



## **China M&A Round-Up**

### Cross-border investment trends

#### **What's the Deal?**

##### **Overseas debt and buying power**

In previous editions we have mentioned the accumulation of pressures on China's FOREX reserves and possible implications for support of the currency, in both its overseas CNH form and Mainland CNY form. While China's FOREX reserves peaked at nearly \$4T in June 2014 and have now settled to a hair above \$3T at the end of September, they stand as a kind of testament to financial power befitting the world's second largest economy.<sup>1</sup> Yet lurking behind the reported reserves are two relevant developments. China will be a current account deficit country in 2019, with unprecedented and substantial "errors and omissions" in its fiscal balance sheet suggesting unreported capital outflows.<sup>2</sup> This is in spite of intensifying capital account controls. And there is a very visible surge in off-shore borrowing. Off-shore borrowing will likely be getting more attention as larger tranches of bonds and bank loans require servicing and as a clear trend line in the RMB exchange rate emerges.

China has morphed from its renowned role as "Factory for the World" to something of a "Banker for the World." The "Going Out" campaign, in which Chinese enterprises were encouraged to undertake overseas acquisitions, was the beginning of this transformation, and in the wake of the Global Financial Crisis

companies in distress all over the world began to look to Chinese buyers and investors for survival. Connecting distressed companies everywhere with potential Chinese buyers became more than a cottage industry, as China seemed to have unlimited resources matched by unlimited appetite to acquire assets everywhere.

The formalization of this campaign came in 2013 with the creation of the One Belt One Road project, shortly thereafter renamed the Belt and Road Initiative (BRI). BRI is a move away from multilateralism to bilateralism; China has generally shown a preference for bilateralism. Notwithstanding the broad participation in the Asia Infrastructure Investment Bank that China founded, in the end, BRI deals are negotiated bilaterally between China and 65 or so client countries. And even though many foreign banks have stepped up to assist in financing BRI projects, the lion's share of BRI encumbrances fall to China through numerous means, from direct lending to debt accrued by major Chinese contractors in the course of building the projects. A major part of China's presentation to the world is a reputation for having extremely deep pockets and a domestic and foreign debt load well within their ability to manage it.

The surge in off-shore borrowing represents a significant shift for China. In the Asian Financial Crisis it was off-shore debt combined with declining currency exchange values that triggered the steep declines in Southeast Asian economies. China's lack of off-shore debt and strong FOREX position shielded it from a direct, disruptive impact.

Regulators have been showing signs of caution about accumulation of foreign debt. Arguably the high leverage of some of China's most ardent overseas investors that peaked in 2016 triggered the central government essentially to take them over, force asset sales abroad for deleveraging, and make major management changes. In some instances, large overseas debt prompted quick equity sales to swap equity for debt to significantly reduce servicing demands. Regulators have since been tweaking rules for foreign borrowing on a regular basis, and there is reason to expect that to continue.

Beginning in 2017, Chinese property sellers began selling offshore bonds. Sales in 2017 were five times the previous year,<sup>3</sup> but they were destined to grow further. By April of this year, Chinese developers more than doubled their USD borrowings, to \$32B, in an effort to refinance more costly short-term on-shore debt. In fact, of a total issuance of \$54B by mid April 2019, for the first time, USD issuance far exceeded RMB issuance, by 50 percent.<sup>4</sup>

China entered 2019 with \$1.9T in officially reported outstanding external debt. While this is not an unmanageable amount for a \$13.4T economy, the growth rate and structure of the debt could be concerning. Total external debt has increased 14 percent in the past year and 35 percent since the beginning of 2017. By the last quarter of 2018, short-term debt accounted for 62 percent of the total, so as China entered 2019 it faced the need to refinance \$1.2 trillion.<sup>5</sup> Recent projections show China facing maturing USD bonds in excess of \$63B in the first half of 2020 alone.<sup>6</sup>

The official figures may not capture the full amount of external obligations. Bloomberg has calculated in addition to the officially reported \$2T, there is another \$650B, or 1/3, taken on by subsidiaries but ultimately assured by Mainland parents.<sup>7</sup>

