chinese law typically governs China inbound M&A documentation, it is key for international investors to expand their knowledge of Chinese law and practice. ”

Finally, an overall perception of a business environment unfriendly to international investors sometimes exists. From preferential treatment of domestic enterprises to stricter law enforcement, foreign investors can face significant difficulties. For some, ultimately this, coupled with rising labour costs, means withdrawing from China or divesting/licensing parts of their operations to Chinese companies. For others, identifying sector-specific opportunities and offering strategic partnerships or acquisitions conferring essential knowhow is the key to success.

### > 3.3 Strategies for success

Foreign investors adopt different strategies for investing in Chinese state-owned enterprises (SOEs) and private companies, shaped around their unique features. For SOEs in core industries, full foreign ownership remains out of reach. Instead, acquisition of stakes is possible, with even some examples of a foreign investor buying a majority stake, as in Carlsberg's 2010 RMB2.38bn successful bid to become the largest shareholder of state-owned Chongqing Brewery. Other inbound M&A opportunities include acquiring SOE non-core assets, divested as China seeks to break state monopolies, energise the private sector and fuel future economic growth, and partnering with SOEs in sectors needing inbound technology transfer.

Private companies offer greater inbound M&A opportunities. Free from SOE-related restrictions, Chinese private companies are increasingly owned and managed by an overseas educated/experienced second generation. As a new breed of Chinese entrepreneur evolves, more open to and knowledgeable about international technology and business, foreign investors are able to deepen their relationships with Chinese private companies to the benefit of both.

It is important to recognise that Chinese parties have a different overall approach to M&A transactions to that of their non-Chinese counterparts. This affects everything from the style and content of negotiations to dispute resolution and enforcement expectations. Whilst the Chinese business community is steadily accumulating international deal experience, Chinese parties do therefore still face many challenges in deal execution. They are not negotiating in their mother tongue. They are typically not fully familiar with international M&A documentation, based on English or US models. Conversely, the law governing such documentation is typically Chinese.

To achieve success, this requires the non-Chinese party to invest time across all management levels in developing a deal structure, process and style which fits the Chinese party and acquiring more knowledge of Chinese law and practice. The Chinese party will correspondingly need to invest time in understanding Western processes and documentation. This inevitably requires both sides to adjust their expectations.



**Nicola Mayo**  
Partner – Corporate

“

A deepening appreciation of each other's priorities and the unique features of Chinese M&A will aid successful deal execution. ”

## 4. China outbound investment

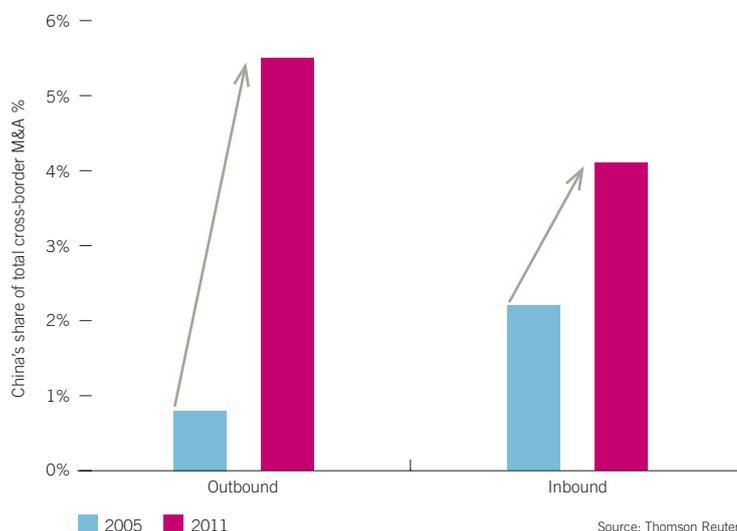
Despite launching its “going global” policy in 2000, China only saw real progress in its outbound investment in the second half of the decade. Since 2005 China has invested over \$327bn in outbound M&A and its share of global outbound M&A has grown from 0.8% in 2005 to 5.5% in 2011 (graph 10). A closer look reveals a more complex picture as China’s outbound M&A strategy continues to evolve in a changing global landscape, where opportunities abound and growth potential is significant.

