North Asia

People's Republic of China

China M&A activity bouncing back from the downturn

Matthew Phillips
Transactions Leader
China

China's main economic indicators in the fourth quarter of 2009, such as GDP growth, industrial output, foreign direct investment, export value and import value, all indicate that China has emerged from the economic downturn.

M&A activity in the second half of 2009 also rebounded and returned to 2008 levels mainly driven by domestic Chinese strategic and financial buyer deal activity. Outbound deal activity reached record levels in 2009, with the highest value and volume of deals ever recorded.

Current Environment

China's GDP grew 8.7% in 2009, mainly driven by the impact of stimulus measures implemented by the government, such as increased government spending for infrastructure projects and relaxed monetary policies. New Renminbi-denominated loans in the first 11 months of 2009 amounted to RMB9.2 trillion, which was approximately 45% higher than in the same period of 2008.

Industrial output increased by 16.1% and 19.2% in October and November 2009, respectively, compared to the same months in the prior year. Interestingly, despite rising industrial output, there was a decrease in the value of exports, indicating that Chinese domestic consumption is gaining importance for the country's economic growth which, historically, has been export driven.

Foreign direct investment amounted to US$77.9 billion in the first 11 months of 2009, down by 9.9% compared to the same period last year. This underscores the decline experienced in the first half of 2009, which saw overseas investors focused on managing the impact of the economic downturn vis-à-vis expanding overseas. Foreign direct investment showed growth in the months following August 2009 after 10 consecutive months of decline, indicating that foreign investors are once again focusing on China and continue to place strategic importance on expanding their presence there.

The value of exports decreased by 18.8% year-on-year in the first 11 months of 2009. However, the rate of decline slowed to 1.2% in November 2009, indicating a possible end to this 13-month trend.

Import values have recently shown strong signs of growth, increasing 26.7% in November 2009 compared to November 2008. This increase was caused by a greater need for steel and iron ore to supply rising industrial output and urban fixed asset investments, as well as the rising price of crude oil[1].

Although import values increased in the fourth quarter of 2009, the total value of China's imports decreased by 15.8% year-on-year for the first 11 months of 2009.

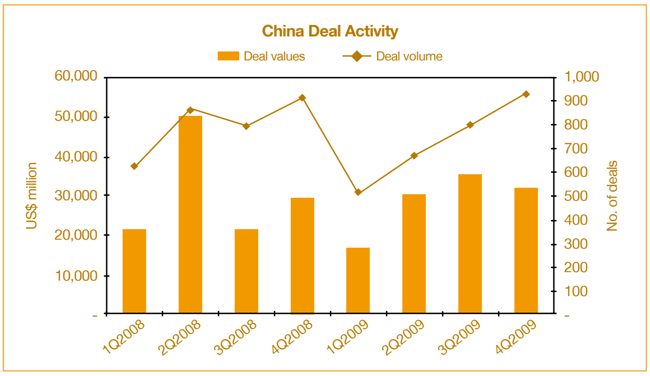
Despite the decline in 2009 export values, overall export values in 2009 still exceeded import values. Additionally, foreign direct investment (FDI) into China rebounded in the second half of 2009. A combination of net exports and continued FDI has led to China's foreign exchange reserves to increase from approximately US$1.9 trillion at the end of December 2008 to approximately US$2.8 trillion at the end of November 2009.

2009 saw a continued increase in property prices and stock market indices. The Shanghai Composite Index closed at 3,277 points at the end of December 2009, representing an increase of 80% compared to 1,821 points, a year earlier. In addition, as mentioned in the mid-year 2009 issue of this publication, the stimulus money may have, indirectly, been invested in the stock market and the Chinese government is also concerned that part of the FDI included foreign speculative capital. This speculative capital may lead to the creation of asset bubbles and an excess of liquidity which could stoke inflation; the first signs of inflation may already exist with the consumer price index (CPI) rising by 0.6% year-on-year in November 2009, after nine months of decline.

In addition to the general market growth, another reason for concerns about the inflow of speculative capital is that foreign investors are anticipating an appreciation of the Renminbi as an additional return on their investment. International political pressure on China to revalue the Renminbi has continued to increase from many foreign countries. When the President of the United States visited China in November analysts expected a slight appreciation that did not happen. In December, Chinese Premier Wen Jiabao re-emphasised that the government would not respond to international pressure to revalue the Renminbi.

[1] For illustration, the average spot price of a barrel of West Texas Crude was approximately US$78 versus US$57 a year earlier. In the first 10 months of 2009 the oil price has not been higher than price in the same period in the prior year.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2009.

In the first half of 2009 deal volumes fell 22% compared to the same period in the prior year and 32% compared to the second half of 2008. However, the number of transactions in the second half of 2009 showed a quick recovery.

