

A brave new world for Chinese M&A

The way is now open for foreign investors to take over Chinese companies. The question is how the authorities will react to a high-profile deal, say David Boitout and Raphael Chantelot

New rules in China enable large foreign investors to acquire substantial shareholdings, and possibly even controlling interests, in listed companies. They promise an entirely new field of M&A activity in China. But they may take a few more months to materialize. It will depend on the willingness of the Chinese authorities to approve high profile transactions in the face of certain public anxiety about foreign investors.

On December 31 2005, the Ministry of Commerce (Mofcom), the China Securities Regulatory Commission (CSRC) and other Chinese authorities (tax, industry, exchange control) jointly published new rules that constitute a major breakthrough in the history of foreign direct investment in China.

These rules, the Administrative Measures for Strategic Investment by Foreign Investors in Listed Companies (referred to as the 2006 Regulations) are intended to regulate acquisitions of large equity stakes by foreign investors in Chinese listed companies. They reverse the traditional containment of foreign investors outside Chinese stock markets.

They come at time when Chinese capital markets are at a crossroads. The Chinese authorities are engaged in the reform of the segmented shareholding structure of listed companies. Under the present system the majority of shares in listed companies, the non-tradable shares, cannot be listed and traded on the stock exchange, and only a minority of shares is actually listed.

However, the 2006 Regulations extend far beyond merely granting foreign investors the right to acquire minority shareholdings in listed companies. Indeed, they expressly contemplate that a foreign investor may acquire control of a Chinese listed company.

The reform of non-tradable shares

Chinese stock markets have two distinctive features that have blocked development and kept foreign investors away. Firstly, only a minority of the

shares in a listed company is actually listed. Secondly, foreigners are normally not allowed to invest in listed shares. These restrictions are now in the process of being removed.

Publicly listed companies in China traditionally have a dual, segmented shareholding structure, whereby only a minority of their shares (so-called A-shares), are listed and tradable on the stock exchange. The other shares are non-tradable, often representing two-thirds of the total and are held by government entities (for former state-owned companies) or private persons (for more recent companies).

Non-tradable shares were created by the Chinese authorities in the early 1990s to prevent uncontrolled sales of state-owned enterprises to private investors. But the system became a burden in the face of the growing need to develop the stock markets and attract more investors to finance Chinese companies. At the same time, the prospect of dilution from the conversion of the non-tradable shares into tradable shares posed a threat to investors, and affected the performances of the stock markets.

Several unsuccessful experiments have been made since 2000. But the Administrative Measures on the Split Share Structure Reform of Listed Companies (referred to as the 2005 Reform Rules), issued by the CSRC in September 2005, now set the framework for the conversion of the non-tradable shares into ordinary A-shares.

A key feature of the 2005 Reform Rules is that they impose a minimum 12-month lock-up on non-tradable shares following their conversion into A-shares. After this period, holders of

formerly non-tradable shares who hold more than five percent of the company's shares may only sell a limited number of shares, no more than five percent of the total shares within 12 months and no more than 10% within 24 months.

Prior to the 2006 Regulations, the general rule was that foreign investors were prohibited from purchasing ordinary A-shares of companies listed on the Shenzhen and Shanghai stock exchanges. The exceptions to this principle were very limited.

One exception allowed foreign investors to purchase so-called B-shares, which are denominated in foreign currency and only issued to non-Chinese investors. But the B-shares are used less and less by Chinese listed companies, and the A-shares and B-shares markets may soon be merged.

Another interesting exception, introduced in November 2002, allowed foreign investors to purchase non-tradable shares of listed companies. But the

burdensome procedures involved made this solution quite unattractive. In any event, the wide ranging reform of non-tradable shares will soon make this alternative irrelevant.

The last exception is for large

financial institutions that count as a Qualified Foreign Institutional Investor (QFII) to purchase limited quotas of A-shares. However, the quotas allocated are limited, and the investment in any company is capped at 10%.

In contrast to these limited exceptions, the 2006 Regulations set the new, general principle that large foreign investors can acquire large stakes of A-shares (at least 10%) in Chinese listed companies with a view to making strategic long-term investments. By doing so, they open up a new and promising route for foreign direct investment in China.

Who can ride?

The conditions for a strategic investment in a Chinese listed company relate to both the foreign investor and the investment itself.

The benefits of the 2006 Regulations are reserved for foreign investors who have at least \$100 million in tangible overseas assets, or \$500 million in over-

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seas assets under management. These relatively low thresholds should allow a wide range of foreign companies to benefit from the 2006 Regulations.

These requirements are satisfied if the investment is carried out by a wholly-owned subsidiary of a company that meets these tests and accepts to be jointly liable with its subsidiary. This introduces a great deal of flexibility for a foreign investor to structure its investment. But any subsequent sale of a subsidiary which has served as an acquisition vehicle will be subject to Mofcom approval.

