Mergers and Acquisitions in China

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CHARLTONS

易周律師行

Solicitors

Hong Kong **Shanghai** **Beijing** **Yangon**

www.charltonslaw.com

Good afternoon Ladies and Gentleman

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I. Introduction

China's accession to the World Trade Organisation two years ago has unleashed unprecedented foreign investment. Statistics released by the Ministry of Commerce in January put the total amount invested IN 2003 at $115bn - 39 per cent more than in 2002.

Over the past few years, multinational manufacturers and household brand names such as Motorola and L'Oreal have expanded production within China, aiming to streamline costs, increase profit margins and establish a niche in one of the world's fastest-growing consumer markets.

There have always been legal hurdles for foreign investors to overcome. Until recently China had no systematic law on mergers and acquisitions. There were limited provisions in Chinese company law, contract law and various administrative regulations and notices. But the classic route for foreign investors was to establish an equity joint venture, a co-operative joint venture or a wholly foreign-owned enterprise.

Now, the legal climate has changed. Beijing has issued M&A-related regulations including the Provisional Rules on Reorganisation of State-owned Enterprises by using Foreign Funds (effective January 2003), the Tentative Provisions on Merger with and Acquisition of Enterprise in China by Foreign Investors (effective April 2003) and the Provisional Rules on Transfer of State Ownership of Chinese Enterprises (effective February 2004), all of which I will be talking about today.

These rules increase disclosure, transparency and certainty in the M&A regulatory regime and ensure that state assets are not sold or transferred at below market value. They make it possible for mergers and acquisitions to be structured more efficiently. These are regulations Foreign investors with broader opportunities to acquire shares in the State-owned enterprises, domestic enterprises, State-owned and legal person shares of listed companies. We will talk about these changes in laws and regulations in detail later.

Instead of launching start-ups, many foreign investors are considering acquisition, while

traditional joint ventures are increasingly rejected in favour of majority shareholdings, if not full ownership.

As well as low labour costs, foreign investors are placing greater emphasis on goodwill, supply of raw materials and the distribution networks, all of which enable them to lift market share more quickly.

PRC Government policy is to step up the privatisation of the State-owner sector, for example, the restructuring of the State assets of 117 State-owned enterprises totaling RMB 22.7 billion through M&A in Changchun, the capital of northeast China's Jilin province has been announced.

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II. Structuring the Optimum China M&A Deal

Foreign investors have a number of options for structuring an acquisition in China

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(i) The first is Direct Acquisition

A foreign investor may purchase all or part of the non-listed equity interest of the target company direct from one of the existing investors. Alternatively, by subscribing to any increased capital of the target company. This applies when the target company is purely domestic company with no foreign parent company. Unlike asset acquisitions, the foreign investor will not specifically select their preferred assets and businesses of the target company.

Direct acquisitions are subject to the approval of the Chinese authorities. This method tends to be the preferred sale method for PRC State vendors as they direct themselves of the liabilities as well as of the enterprise being sold.

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(ii) Indirect Acquisitions

A foreign investor can acquire or increase control a target company by purchasing offshore some or all of the shares held by the target company's foreign parent(s). However, this type of acquisition is only available if the PRC target company has foreign investors' equity.

As the transaction can be completed entirely offshore, it does not require approval of the PRC authorities. Also, from a PRC regulatory point of view, it is not necessary to obtain consent from any other partners of the PRC target company or from the board of directors of the PRC target company.

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(iii) Asset Acquisition

A foreign investor can use a newly established foreign invested enterprise or an existing foreign invested enterprise as an acquiring vehicle to purchase directly some or all of the business and assets of a target company. A definite advantage of asset acquisitions are that a foreign investor can select its preferred assets and businesses of the target company. Therefore, generally, any existing obligations, liabilities or restrictions of the target company will remain the responsibility of the target company.

The foreign investor must establish a registered presence in China in the form of a foreign invested enterprise to acquire and operate domestic assets. Separate approval from the PRC authorities is required for a new foreign invested enterprise which is established for the purpose of acquiring the assets of the PRC target company.

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(iv) Acquisition of a State-owned corporation

Special regulations govern acquisitions of State-owned interests. Most notably regulations are the State-owned Enterprise Restructuring Regulations (effective from 1 January 2003) and the Provisional Regulations on Administration of the transfer of State-owned Assets (effective from 1 February 2004).