### > 4.1 China’s key outbound regional and sector targets

Initially China’s expenditure on global outbound M&A was modest, at just \$9.4bn in 2005. But from 2006 it rocketed, doubling year-on-year before peaking at \$70bn in 2008. With the 2008 international financial crisis, China reined in its investment. Pulling back to \$47bn in 2009, it levelled out at \$54bn in 2010 and \$57bn in 2011, indicating sustained commitment to outbound M&A but recognition of seismic international changes.

China’s regional targeting reflects this stance (graph 11). Its three main target regions in this period were the rest of Asia – attracting almost \$100bn, the Americas – attracting over \$73bn, and Europe – attracting \$68bn. Chinese outbound M&A in the rest of Asia peaked in 2008 at \$45bn but then plummeted to just \$10bn and \$11bn in 2010 and 2011 respectively. As China’s investment in Asia decreased, so its investment in the Americas and Europe increased. Both regions display significant growth, with Chinese outbound M&A in the Americas in 2012 already rivalling its 2010 high of \$30bn and Europe attracting just under \$17bn in 2011.

Graph 10: China’s share of global cross border M&A, 2005 and 2011





**Thomas Ng**  
Partner – Banking & Projects



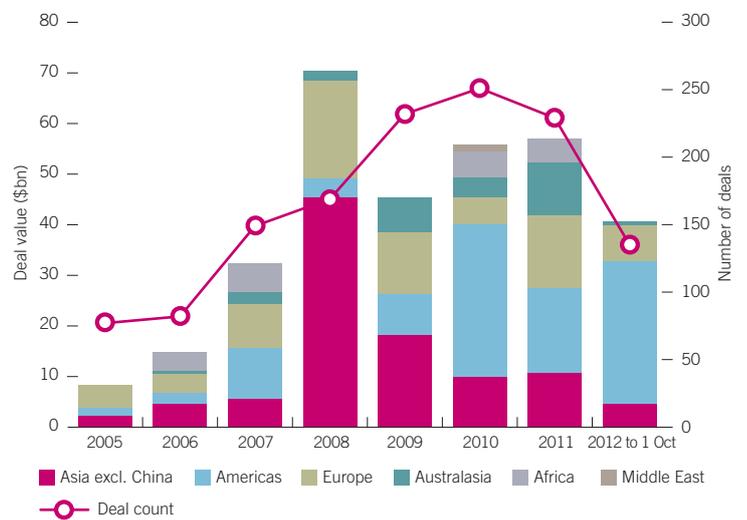
Backed by Chinese bank lending, China’s strong interest in Africa and Latin America targets natural resources key for China’s economy.



In Australasia and Africa, China has spent less. From 2005 to 2012, Chinese outbound M&A totalled \$28bn in Australasia and approaching \$20bn in Africa. Australasia has seen growing investment, from \$2bn in 2007 up to \$10bn in 2011. In Africa, investment has been more contained and consistent. Although limited in 2008 and 2009, China’s outbound African investment has been between \$4bn and \$6bn in other years.

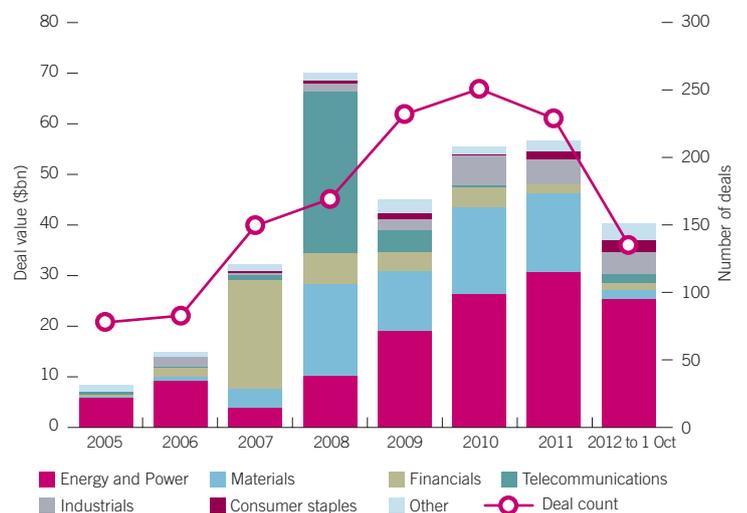
In brief, China has grown its presence in every region. Fundamental in progressing technologically and producing globally competitive firms, so avoiding the “middle income country trap” described in Section 1.1, is its global investment in developed and emerging markets alike.

