



People's Republic of China

After years of growing deal activity, China experienced a decline in transactions in June to November of 2008. Domestic M&A activity saw a rebound at the end of the year; however it is unclear whether this was caused by a general recovery or by a year-end rally also experienced in prior years



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Current Environment

A favourite slogan among Chinese people during the recent Olympic games was '中国人加油' 'Zhong Guo Ren Jia You'. This can be translated as 'Go China!' and literally 'Jia You' means 'add gas', for example to increase the heat or to re-fuel your car. Recent months have seen the need for the government to 'Jia You' as economic growth started to slow significantly.

In 2008, GDP growth was 9.6%, but this was slower than the record high of 11.4% in 2007, and by Q4 growth had slowed to 8% p.a. This reflected a slowdown across the economy but this was most pronounced in exports and fixed asset investment.

In November 2008, Chinese exports declined for the first time in seven years as China's main trading partners in Europe and the US slipped into recession. At a national level this effect is being partly offset by declining imports as global commodity prices fall, but it is having a noticeable impact on major export areas such as the Pearl River Delta.

China's industrial output growth in October was the lowest in seven years, as falling investment growth (both domestic as well as FDI) in apartments, factories and infrastructure resulted in a lower demand for steel, aluminium and cement.

However on the positive side, inflation, which reached a high in February 2008 of 8.7% p.a., was down to 4% p.a. by November 2008. This was due to reduced raw material import prices, as well as the alleviation of the inflationary spike caused by pork shortages earlier in the year. The fall in inflation has allowed the government to change its policy emphasis from cooling demand to stimulating the economy. Several policies introduced earlier in the year to prevent a bubble in the stock and real estate markets have been reversed, including a reduction in interest rates; easing of property down payment regulations; lowering of property transaction taxes; abolition of bank lending quotas; and a reversal of stamp duty tax on stock purchases.

To increase export levels, VAT rebates were re-instituted for export companies. After three years of gradual appreciation of the Rmb against the US\$, a depreciation of the Rmb was noticed in November 2008. Although the increase in US\$ value from 6.83 to 6.89 is small, it may have a positive impact on exports.

To accelerate investment and capital expenditure, a Rmb4 trillion (US\$586 billion) stimulus package for national infrastructure and social welfare projects, including constructing new railways, subways, airports, and hospitals, was announced. US\$100 billion was scheduled to be spent by the end of 2008.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

With 867 announced deals, deal activity in China's M&A markets in the fourth quarter of 2008 was down by 4% compared to the same period last year. However, 2008 began strongly with 24% growth in deal activity in the first six months, to reach 1,476 announced transactions (valued at US\$73 billion) in the first half of the year compared to 1,186 in the first half of 2007 (valued at US\$40 billion). Activity levels dropped in the period June to November, resembling deal activity levels last seen prior to 2006, largely because of global financial uncertainty. While the 'real' economy remained relatively robust, both strategic and financial buyers were waiting on the sidelines to see how events developed. Deal activity in December 2008 was comparable again with activity levels experienced in December 2007, mainly driven by domestic deal activity.

Inbound deal activity decreased by 11% in 2008 compared to the prior year as foreign strategic buyers paused to see how far global events would affect China, and also looked to preserve cash to manage their existing operations 'back home'.

The manufacturing sector was the most active sector by number of deals, while real estate was the biggest sector by deal value. Some sectors have shown growth in 2008 compared to 2007, mainly as a result of higher activity levels in the first half of 2008. Deals in media, textiles and infrastructure showed growth compared to full year 2007. This reflects some relaxation of foreign investment regulations related to advertising; a consolidation in the garment industry partly as a result of declining export demand; and the increased popularity of the infrastructure sector, which is likely to remain attractive after the announcement of the government stimulus plan.



The new anti-monopoly law which came into effect on 1st August 2008 has not obstructed companies from doing deals, with inBev's acquisition of Anheuser Busch cleared by a Ministry of Commerce ("MOFCOM") review. However, the approval differed in some respects from what is common in other countries. While approving this transaction, MOFCOM put in place restrictions on potential future acquisitions in China by inBev/Anheuser Busch.