I will discuss these regulations which now form the main framework for foreign invested M&A in China in detail.

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III. Current Government Policy

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(i) Resolution of CPC Central Committee

CPC Central Committee's Resolution on Several Issues Concerning Improvement of Socialist Market Economic System approved at the Third Plenary Session of the 16th CPC Central Committee clearly pointed out that China should further strengthen the vitality of public ownership, actively develop a mixed sector of the economy and realize the diversification of investment sources, making joint-stock system one of the major forms of public ownership. It also clearly specifies that China should further consolidate and develop public ownership, while encouraging, supporting and guiding the growth of non-public ones, which will provide new development incentives for non-public and foreign invested enterprises to participate in the transformation and restructuring of state-owned enterprises.

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(ii) Support from SASAC

The SASAC supports and promotes promote mergers and acquisitions in enterprises with State-owned background. SASAC states that “one of the major tasks of SASAC at present as well as in the future is to stick to the guideline of "the state economy should enter into certain sectors while withdrawing from others, and focus on some business sectors while shrinking from others" to promote mergers, combinations and restructuring between enterprises, facilitating rational flow and optimised disposition of state-owned assets while speeding up the strategic adjustment of the layout and structure of the state economy.” SASAC will also shift Chinese government's function of economic administration to market service and creation of positive environment for development. To establish positive legal and policy environments as well as promote non-public and foreign invested enterprises' participation in state-owned enterprises' restructuring and transformation process should be regarded as the integral needs and trends for reforms and strategic adjustments in state-owned enterprises.

(iii) World Trade Organization

China's integration into the world economy has already accelerated following WTO entry, emerging gradually as a newly established M&A market. China is changing its foreign investment policies and shifting the emphasis from traditional joint ventures to M&A as a

means of divesting State assets into foreign ownership.

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IV. Laws and Regulations and the Opportunities created

There are three important new regulations particularly govern the acquisition of assets and shares of PRC domestic enterprises and Stated-owned enterprises by foreign investors.

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1. Provisional Regulations on the Merger and Acquisition of Domestic Enterprises

On March 7, 2003, the PRC Ministry of Foreign Trade and Economic Cooperation ("MOFTEC"), the State Administration of Taxation ("SAT"), the State Administration of Industry and Commerce ("SAIC") and the State Administration of Foreign Exchange ("SAFE") jointly issued the Provisional Regulations on Foreign Investors Merging with and Acquiring Domestic Enterprises (the "M&A Rules"), which became effective on April 12, 2003. The M&A Rules are the first comprehensive regulation aimed at making all types of mergers and acquisitions involving foreign investment subject to consistent standards and represent another step toward the overall modernization and rationalization of China's foreign investment laws and regulations.

This is by far one of the most important regulations in relation to mergers and acquisitions by foreign investors in China. The key features of the M&A Rules are:

A. Scope

Article 2 of the M&A Rules provides that they are applicable to **acquisitions of domestic PRC enterprises without foreign investment by foreign investors**. They apply to:

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a. Share Acquisitions

(i) acquisition, by agreement, of equity in a domestic company and its conversion into a foreign invested enterprise; or

(ii) subscription of additional registered capital in a domestic company and its conversion into a foreign invested enterprise.

15 b. Asset Acquisition

(i) establishment of a new foreign invested enterprise and its acquisition, by agreement, of the assets of a domestic company; or

(ii) acquisition of assets in a domestic company by a foreign investor by agreement and injection of those assets as registered capital into a foreign invested enterprise.

The Ministry of Commerce's view is that these regulations apply to any target company established as a company under PRC Company Law. Therefore, they apply to limited liability companies and companies limited by shares, including State-owned enterprises organized as limited liability companies and companies limited by shares.

16 **B. Foreign Investors Qualifications**

The M&A Rules do not replace any existing foreign investment laws and regulations, but rather provide guidance and implementation mechanics. As is the case with other foreign investment laws and regulations, as an overriding condition, all foreign investments must follow the Foreign Investment Industry Guidelines ("Industry Guidelines") which delineate the categories of encouraged, permitted, restricted and prohibited industries for foreign investment. An enterprise engaged in an "encouraged" business, for example, may qualify for local (and generally more lenient) approval processes. The Regulations are no exception, which means that no acquisitions are allowed if the target is in a prohibited category and no acquisition of a controlling interest is allowed if the target is in a restricted category where the Chinese parties must have the controlling interest.