Graph 11: China outbound M&A by target region, 2005-2012



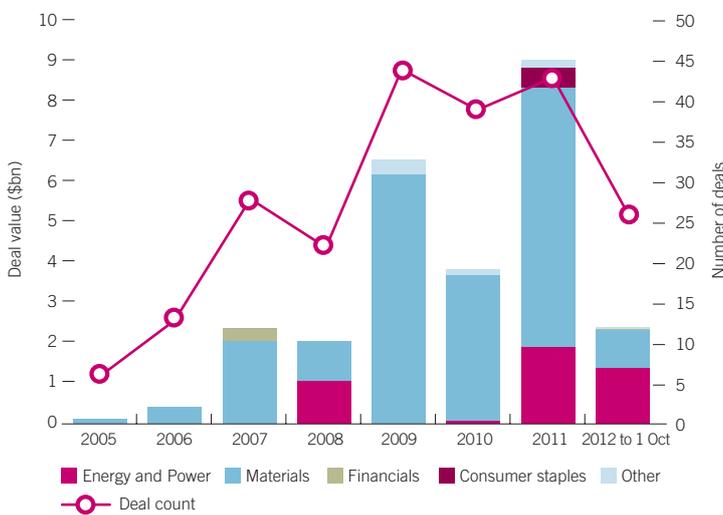
Source: Thomson Reuters

Graph 12: China outbound M&A by target sector, 2005-2012



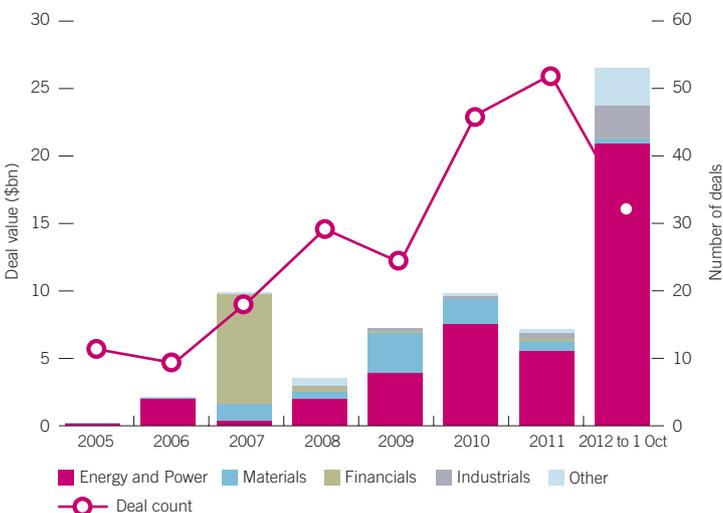
Source: Thomson Reuters

Graph 13: China outbound Australia M&A by target sector, 2005-2012



Source: Thomson Reuters

Graph 14: China outbound North America M&A by target sector, 2005-2012



Source: Thomson Reuters

Spotlight on Canada and Brazil

In Canada, Chinese M&A investment, growing from \$153m in 2005 to \$18.7bn in 2012 (to date), targets Canadian energy/mineral assets. Landmark deals, such as Chinese CNOOC's 2012 announced \$15.1bn acquisition of Canada's Nexen, stand against a backdrop of smaller Chinese acquisitions of Canadian natural resources. Despite Canada's traditional openness to investment, a key issue is its attitude to such deals. Canada's 2010 blocking of BHP Billiton's proposed \$38.6bn purchase of Canada's Potash Corporation highlights the potential to stop certain transactions.

In Brazil, which has received over 65% of China's \$33bn M&A investment into Latin America since 2005, a range of assets holds appeal. Displaying increasing diversification through its acquisition of Brazilian industrials, consumer staples and high technology, China has nonetheless favoured energy/power and materials in Brazil.



China's ongoing imperative to secure natural resources is clear. Of the \$327bn invested since 2005, \$130bn has been ploughed into energy/power, and \$70bn into materials. These two sectors account for over 60% of China's global outbound M&A in this period (graph 12). As shown in graphs 13-16 and discussed in the "Spotlight on Canada and Brazil", natural resource-rich countries are among China's prime targets.