China's regulators have moved back and forth on rules governing foreign debt. As early as 2014, a permissive shift allowed Mainland China companies to guarantee foreign borrowing without prior approval.<sup>8</sup> Borrowing was not, however, fully freed from oversight. Because the intent was to finance overseas purchases, borrowing continued to be regulated through the use of proceeds. Further liberalizations were piloted, for example in the Shanghai Pilot Free Trade Zone through 2015 and 2016, culminating in a PBoC circular raising the ceiling for foreign borrowing in the first quarter of 2017.<sup>9</sup> But policy began to shift away from liberalization toward tightening in late 2018 and early 2019, as the tally of 2018 foreign debt approached \$2T. Spokesmen for the banking and foreign exchange authorities began to talk about integrating "the two positions of 'macro-prudence + micro-monitoring,'" as a way of managing foreign debt risks.<sup>10</sup>

Regulators sought to bring under control the lightening fast growth of foreign debt that was used to repay domestic debt. Beginning in the middle of 2018, regulators were tightening the rules governing using foreign debt to reduce overall financing cost. In July 2019 these restrictions tightened more. Banking authorities restricted new foreign debt issuance to what was required to service or refinance existing foreign debt but not domestic debt.<sup>11</sup>

The efforts to constrain refinancing domestic debt with foreign debt also reveals concern over the domestic banking giants, who provided the main channel for liquidity injections into the economy with credit to state-owned enterprises. While profitability of the biggest banks has not been a concern, they have not energetically driven the initiative to lend to more small and medium enterprises. And since broad licenses were extended for the first time ever to private companies, most importantly the Internet platform operators, the explosive growth of payment systems, wealth management, and cutting edge Fintec services have eluded the big banks and hurt their profitability.<sup>12</sup> The big Internet platforms have focused on small and medium enterprises, complicating the mission and constraining the growth of the state-owned giants. This rhythm of developments and regulations over a five-year period demonstrates both the stunning scale and speed of financial innovation with which markets and regulators engage.

What do these trends indicate? First, Chinese enterprises may have trouble meeting some of their external debt obligations, and that poses a more significant challenge than domestic debt. In fact, in February 2019, a state-owned aluminum company defaulted on a USD bond in Hong Kong the first such default in 20 years.<sup>13</sup> Beyond the visible debt issues, there have also been reported incidents of Chinese companies being unable to meet their funding obligations in major off-shore capital projects, in some cases for billions of USD. And headline acquisitions

of the last several years have not fared as well as projected, adding to hard currency debt resolution headaches. So far, China has funded solutions to high profile BRI projects where the client state defaulted, given the importance of the BRI initiative to the leaders, not to mention its high visibility.

Media coverage of China's foreign debt issues is likely to continue and expand, which might prove to be a double-edged issue for programs like BRI. An emerging picture of external debt problems, even defaults, is inconsistent with the presentation of deep pockets and fiscal responsibility that is considered key to successful BRI initiatives. On the other hand, it is a positive sign that projects are likely to be more inclusive, should China become increasingly unable to manage the costs of the huge portfolio of projects underway or committed. There would be little choice other than to open the door to more significant and more flexible participation by foreign financial service companies, banks, and investors.

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<sup>1</sup> <https://tradingeconomics.com//China/foreign-exchange-reserves>

<sup>2</sup> [www.ceicdata.com/State Administration of Foreign Exchange](http://www.ceicdata.com/State%20Administration%20of%20Foreign%20Exchange)

<sup>3</sup> <https://www.scmp.com/business/banking-finance/article/2125308/record-debt-maturing-next-year-chinese-developers-set-tap>

<sup>4</sup> <https://www.ft.com/content/03d1dfc2-6286-11e9-b285-3acd5d43599e>

<sup>5</sup> <https://www.bloomberg.com/opinion/articles/2019-01-06/china-s-dollar-debt-is-surg-ing-and-that-spells-trouble>

<sup>6</sup> <https://www.bloomberg.com/news/articles/2019-08-25/china-s-companies-have-unseen-foreign-debt-that-s-maturing-fast>