17 **C. A New Type of Foreign Invested Enterprise**

Foreign investment of less than 25% in a company is permitted for all transactions covered by the Regulations. Article 5 of the M&A Rules states that in the event a foreign investor's contribution falls below 25%, this will be noted on the approval certificate and business license of the foreign invested enterprise. Such type of foreign invested enterprise would not

be able to take advantage of any preferential treatment available to a foreign invested enterprise with 25% or more foreign investment.

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D. Asset Appraisal

The Regulations provide that the acquisition price must be based on an asset appraisal and that transactions involving state-owned equity interests or assets must comply with special regulations on the management of state-owned assets. I will discuss the details of special regulations relating to State-owned assets later. Reflecting the government's sensitivity to tax evasion, the dissipation of assets at below fair value and the use of M&A transactions to move assets offshore, the rules expressly prohibit setting an acquisition price significantly below the appraised value of the assets to be sold. Within these boundaries, existing laws and regulations generally allow the parties to freely negotiate the transfer price, which means the parties could effect a share or asset transfer at a very low price if this was supported by an appraisal which I will talk about shortly. Also, there are separate regulations governing the disposal assets of state-owned interests.

Under the Regulations, a domestic appraiser must be used - however what often happens is that a foreign investor will also appoint its own appraiser to provide on benchmark for the value of the assets and to assist in the negotiation with the domestic valuer.

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E. Creditors' Rights

Under Regulations, a disposal of shares does not affect the creditors rights of a domestic enterprise. Debts and creditors' rights remain with the enterprise after conversion to a foreign invested enterprise. On the other hand, the selling domestic enterprise retains its debts and creditors' rights under an asset purchase transaction.

The parties to the transaction, creditors and other unspecified parties can enter into separate contractual arrangements regarding the disposition of the obligations and creditors' rights of the merged or acquired domestic enterprise.

F. Payment of Consideration

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The general rule for purchases of equity or of assets is that the purchaser must pay the seller within three months after issuance of the business license of the foreign invested enterprise created as a result of the equity or asset purchase transaction. However, an extension may be granted with approval, so that 60% is payable within six months after issuance of the business license, and the full amount within one year.

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[In the case of an equity merger or acquisition leading to an increase of the registered capital of the resulting foreign invested enterprise, if the joint venture agreement or articles of association of such foreign invested enterprise provide for a one-time payment, the investor must make payment in full within six months of the new business license; if payment in installments is provided, the investor must pay at least 15% of the full subscription price in the first installment and pay the remainder in full within three months of the new business license.]

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G. Registered Capital Share

In the case of an acquisition of equity interests from existing domestic shareholders, the registered capital of the resulting foreign invested enterprise shall be the same as that of the original domestic entity. On the other hand, if a foreign investor subscribing for the increased portion of registered capital of the resulting foreign invested enterprise, the registered capital of the resulting foreign invested enterprise will be the sum of the original registered capital and the newly subscribed capital and the relative ownership percentages between the foreign investor and the existing domestic shareholders will be negotiated between the parties based on the appraised value of the assets of the original domestic entity.

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H. Ratios Between Registered Capital And Total Investment

The Regulations also set forth the following upper limits for total capital based on the registered capital of the resulting foreign invested enterprise in the case of a share acquisition or subscription:

[(i) if registered capital is US$2.1 million or less, the total amount of investment shall not exceed 10/7 of registered capital;

(ii) if registered capital is greater than US$2.1 million and not greater than US$5 million, the total amount of investment shall not exceed two times registered capital;

(iii) if registered capital is greater than US$5 million but not greater than US$12 million, the total amount of investment shall not exceed 2.5 times of the registered capital; and

(iv) if registered capital is greater than US$12 million, the total amount of investment shall not exceed three times of the registered capital.]

I. Application, Examination and Approval Procedures

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The M&A Rules set forth the application and approval procedures for the types of transactions covered. The application documents to be submitted are similar to those currently required for the conversion of a domestic entity into an FIE, including shareholder approval, application for conversion, joint venture agreement and articles of association of the resulting FIE equity transfer agreement, increase capital or asset transfer, corporate and creditworthiness documents of the foreign investor, corporate documents of the domestic entity and plan of disposition of employees.