By contrast, the financial services sector shows more selective investment, with 2008 marking a turning point. Before the 2008 financial crisis and ensuing bank failures, increased bank regulation/capital requirements and investor losses, China invested strongly, with its 2007 financial services investment totalling \$22bn. Collapsing to \$6bn in 2008, this has since been low, at between \$2bn and \$4bn annually.

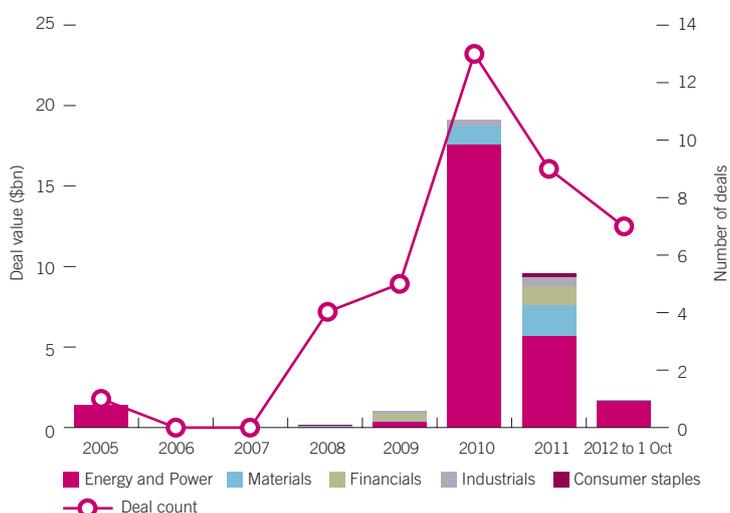
Seeing fewer opportunities in Western Europe's troubled banking sector, China has looked mainly south. Since 2008 it has made targeted investments in Latin American and African financial services. For example, in 2011 China's ICBC agreed to acquire Standard Bank Argentina. Seeking emerging markets expansion, China aims to service Chinese firms investing in those markets and to tap into a new local market.

Globally, China is using its financial services M&A investments strategically to complement its other key goals. With a strong banking network established in Western Europe, it is now likely to focus on increasing this network's capital, so developing its lending platform for Chinese corporates with European M&A ambitions. Elsewhere, Chinese banks are opening branches to facilitate

financings by Chinese bidders and to develop business with borrowers new to China, including providing finance in RMB. This both develops Chinese banks' international capability as a tool to facilitate Chinese companies' growth on the world stage and increases Chinese banks' presence in financings globally.

China is also diversifying into other asset types. Globally and regionally, it is increasingly targeting a broader range of sectors, including telecoms, industrials and consumer staples such as food/beverage, high technology, healthcare and retail. This fits with its 12th Five Year Plan objective to develop the seven strategic emerging industries listed in Section 3.1 and shows China implementing its "going global" policy as it seeks to innovate, learn in developed markets and increase domestic consumption.

Graph 15: China outbound Latin America M&A by target sector, 2005-2012



Source: Thomson Reuters



**Jorge Bleck**  
Partner – Corporate

“ The Eurozone debt crisis has afforded China unexpected opportunities to invest in countries such as Portugal, so gaining new markets and strengthening global relationships. ”

> 4.2  
**Interlocking reasons behind China's global M&A**

The single largest driver for China's outbound M&A is its need to secure natural resources to support upgrading and developing its industrial capability, as explained in Section 1.5. Beyond this, the broadening range of asset types acquired and deepening reach into more countries reveal an increasing range of factors behind China's outbound M&A.

First, China wants to make profitable financial investments in assets generating steady revenue, accessing comparatively wealthy overseas markets. These offer cash-rich China a welcome alternative to deepening its foreign currency reserves, enabling it to balance its portfolio and achieve a stable return on investment. Infrastructure assets in mature Western markets appeal as they are established, regulated and typically give a good return. CIC's 2012 acquisition of a stake in the UK's Thames Water exemplifies this trend.

