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RECENT TRENDS AND ISSUES IN OUTBOUND ACQUISITIONS BY CHINESE COMPANIES

By Fang Xue, Yuefan Wang and Qi Yue

Fang Xue is a partner and Chief Representative of the Beijing office of Gibson, Dunn & Crutcher LLP. Yuefan Wang and Qi Yue are associates in Gibson Dunn's Beijing office. Contact: fxue@gibsondunn.com.

Chinese outbound M&A activity continues its breakneck pace in 2016. In the first three quarters of the year, the total value of deals announced exceeded $218 billion, already almost double the total for the entire previous year and putting China on pace to be the number one cross-border acquirer in the world for the year.[1] Chinese acquisitions of U.S. companies are a key part of this significant growth, amounting to well over $30 billion in the first half of 2016, representing a sevenfold increase from the same period last year and accounting for almost 30% of China's total outbound M&A.[2] The drivers of this record-breaking outbound M&A activity continue to be a combination of slowing domestic growth, supportive government policies, consolidation among small-to-medium-sized potential domestic targets, growth potential in foreign markets, attractiveness of foreign firms, and the fundamental changing of the Chinese economy.

However, while overall outbound Chinese M&A into the U.S. remains strong, a number of countervailing trends persist. Along with the increase in Chinese acquisitions of U.S. companies, there has been a concomitant increase in withdrawn bids. In the first half of 2016, 15 deals were withdrawn by Chinese buyers, representing a total value of $24 billion, up from 10 withdrawn bids representing $1.6 billion in 2015.[3] Indeed, by the estimate of the Boston Consulting Group, Chinese buyers complete just 67% of announced outbound deals, far fewer than peers in the U.S., Europe, and Japan.[4] This high incidence of failed transactions has led many observers to question the commitment of Chinese buyers to follow through on deals, even when Chinese buyers propose higher purchase prices.

While this problem may be attributed in some cases to relative inexperience with cross-border deals, there are a number of factors unique to Chinese buyers that play a larger role—CFIUS review, PRC regulatory requirements, Chinese financing, and Chinese acquirers' often opaque ownership structures. Because of these risks, foreign sellers often ask for a "China premium" on prices as well as reverse termination fees and additional covenants to provide more comfort that deals will be completed.

CFIUS

The Committee on Foreign Investment in the United States is an inter-agency committee of the U.S. federal government authorized to review, investigate and

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block transactions of investments that could result in the control of a U.S. business or assets by a foreign person that may raise national security concerns.

CFIUS is focused on areas of particular national security concern, including foreign control of U.S. businesses that:

- Provide products/services that could expose national security vulnerabilities, including cyber-security concerns or vulnerability of supply chain;
- Implicate critical infrastructure;
- Are involved in activities related to weapons and munitions manufacturing, aerospace and radar systems, or that otherwise do business in defense, security or law enforcement sectors;
- Engage in R&D, production or sale of technology, goods, software or services subject to export controls;
- Produce advanced technologies useful to national security, including "dual use" technologies that have both commercial and military applications; or
- Create potential espionage concerns, for example by nature of a business or asset's proximately to military locations.

CFIUS pays particular focus on the acquisition of control by foreign persons that are controlled by a foreign government or from a country with nonproliferation or other security concerns. CFIUS, which is not a judicial court, reports directly to the U.S. President. It is often viewed as political in nature and is especially sensitive to the prevailing political environment.

CFIUS is perceived by Chinese acquirers as a major barrier to U.S. acquisitions as they are concerned that CFIUS may either block a transaction or impose significant regulatory and operational costs on them as a means of mitigating perceived national security risks. Sometimes the mere threat of CFIUS review can still cause buyers to withdraw offers and sellers to reject bids.