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There are also some additional requirements based on whether the transaction is an equity interest or asset transaction. For instance, all shareholders of a domestic limited liability company must unanimously consent to the transfer of an equity interest or subscription. Also required for the transfer of an equity interest is the audited financial report of the target domestic company for the most recent financial year. An asset acquisition, however, will require only titleholder consent (i.e., the domestic entity) of the assets being transferred, which means only the board of director's resolution is required. An asset acquisition requires public notice to creditors, which is not a requirement for an equity interest transaction. Shareholder approvals are required for a transfer of shares, regardless of the percentage interest being transferred.

The timeframe for approval and the requirements for registration with the SAIC are similar to existing rules on the establishment of FIEs.

Although the Regulations introduce a "shell company" concept to PRC asset acquisitions, it appears that the establishment of the shell FIE and the asset acquisition should be effected simultaneously and need to be approved at the same time. When applying for setting up the shell FIE, the foreign investor needs to submit the required asset acquisition agreement between the proposed FIE and the domestic enterprise. Given that the proposed FIE has yet to be established in this instance, this provision may be construed to mean that the foreign sponsor will have to sign the acquisition agreement on behalf of the proposed FIE. In any case, the setting up of the shell FIE and asset acquisition agreement should probably be part of the same application package to be submitted for approval.

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J. Anti-Competition

For the first time, the Regulations set out on an anti-competition relating to framework to foreign investment.

If any of the following situations is present in a proposed acquisition of a domestic company, the foreign investor should file a report with the MOFCOM and State Administration for Industry and Commerce:

(i) turnover of a party (including affiliates of the foreign investor) in the China market exceeds RMB 1.5 billion in the current year;

(ii) the foreign investor has cumulatively acquired more than 10 domestic enterprises in related industries within one year;

(iii) China market share of a party exceeds 20% during the current year; or

(iv) The proposed acquisition will result in the China market share of a party reaching 25%.

If a transaction does not implicate any of the above four sets of circumstances, it may still be subject to anti-competition review. If MOFCOM or SAIC believe that a transaction may result in excessive market concentration, harm to legitimate competition or damage to

consumer interests, they have the discretion to call hearings involving relevant departments, institutions, enterprises and other interested parties, and may disapprove the transaction on the basis of such hearings.

[I now turn to regulations which cover acquisitions of interests in State-owned enterprises.]

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2. Provisional Regulations on Reforming State Owned Enterprises with Foreign Investment ("SOE Reforming Regulations")

The provisional regulations on reforming state owned enterprises ("SOE") foreign investment were issued jointly by the State Economic and Trade Commission, the Ministry of Finance, the State Administration of Industry and Commerce and the State Administration for Foreign Exchange and became effective on 1 January 2003.

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Applicability and Scope

The SOE Reforming Regulations contemplate the following five methods of restructuring SOEs using foreign capital:

(i) foreign investors may restructure a SOE into a FIE by acquiring all or part of the State interest in a SOE;

(ii) foreign investors may restructure a "company with state interests" into a FIE by acquiring all or part of the State shares in a "company with state interests";

(iii) foreign investors may acquire from domestic creditors, debt owed to them by the SOE and restructure such enterprise into a FIE; and

(iv) foreign investors may acquire all or the majority of the assets of a SOE and subsequently establish a FIE; and

(v) foreign investors may purchase an equity stake and become shareholders in a SOE and convert such SOE into a FIE.

[***Foreign Investor Qualifications***

Foreign investors wishing to take part in the restructuring of a SOE must meet the following criteria:

(i) they must have the business qualifications and technical expertise required by the SOE;

(ii) they should be in a similar line of business as the SOE being restructured;

(iii) they must have a sound business reputation and management capabilities;

(iv) they must have a solid financial position;

(v) they must introduce advanced technology and management expertise; and

(vi) they must possess the capability to introduce corporate governance practices.

As is often the case with foreign investor qualifications set out in PRC legislation, these qualifications are highly subjective, and it is unclear from the SOE Reforming Regulations how or by whom such conditions will be defined.]