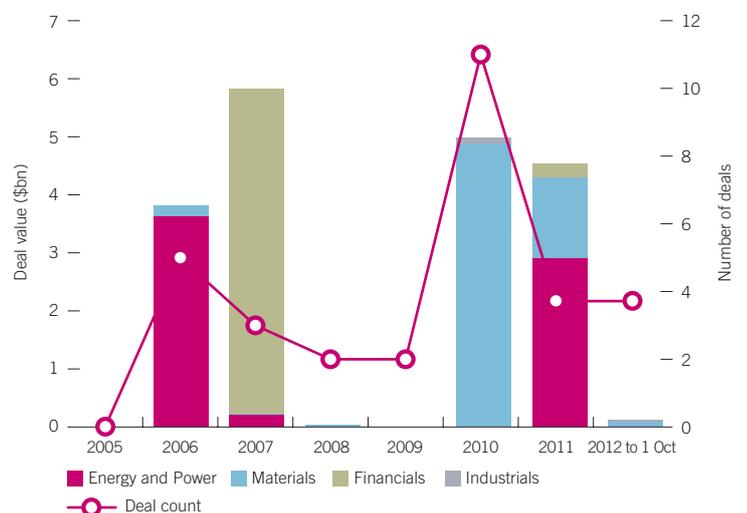
Second, it wishes to acquire well-known foreign brands and products, together with their related knowhow and technology. Taking these back to China is intended to unlock a new home market, tapping into China's aspirations as a growing economy that wishes to overcome the "middle income country trap". For example, through its 2012 acquisition of a £1.2bn stake in UK-based Weetabix, China's Bright Food aims to develop this Western food brand for evolving Chinese tastes. Similarly Western luxury brands appeal, offering potential to open new, high-end markets in Asia. For example, Chinese investors acquired stakes in 2012 in Italy's prototype and sports car manufacturer, De Tomaso Automobili S.p.A., and Italy's luxury yacht manufacturer, Ferretti S.p.A.

Third, it wishes to enter new countries. This allows China to access new markets in those countries and to leverage such investments strategically to open or deepen relationships with other jurisdictions linked to those countries. China's recent investments in Portugal are a case in point. Through Chinese Three Gorges's 2011 acquisition of a €2.69bn stake in Energias de Portugal (EDP) and Chinese State Grid's 2012 acquisition of a €387m stake in Redes Energéticas Nacionais (REN), China has gained new markets in Portugal. But the more significant benefits to China extend much further. Three Gorges targeted EDP's broader markets, including Brazil and the rest of Europe. Through REN, State Grid sought to access the wider

European power market and strengthen ties with key African and Latin American countries including Portugal's former colonies Brazil, Angola and Mozambique. Both directly and indirectly, this type of transaction integrates China more deeply into the global landscape.

Finally, China will take advantage of market conditions. Although China's underlying strategic objectives provide the main impetus for a transaction, a trend of opportunistic acquisitions is visible. For instance, the Eurozone crisis has created unexpected opportunities. Troubled Portugal and Italy have attracted Chinese M&A investment recently, with Portugal's forced asset divestment programme after its May 2011 EU bailout triggering \$6bn asset sales to China in 2011 alone.

Graph 16: China outbound Africa M&A by target sector, 2005-2012



Source: Thomson Reuters



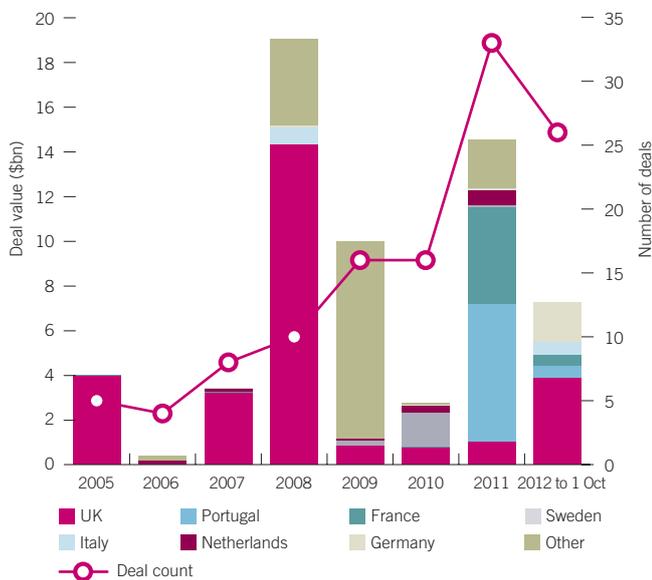
**Judie Ng Shortell**  
Partner – Corporate