The 2006 Regulations also require the foreign investor to fulfill the so-called classic requirements: a sound financial position, good credit rating and established management experience; sound governance structure and internal control systems; and no significant sanctions in the past three years.

So far only two routes are available for investing under the 2006 Regulations: acquiring existing shares in a private transaction or subscribing to new shares in a private placement.

The target company must have completed the reform of its non-tradable shares and the investment must represent at least 10% of the shares. The foreign investor must also obtain the prior approval of Mofcom and agree to a three year lock-up.

These two last conditions clearly reflect that, in the eyes of the Chinese authorities, any investment under the 2006 Regulations must be a long-term partnership. It is in this light that Mofcom will review the applications submitted by foreign investors.

Obviously, the lock-up period is the key condition for any foreign company. No sales or other form of transfers are possible during this period and Mofcom is unlikely to grant exemptions easily. After three years, the shares may be sold in the open market and the proceeds of the sale can be transferred outside China.

How to invest

Under the 2006 Regulations a strategic investment must be approved by the board of directors of the target company and then by its shareholders' general meeting. Then the foreign investor must file with Mofcom for preliminary approval, which is normally delivered within 30 days.

Once it has obtained approval in principle from the Mofcom, the foreign investor can proceed with the purchase of the shares and their registration with a securities firm. The last stage in this process is

applying to Mofcom for a final certificate of approval. If the target shares are held by state-owned entities, the specific procedure for the transfer of state owned assets (mandatory valuation and auction procedure) will apply.

If a foreign investor acquires more than 25% of the total shares, the target company may enjoy the favorable tax treatment granted to Foreign Invested Enterprises in China. This is conditional on the foreign investor committing to maintain its shareholding for more than 10 years.

Towards foreign takeovers

The 2006 Regulations go far beyond addressing foreign acquisitions of minority stakes in Chinese listed companies. Indeed, they expressly contemplate a foreign investor taking over a listed company, which was inconceivable a few years ago.

But such a radical change will take time, as it will probably raise political concerns and reluctance on the part of the Chinese authorities. Several legal uncertainties also need to be solved. One pressing and crucial question, for instance, is whether transactions can take place immediately.

When reading the 2006 Regulations in conjunction with the 2005 Reform Rules, one may get the impression that no transaction can be carried-out under the 2006 Regulations in the near future. The one year lock-up period and subsequent restrictions in the 2005 Reform Rules seem to bar foreign investments in formerly non-tradable shares over the next three years.

Such an interpretation seems inconsistent with the purpose of those regulations, which is to have foreign investors support the implementation of the Reform Rules by absorbing the former non-tradable shares arriving on the market as a result of being converted into A-shares.

A more practical interpretation of the 2005 Reform Rules is that they only apply to sales effected via trading (to avoid a chaotic flood of sell orders on the new shares). If that is the case, the rules would not block sales to identified investors off-market (such as the purchase by foreign investors of large blocks of new A-shares).

The CSRC is reviewing new rules which are expected to confirm that, aside from trading on the stock exchange, tradable shares can also be transferred by agreement. Such agreement could be a contract for the acquisition of shares in a

listed company by a foreign investor as contemplated by the 2006 Regulations.

As a result, strategic investments under the Regulations could take place immediately and would not be subject to the lock-up and trading restrictions set forth in the 2005 Reform Rules.

Most Chinese listed companies are controlled by the holders of non-tradable shares (who generally hold two thirds of the shares). The purpose of the 2006 Regulations is to ease the acquisition of these shares (after they have been converted into A-shares) by foreign investors. As a result, it seems inevitable that, in many transactions, foreign investors will actually take control of Chinese listed companies.

This type of foreign takeover will probably take more time to materialize. But any foreign investor planning an investment in a Chinese listed company, or thinking of acquiring control in the longer term, should be aware that the acquisition of a shareholding exceeding 30% will trigger the obligation to launch a tender offer.

Under the revised Chinese Securities Law any entity purchasing more than 30% of the shares in a listed company must issue an offer to all its shareholders, unless it is exempted by the CSRC. The details of the general offer procedure are contained in the 2002 Takeover Rules, which are being revised by the CSRC.

Under these rules, the purchaser must file a takeover report detailing the main provisions of this agreement with the CSRC and issue a press release summarizing the information.

The price in a general offer should be the higher of the price paid by the foreign investor in the acquisition of the controlling block and 90% of the average of the stock price in the 30 trading days preceding announcement of the takeover.

One last, important point is that the takeover rules seem to go beyond the 30% threshold by referring to the notion of practical control. Even if the foreign investor decides to remain under the 30% ownership threshold, there is a risk that the tender offer obligation may be triggered. It could occur, for instance, if a shareholders' agreement were to be signed by other major shareholders to share management rights (and as result, practical control).

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