Domestic and inbound M&A deal volumes in China in the second half of 2009 are returning to robust 2008 levels, indicating that the impact of the global economic downturn on M&A in China was short lived. Almost 1,600 domestic (China buyer) and inbound (foreign buyer) transactions were recorded in the second half of 2009, a total of about 2,700 deals for the full year. This compares to 1,607 deals for the second half of 2008, and a total of approximately 3,000 deals for the full year of 2008.

Underscoring the return of healthy deal volumes is the number of domestic transactions, indicating that deal makers are pleased with the growth of the Chinese economy through the global financial crisis and that they continue to be confident about the future.

Foreign strategic investors

Foreign strategic deal activity continued the decline that started in 2007, with less than 500 announced deals for the full year of 2009, representing a 27% drop from 2008 levels. Foreign buyers have been sorting out problems with their existing operations and this has taken their focus away from expansionary acquisitions.

Financial buyers

Financial buyer activity is comparable to 2008, but represents only 4.5% of overall domestic and inbound deal volume, less than 123 announced transactions. However, with 39 announced transactions in the third quarter of 2009, the domestic (as opposed to foreign) financial buyer activity reached its highest quarterly level. The annual deal activity levels for domestic financial buyers was at its all time high with 94 deals for 2009 compared to 87 deals in the full year of 2008.

Foreign financial buyers were more focused on maintaining and improving operations at their portfolio companies and found new deals harder to come by as gaps in pricing expectations between sellers and buyers continued. Only 29 foreign financial buyer transactions were announced in 2009, making it the year with the lowest number of announced foreign financial transactions since 2006. Some noteworthy exit transactions reported include:

- TPG/Newbridge's sale of its Shenzhen Development Bank stake to Ping An (US$2.3 billion); and
- 3i's and PraxCapital's sale of their stake in restaurant chain Little Sheep Group Ltd. to Yum! Brands Inc. (US$40 million).

Sector activity

As usual, deal activity was fairly evenly spread across industry sectors, however the industrial manufacturing sector was the most active by number of deals in the second half of 2009. The financial services sector had the highest announced deal value in 2009 (including the Shenzhen Development Bank transaction), followed by the real estate sector.

Outbound deal values are at record levels

Outbound activity is growing strongly, with deal volumes up by at least 33% in the second half of 2009 compared to each of the previous half-year periods. Outbound deal values for the full year 2009 were at a record level of around US$32.8 billion, approximately 82% higher than 2008. The largest announced deal was the US$8.9 billion acquisition of Swiss Addax Petroleum by Sinopec in the first half year, and there were three other deals valued over US$1.5 billion announced in the second half of 2009 including:

- Yanzhou Coal Mining Co. Ltd's acquisition of Australian Felix Resources Ltd. (US$2.6 billion);
- PetroChina's investment in Canadian Anthabasca's oil sand assets (US$1.7 billion); and
- China Investment Corporation's (CIC) 15% investment in AES Corporation (US$1.6 billion).

Besides the AES investment noted already, CIC announced eight more investments in 2009 with a combined announced value of approximately US$3.3 billion mainly in the energy, mining and real estate sectors.

The 2009 value of outbound deals is still only around a third of the value of domestic and inbound transactions, and Chinese outbound deals are focused on the energy and resources sector. With the Chinese government's encouragement, and Chinese companies' focus on overseas expansion, we expect to see outbound transactions continue to grow in 2010.

Outlook

The stage is set for continued growth in M&A activity, supported by growing investor confidence and continued economic growth (the World Bank estimates 8.7% GDP growth for 2010) focused on increasing domestic consumption. Domestic deal activity in 2010 is expected to grow by more than 20% compared to 2009.

There are also indications that foreign strategic buyers will re-emerge in greater volume and deal size starting in the second quarter of 2010, reflecting a pent-up appetite for acquisitions in China. In the last few weeks of 2009, we have already seen an increasing appetite for deals from both foreign and domestic buyers.

Domestic private equity (PE) activity is likely to grow strongly in 2010 and foreign PEs appear to remain as committed as ever to the Chinese market, with many looking to set up Renminbi denominated funds to facilitate easier deal making as well as provide access to new sources of funding and debt financing. From discussions with our clients, we understand that PE investors have a significant volume of attractive prospects in their deal pipelines and we expect to see many of these coming through in 2010, bringing activity back to 2008 levels.

As economic growth in 2010 is expected to be more reliant on consumer spending, rather than the economic stimulus spending experienced in 2009, sectors which cater to domestic consumption in China are expected to be favoured targets for M&A by both domestic and foreign acquirers.

The China outbound growth story will continue and year-on-year outbound M&A growth of about 40% is not an unlikely outcome. Whilst deals for energy and resources will continue to dominate, owners of the larger Chinese privately-owned enterprises are looking for know-how and access to foreign markets and deals in other sectors can also be expected to grow strongly. ■