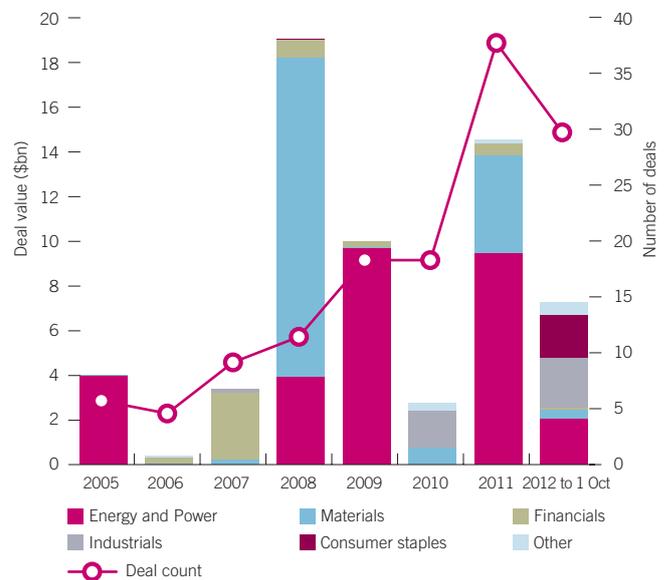
From seeking good financial investments to acquiring foreign brands and knowhow, and deepening their global relationships, diverse factors motivate China's outbound M&A. ”

Graph 17: China outbound Western Europe M&A - (i) target country and (ii) target sector, 2005-2012

(i) China outbound Western Europe M&A by target country



(ii) China outbound Western Europe M&A by target sector



Source: Thomson Reuters

## Europe: one country?

Seen from China, Europe can look like a single country. With an overarching Europe-wide political and legal framework and a single currency for Eurozone countries, this perception holds some truth, but it conceals much.

Individual countries, with their own legal and regulatory regimes, make up Europe. Affecting matters such as tax, company, competition and employment/pension law, it is essential to be able to navigate each country's regime in order to do business in Europe.

The asset opportunities offered across Europe are varied. Italy's luxury brands, Germany's automotive/engineering strengths and Western European infrastructure assets all appeal to Chinese purchasers. In Russia, Chinese M&A focuses on natural resources, complementing China's involvement in Russian power projects and oil/gas supply from major Russian corporates.





**Clodagh Hayes**  
Partner – Corporate



Chinese companies have clear strategic goals when making their outbound investments, and can often achieve these through majority or minority stakes. ”

### > 4.3 Strategies for success

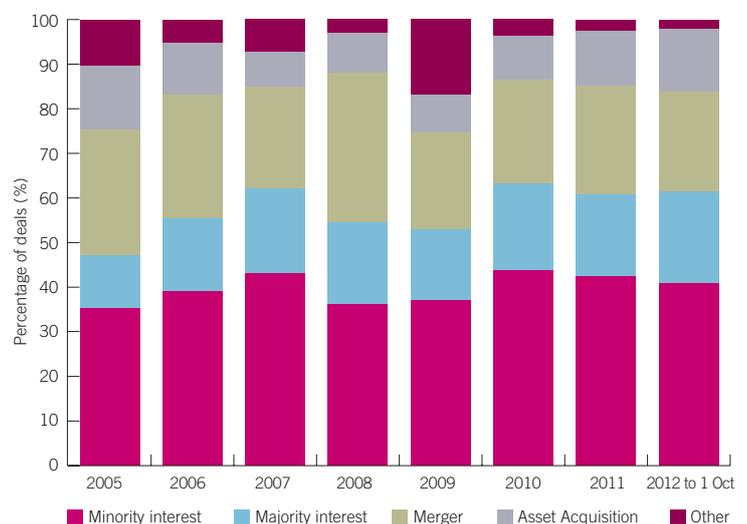
The structure of a transaction is key to its success. In the early days, Chinese entities tended to seek 100% control of the offshore target from day one. But cultural differences, for example in management style, transfer of knowhow essential to the business and the logistical challenge of integrating two very different types of company present significant difficulties in practice. Whilst outright acquisitions still take place, there is therefore a clear trend away from this. The structure now consistently preferred is acquisition of a stake in the target (graph 18).