The inBev/Anheuser Busch merger was a transaction of two foreign companies with activities/subsidiaries in China. The largest ever acquisition of a Chinese domestic company by a foreign company, Coca Cola's proposed US\$2.5 billion acquisition of Huiyuan Juice, announced in the third quarter of 2008, is seen as a real test case of the new anti-monopoly law. Huiyuan is a domestic company with a famous brand in the Chinese market, and the deal is therefore likely to be subject to significant scrutiny.

Private Equity

Both domestic and foreign Private Equity ("PE") investors continued to raise China related funds (both Rmb as well as US\$ funds) during 2008. In 2008, approximately US\$14.4 billion was raised compared to US\$7.3 billion in 2007.

Private Equity buyers see buying opportunities as valuations decrease and alternative sources of capital dry up, and have the cash to make acquisitions. However, vendors remain reluctant to accept lower valuations, leading to a 'valuation gap'. Consequently, the number of deals fell by nearly 60% in the second half of 2008 compared with the same period a year earlier, and average deal sizes remained quite small for the industry at less than US\$100 million, although this number is showing an upward trend.

Domestic Chinese PE funds are becoming more active, and, since they do not need some of the approvals that foreign funds need, they have a faster transaction execution time compared to their foreign peers. This could be a big advantage in current market conditions where growth deals with minority stakes continue to dominate, with few leveraged buy-outs.

Another reason for decreased financial buyer activity is that the IPO exit opportunities have ceased as a result of the current stock market conditions. Many of the deals done in 2007 were pre-IPO investments. This type of transaction is not currently viable, and many of the pre-IPO deals which were done in 2007 are now coming unstuck and need to be restructured.

Outbound

Outbound deal volume slightly decreased in the second half of the year compared to the same period last year, falling 7% to 96 transactions, again due to the impact of the global economic downturn. Chinese companies still have money and government support to invest abroad but have put M&A activities on-hold in the second half of 2008 to wait for overall

economic conditions to improve. Many of China's outbound investments from earlier years are showing large unrealised losses, and while the current economic turmoil clearly represents an opportunity for well funded Chinese buyers, they are understandably wary about moving too quickly.

The European bank and insurance company Fortis NV/SA was nationalised by the Belgian government at the end of September, to prevent it from collapsing. Ping An Insurance was the largest shareholder, with 5% of the shares in Fortis, and has asked for support from the Chinese government to help negotiate with the Belgian government to have its losses compensated. Ping An is referring to a treaty between Belgium and China that was established to protect investors from losses resulting from nationalisation by the government.

As in earlier years, the main industries for Chinese acquisitions abroad were still mining and financial services. However, other sectors were evident, including deals in high-tech industries such as medical equipment, hardware/software, and biotechnology. This reflects the increased level of maturity of the Chinese economy and the shifting of China's focus to industries higher up the value chain.

Outlook

Although growth forecasts are being reduced, the World Bank still expects GDP growth of 7.5% in 2009. While this would be an enviable rate of growth in many countries, the government is keen to maintain a high level of growth to maintain rising living standards and prevent social instability. Most commentators expect a weak first half, followed by recovery in the second half as the government stimulus package takes effect.

Looking forward, overall M&A activity in China will remain slow in the first half of 2009 with some pickup anticipated in the second half as pricing expectations align, and both domestic and foreign buyers take advantage of opportunities to consolidate and restructure in sectors affected by the slowdown. The government has also been discussing permitting loans to finance M&A activity which would give the market a further boost.

We expect to see foreign investment into China increase as well as outbound deals to secure resources at relatively low prices. One possibility is Chinese buyers making tender offers for oil and mining companies listed abroad, benefiting from falls in stock market prices, and the same could happen in China with PE investors focusing on Private Investment in Public Equity. Within China, PE deals may be the first to recover. But given its much larger scale, domestic and foreign strategic buyer activity will need to stage a strong recovery if we are to see any growth at all in 2009.

Despite present difficulties, we expect M&A activity in China to recover more quickly than other regions of the world, largely due to both China's comparatively strong current growth rate, and the longer term potential offered by the Chinese market. ■