- **Lumileds**. GO Scale Capital's $2.8 billion bid for an 80% stake in Philips NV's Lumileds subsidiary was blocked by CFIUS on national security grounds; even though Philips and Lumileds are both based in the Netherlands, CFIUS found that Lumileds had a large U.S. patent portfolio and sizable manufacturing and R&D presence in the U.S.
- **Western Digital**. Unisplendour Corp. Ltd terminated its $3.78 billion offer for a 15% stake in Western Digital Corp. after a decision by CFIUS to conduct an investigation.
- **Fairchild Semiconductor**. Fairchild Semiconductor International Inc. rejected a topping bid (a bid offered by a third party for a target that has already signed a merger agreement with another buyer) by China Resources Microelectronics Ltd. and Hua Capital Management Co. Ltd. after Fairchild's board concluded that the bid, which included a proposed $108 million CFIUS reverse termination fee, was not superior to another bid with a lower purchase price because CFIUS review posed an "unacceptable level of risk."
- **Strategic Hotels & Resorts**. Anbang Insurance Group entered into an agreement worth $6.5 billion with Blackstone Group

LP for 16 hotels. While 15 of the 16 hotels ultimately were sold to Anbang, Blackstone kept the iconic Hotel Del Coronado in San Diego amid objections from CFIUS because of the hotel's close proximity to a major naval base.

Merger agreements between Chinese buyers and U.S. sellers address CFIUS risk in two potential ways: reverse termination fees (RTFs) and covenants. RTFs are, as the name implies, the opposite of a traditional break-up fee: the buyer pays the seller a fee if a deal does not close due to the failure to satisfy a particular closing condition. Sellers may specifically ask for payment of an RTF related to CFIUS. In our survey of recent deals and bids, less than 25% had an RTF specifically triggered by failure to obtain CFIUS approval.

Agreements also typically include covenants related to mitigation measures imposed by CFIUS or the buyer's efforts in obtaining CFIUS approval. Breach of these covenants may trigger payment of the RTF as well. In our survey of recent deals, almost 70% had covenants related to CFIUS. Of these, the vast majority provided that the buyer is responsible for mitigation measures related to CFIUS, as long as such measures do not have a "material adverse effect" on, or an "adverse effect that is material to," the buyer or seller. Other less common covenants include:

- "Reasonable best efforts" standard for mitigation measures;
- Ceilings and floors for divestitures; and
- "Hell or High Water" covenants where buyer bears full responsibility for CFIUS risk, including unlimited divestitures.

The "Hell or High Water" covenant is particularly harsh for buyers, and less than 5% of deals surveyed had such a covenant. Additionally, a number of agreements do not have specific CFIUS covenants but rather covenants related to "governmental approvals" or similar language.

There are a number of reasons why RTFs tied to CFIUS approval are far less common. Chinese buyers are understandably hesitant to pay a breakup fee for a condition over which they have little control; while arguably U.S. sellers would have a better understanding of their domestic regulatory regime. Chinese buyers are also worried that RTFs conditioned on CFIUS approval would provide a disincentive for sellers to take full action to ensure such approval. Indeed, based on our survey, Chinese buyers who agreed to RTFs for CFIUS approval appeared to be either in a competitive auction setting or in connection with submitting a topping bid. For example, HNA Group Co. won its bid for Ingram Micro Inc. in part because it offered Ingram a $400 million CFIUS RTF where its two closest rivals did not.[5]

PRC Regulatory Approvals

While PRC outbound investment regulations are generally trending toward deregulation, the regulatory requirements can still be unpredictable, with little or no advance notice of changes. In general, all outbound investments by Chinese companies involve a filing with, or, in certain circumstances, approval of, the following regulatory bodies: the State Administration of Foreign Exchange (SAFE); the National Development and Reform Commission (NDRC); and the Ministry of Commerce (MOFCOM). Public companies listed in China that wish to use equity financing in connection with a major acquisition will likely require the approval of the China Securities Regulatory Commission (CSRC) as well. State-owned enterprises (SOEs) will also need the approval of the state-owned Assets Supervision and Administration Commission (SASAC) for outbound investments.

Sellers often negotiate for payment of an RTF due to a failure to obtain PRC regulatory approvals. Of recent deals and bids surveyed, almost 70% had RTFs with such a trigger. Additionally, merger agreements often have covenants requiring the seller and/or the target to file for, and to cooperate in obtaining, PRC regulatory approvals. Nevertheless, the chief concern is usually not uncertainty over *whether* PRC regulatory approvals will be obtained, but rather *when* they will be obtained; parties should therefore provide for sufficient termination dates in their merger agreements. Of recent deals surveyed, initial termination dates ranged from as short as three months to as long as nine months, with about half having initial termination dates of six months, with options to extend.