This structure offers the Chinese purchaser clear advantages. It can ease into a new environment. If the seller remains involved, it may exploit the seller's knowledge of the business, so gaining the expertise it keenly wants. Finally, it may seek equity step-up rights, with a put/call option, to obtain 100% control in the future.

This structure may also hold disadvantages. It may exclude the Chinese purchaser from transactions which must be done by outright sale, such as time-critical deals motivated by financial distress or government/authority ordered divestments triggered by the Eurozone crisis. Anti-trust issues will require careful consideration. While an initial minority interest acquisition may not trigger competition clearances, the exercise of subsequent step-up rights may require these.

Given the complementary strengths of China's SOEs and private equity funds, the Chinese government is encouraging these two groups to join forces on outbound M&A. Acquisition-savvy private equity funds can assist less-experienced SOEs with deal execution, and capital-rich SOEs, in substantially funding the acquisition, can create private equity investment opportunities. Pointing to a growing trend of partnership, examples include SOE Sany's January 2012 investment alongside CITIC in Germany's Putzmeister.

Graph 18: China outbound M&A by deal structure, 2005-2012



But whether this structure will be wholly successful remains to be seen. SOEs typically make strategic acquisitions and have a long-term perspective, whereas private equity funds seek capital growth and an appropriate exit and take a shorter-term view. A potential solution is for the SOE to buy out the private equity investment, possibly under the terms of a put/call option.

Chinese banks have a key role to play in supporting China's outbound M&A. As the largest banks in the world, with stronger balance sheets than their European and North American counterparts, they give Chinese bidders unparalleled access to acquisition financing. Their balance sheet strength also allows them to refinance target debt and provide extended post-acquisition financing, an advantage which can differentiate Chinese bidders. For example, a key factor in Three Gorges winning the 2011 bid for Portuguese EDP was the €1bn financing provided by China Development Bank to EDP as part of the bid.

Chinese companies need to address potential overseas suspicions as to their intentions post acquisition. With foreign sellers concerned that China may simply close the target's existing operations and migrate all technologies back to China, occasional international reluctance to engage with China may dampen Chinese outbound M&A. In response, Chinese companies are demonstrating more willingness to commit to the target's local markets, recognising the need to tap into the global talent pool, to stay at the forefront of technological development and competitiveness, and the levelling playing field in labour costs between China and its international competitors.

The acquisition process itself may require adjustment to fit Chinese purchasers, with the often-used Western auction requiring speed and certainty. With examples of Chinese purchasers failing to acquire assets in auction sales, practical solutions are essential. International sellers looking to attract Chinese bidders may need to adapt their processes, possibly introducing a pre-auction stage to give potential purchasers more time or preparing for more detailed vendor due diligence. Notably, Chinese sovereign wealth funds are not required to obtain the same government approvals as other Chinese entities, giving them a comparative advantage. Appealing to an international seller as they can offer more deal certainty and faster deal execution, this has contributed to a trend of outbound M&A investment by these funds as they couple regulatory advantage and deepening deal experience.



**Wolfgang Sturm**  
Partner – Corporate



Increasing Chinese knowledge of the Western auction process, together with international sellers adapting their processes to fit Chinese purchasers, will nurture more successful China outbound M&A. ”



**Peter Goes**  
Partner – Corporate



Continuing to extend international sellers' knowledge of Chinese-specific issues, and Chinese purchasers' familiarity with international M&A documentation, will help address practical challenges in deal execution. ”

Finally, the deal execution challenges discussed in Section 3.3 apply equally to outbound M&A. Additionally, the law governing outbound M&A documentation is typically not Chinese but an internationally recognised law, such as English or New York law. Any change to this position is likely to take time, requiring a developed Chinese legal regime with a consistent history of interpretation and enforcement and a large population of players familiar with that regime.