<sup>7</sup> <https://www.bloomberg.com/news/articles/2019-08-25/china-s-companies-have-unseen-foreign-debt-that-s-maturing-fast>

<sup>8</sup> <https://www.scmp.com/business/banking-finance/article/1517817/rule-change-lets-chinese-firms-guarantee-offshore-debt>

<sup>9</sup> <https://www.hoganlovells.com/media/hogan-lovells/pdf/new-pboc-circular-potentially-raises-the-overseas-borrowing.pdf>

<sup>10</sup> <http://www.chinabankingnews.com/2019/03/30/chinese-foreign-debt-approached-usd2-trillion-in-2018>

<sup>11</sup> <https://www.reuters.com/article/us-china-economy-property/china-tightens-curbs-on-property-firms-raising-money-offshore-idUSKCN1U7164>

<sup>12</sup> <https://www.thecorporatetreasurer.com/Article/how-big-a-slice-will-new-payments-take-out-of-chinas-banks/455282>

<sup>13</sup> <https://asia.nikkei.com/Economy/Chinese-state-company-defaults-offshore-first-time-in-20-years>

## Updates coming next month: New name and expanded focus

Starting with our January issue, our newsletter will have a new name and expanded focus to encompass more topics of interest to those doing business in and with China. We look forward to sharing more great insights and information with you.

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## Trends to watch

[China should cut rates, but not use monetary flooding: central bank adviser](#), Reuters, 11/11/2019

[China is struggling to offload foreign acquisitions, from yachts to pizza](#), Bloomberg, 10/22/2019

[China's economic growth drops to lowest level since 1992](#), CNN, 10/18/2019

## Outbound M&A from China

## **Consumer**

[China Mengniu offers 59% premium for baby-formula maker Bellamy's](#), Bloomberg, 9/16/2019

[Fosun invests \\$112 mln in realty venture with Ahuja Constructions](#), The Economic Times, 9/20/2019

## **Financial Services**

[Fortune Noble acquires majority stake in Suntrust](#), The Manila Times, 10/30/2019

## **Energy, Resources & Industrials**

[Sempra nears \\$3 bln Chile sale to China's State Grid](#), Reuters, 10/11/2019

[China Moly joins Huayou in Indonesia nickel project](#), Reuters, 11/10/2019

## **Life Science & Health Care**

[Inotrem announces \\$43 mln series B financing to develop first-in-class immunology therapeutics](#), BusinessWire, 9/12/2019

[Blue Sail Medical and Biosensors International enter the Structural Heart market with the acquisition of Switzerland-based NVT](#), Bloomberg, 9/23/2019

[Elicio Therapeutics completes \\$33 mln series B financing](#), BusinessWire, 10/2/2019

## **Technology, Media & Telecom**

[The9 Limited signs definitive agreement with Kapler Pte. Ltd](#), PR Newswire, 9/26/2019

[Tencent, Tiger Global, others back MyGate](#), Livemint, 10/17/2019

# **Inbound M&A into China**

## **Life Science & Health Care**

[Amgen takes 20% stake in Chinese biotech BeiGene for \\$2.7 bln](#), CNBC, 10/31/2019

## **Technology, Media & Telecom**

[The self-driving-truck startup that's been quietly moving UPS loads just pulled in \\$120 mln in fresh funding](#), Business Insider, 9/17/2019

# China Domestic M&A and Industry Consolidation

## Consumer

[German wholesaler metro agrees to sell China business to Wumei](#), Bloomberg  
10/11/2019

## Life Science & Health Care

[China Biologic products receive non-binding bid from investor group](#), Seeking Alpha, 9/18/2019

[Alibaba, YF Capital to pay \\$1.03 bln for 16.2% stake in Meinian Onehealth](#), DealStreetAsia, 10/28/2019

## Technology, Media & Telecom

[Alibaba increases stake in Cainiao Network to 63% from 51%](#), CaiXin Global, 11/9/2019

[Tencent returns to \\$150 mln VIPKid investment](#), Seeking Alpha, 9/19/2019

[Bitauto announces receipt of preliminary non-binding "going private" proposal](#), PR Newswire, 9/13/2019

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