Recently, there have been signs that moving money out of China is becoming a challenge for Chinese acquirers, including longer approval periods. The merger agreement in the recent take-private of Trina Solar allocated three months specifically to obtain the required foreign exchange approvals, a heretofore unseen clause.

Financing

U.S. sellers often cite buyer financing problems as the cause of withdrawn bids, while Chinese buyers usually point to other reasons. One reason for the confusion may be that Chinese buyers and U.S. sellers often view the sufficiency of funding differently. Chinese financing may not be as committed at signing as compared to a typical U.S. deal. Indeed, local Chinese banks may be unable to produce U.S.-style debt commitment letters. Chinese buyers also typically do not agree to be subject to an obligation to enforce funding obligations of Chinese banks. Whether direct or indirect, real or perceived, financing issues have dogged a number of high-profile deals:

- **Terex**. Zoomlion Heavy Industry Science & Technology Co. Ltd.'s topping bid for Terex Corporation may have failed partly due to financing issues; in a public dispute, Terex claimed that Zoomlion was not able to arrange for committed financing. However, Zoomlion said the issue was ultimately the parties' inability to agree on price.

- **Pericom Semiconductor.** Montage Technology Group's topping bid for Pericom Semiconductor Corp. was rejected by Pericom. In another public falling-out, Pericom said that the deal fell through in part due to regulatory concerns and also asserted that Montage was "unable or unwilling to obtain committed financing," while Montage alleged that Pericom was merely employing "scare tactics."

- **Starwood.** Anbang Insurance Group's failed bid for Starwood Hotels and Resorts Worldwide, Inc. is likely the most notorious example of a failed bid by a Chinese acquirer. Anbang's high-stakes bidding war with Marriot International, Inc. eventually ended with Anbang abruptly withdrawing its offer three weeks after it unveiled a non-binding bid.

Credit Support for Reverse Termination Fees

Sellers typically request RTFs for two reasons. First, sellers typically want Chinese buyers to bear regulatory risks, as described above, by asking for an RTF triggered by the failure to obtain required PRC regulatory approvals. Second, judgments against Chinese buyers in U.S. courts impose enforcement issues, particularly where such buyers do not have any assets in the U.S., and RTFs may provide more reliable recourse to ensure the buyer has real incentive to perform. Sellers also typically ask Chinese buyers to provide some form of credit support for the obligation to pay the RTF, and sometimes the purchase price. Of recent deals surveyed, approximately75% had some form of credit support for RTFs. The following are the common types of credit support mechanisms used:

- Requiring a cash deposit into an offshore escrow account located outside of China (approximately 55% of recent deals surveyed with RTFs);
- Requiring a cash deposit into an onshore escrow account located within China (approximately 20% of recent deals surveyed with RTFs);
- Parent or shareholder guarantee (approximately 20% of recent deals surveyed with RTFs); or
- Letter of credit (approximately 15% of recent deals surveyed with RTFs).

Note that a small number of deals surveyed had more than one form of credit support (*e.g.*, both an onshore and offshore escrow account, or both a guarantee and an escrow account).

Conclusion

Though the past few years have seen Chinese buyers join the ranks of the most prolific cross-border acquirers, a number of high-profile withdrawn bids have highlighted and reinforced the idea that Chinese buyers are sometimes unable or unwilling to close deals. While inexperience is partly to blame, Chinese buyers still face particular challenges that U.S. and other foreign acquirers do not face. As is often the case, perception can become reality; the danger is that this perception may unfairly bias U.S. companies against selling to Chinese buyers. Indeed, the real casualty may ultimately be U.S. shareholders who are unable to capture the higher purchase prices often offered by Chinese buyers. The solution may lie in experienced advisors, better communications and a fair allocation of transaction risks—while the road may be bumpy, the destination offers promising rewards for Chinese buyers, U.S. sellers, and, ultimately, shareholders on both sides.

ENDNOTES:

[1]*China Deal Watch*, Bloomberg.com, October 24, 2016.

[2]Dealogic.com.

[3]"China Inc. Tries to Buy the World, with Impeccable Timing," Wolfstreet.com, May 11, 2016.

[4]"Gearing Up for the New Era of China's Outbound M&A," The Boston Consulting Group, September 24, 2015.

[5]Definitive Proxy Statement filed with the SEC by Ingram Micro Inc. on May 19, 2016.