Entities who count Chinese nationals with international education and deal experience, or vice versa, among their employees have a natural advantage. Conversant with issues of style and substance on both sides of the table, and potentially fluent in Chinese and English, they are best-equipped to handle the myriad challenges of a transaction. In other cases, practical alternatives can assist. For example, using advisers with combined Chinese/international capability and constantly extending knowledge of each side's position both have a role to play.



*The colour red and the Chinese knot carry special significance in China. Together they symbolise the expression of good wishes, for everything from unity and harmony to prosperity and achievement. The giving of a Chinese knot in a business relationship is often auspicious – a way to wish the recipient every success.*

# 5. Chinese inbound and outbound M&A checklist

## > Chinese inbound and outbound M&A checklist: for non-Chinese market participants

<b>Deal rationale</b>	<p><b>Key commercial drivers:</b> determine approach to key issues (e.g. deal structure, due diligence, timetable, post-deal integration).</p> <p><b>Key attributes (e.g. people, assets, products, markets, licences):</b> check fit purpose.</p>
<b>Risk profile</b>	<p><b>Key risks:</b> assess political, sector, compliance risk.</p>
<b>Counterparty</b>	<p><b>Key issues:</b> identify counterparty's ultimate stakeholders, possible post-deal role, incentives required, offshore assets available as security – Chinese enforcement issues.</p> <p><b>State-owned counterparty:</b> consider sovereign immunity, potential extra regulatory scrutiny, valuation/bidding requirements (I).</p>
<b>Investment restrictions</b>	<p><b>Key issues:</b> identify foreign ownership restrictions, investor eligibility requirements, limits on presence (number of joint ventures, permitted investments) (I).</p>
<b>Policy issues</b>	<p><b>Foreign investment issues:</b> consider national security, continuance of incentives/subsidies, target business licences.</p>
<b>Approvals</b>	<p><b>Key Chinese approvals:</b> identify approval requirements of MOFCOM/Chinese financial regulator/other Chinese government or regulatory body, competition clearances – Chinese remedies possibly stricter than US/EU (I), internal approvals, third party consents (e.g. statutory/contractual pre-emptive rights) (I).</p> <p><b>Timing:</b> assess impact on timetable of approval requirements.</p>
<b>Acquisition structure</b>	<p><b>Key features (e.g. onshore/offshore target, equity/asset acquisition, ownership restrictions):</b> determine appropriate structure.</p> <p><b>Possible structures:</b> map options (e.g. outright control, majority or minority stake – step-up rights/put or call option, joint venture, partnership) to deal's requirements.</p> <p><b>Tax:</b> identify withholding tax liability and treatment.</p>



<b>Financing structure</b>	<p><b>Acquisition financing:</b> identify funding required and available sources.</p> <p><b>Ongoing financing:</b> identify funding required and available sources, debt: equity ratio/thin capitalisation restrictions (I).</p> <p><b>Chinese banks:</b> consider potential role as finance provider.</p> <p><b>Chinese exchange controls:</b> may impact purchase price remittance.</p>
<b>Due diligence</b>	<p><b>Local practice:</b> determines appropriate approach.</p> <p><b>Practical issues:</b> assess timing, extent of available/desired information, facilitating role for meetings.</p>
<b>Deal protection</b>	<p><b>Overarching principles:</b> consider appropriate overall investment principles and approach to key commercial issues.</p> <p><b>International warranty package:</b> consider Chinese receptiveness, importance of disclosure to assess deal's risk profile (I).</p> <p><b>Price protection:</b> fixed price – valuation to be finalised early, payments in kind and deferred consideration restricted in China (I).</p> <p><b>International valuation techniques:</b> check acceptable to Chinese party.</p> <p><b>IP rights:</b> consider protection in China, registration (I).</p> <p><b>Legal issues:</b> check choice of law, dispute resolution – arbitration/courts, enforcement options.</p> <p><b>Chinese language:</b> translations or language of documents.</p>
<b>Governance</b>	<p><b>Key policy:</b> consider control rights, 50-50 or minority protection.</p> <p><b>Local practice:</b> impacts management, governance, step-up/exit rights.</p>
<b>Integration</b>	<p><b>Key issues (e.g. compliance structure, local culture, management, licensing):</b> impact post-deal-integration.</p>

# 6. Key contacts

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This report is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of the contacts listed in the report.

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