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Required Reorganization Plan

A reorganization plan, which is in many respects similar to the “feasibility study report” required for all FIEs, must be submitted by the reorganizing party of the SOE, highlighting information about the foreign investor, its financial status, its business scope and equity structure, and plan for settlement of staff. In addition, it appears from the SOE Reforming Regulations that, in permitting foreign investment in the restructuring of SOEs, one of the State’s main requirements is the introduction of sound corporate governance into the target SOE. Article 5 of the SOE Reforming Regulations specifically requires foreign investors to provide plans to improve the enterprise’s corporate governance structure and promote sustained growth of the SOE. Such a restructuring plan must also include measures for

strengthening corporate management and a plan of investment, and provide for the introduction and development of new products and technology. The submission of a reorganization plan is a new requirement for foreign investors.

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Employee Protection

The SOE Reforming Regulations specifically impose requirements for ensuring the welfare of SOE employees. Specifically, the SOE Reforming Regulations require the SOE being reorganized to first seek the opinions of the staff and worker's congress of the SOE. Also, in the event that the controlling interest in the SOE will pass to the foreign investor upon acquisition, or if all or the main business assets of the SOE will be sold to the foreign investor, the reorganizing party of the SOE must formulate a plan for settling the staff, and such plan is subject to the staff's approval.

While these specific employee protection requirements are new to foreign investors, the absorption of, and responsibility for, the staff of their Chinese partners is not. However, the effect of these new requirements may be that SOEs will have more leverage in negotiations with foreign investors over the number of employees to be absorbed by a FIE after completion of an acquisition.

The reality is that personnel are the key to a successful transaction:

- **Consultation with staff is often beneficial in any event in China to allay unrest - in one M&A transaction I was involved in relating to a cement plant, there was significant worker unrest involving malicious reports to Government authorities about the management negotiating the transaction and workers' rallies. This delayed the process considerable.**

- **In many cases, management are the key to a successful acquisition.**

- **They have access to information about the business necessary to carry out a due diligence process.**

- **Their support in agreeing the terms of the transaction and obtaining local**

government support can be crucial.

- **The reality is that foreign investors buying State-owned enterprises in most cases need to agree incentive packages with existing management regarding their retention and remuneration alter the acquisition to achieve a successful transaction. Having management on side can be one of the main means of reducing acquisition risk by ensuring a higher level of knowledge and transparency regarding the business operations before acquisition.**

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Approvals

The approval thresholds and procedures under the SOE Reforming Regulations mirror in many respects existing foreign investment rules. The reorganization plan must be submitted to the relevant department of the State Development and Reform Commission ("SDRC") for examination (and in some cases, depending upon the nature of SOE, the SASAC as well). The SDRC and SASAC are now responsible for these functions as a result of the dissolution of the SETC. The same US$30 million threshold used in establishing a FIE is used for determining the level of approval required under the SOE Reforming Regulations.

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Upon receipt of official reply from the SDRC regarding the reorganization plan, an acquisition agreement entered into by the reorganizing party of the SOE and the foreign investor must be submitted to the MOF for approval. Several documents are required to be submitted along with the acquisition agreement, including but not limited to:

(i) an audit and asset appraisal report of the SOE;

(ii) a staff and worker settlement program;

(iii) an agreement for settling claims and debts;

(iv) a restructuring plan;

(v) resolutions of the reorganizing party of the SOE; and

(vi) the opinions or resolution of the congress of the staff and workers of the SOE.

Upon receipt of approval from the MOF, the reorganizing party of the SOE must then proceed with the examination and approval procedures for FIEs in accordance with the relevant FIE rules and the PRC Company Law. While it is not explicitly stated in the SOE Reforming Regulations, MOFCOM has confirmed its jurisdiction over this examination and approval for the establishment of FIEs, and as such it will be the final authority for approval after the SDRC and the MOF.

Upon completion of these approval procedures, registration procedures must be followed in accordance with the Catalogue for Guiding Foreign Investment in Industries and other applicable laws, and foreign investors must pay for the acquisitions in freely convertible currency from abroad. However, similar to other acquisitions in China by foreign investors, foreign investors may use their RMB profits derived from their existing operations in China to purchase their interests.

3. The most recent regulations are the Provisional Regulations on Administration of the Transfer of State-owned Assets - these set out in greater detail the procedures for acquiring State-owned companies

The State-owned Assets Supervision and Administration Commission ("SASAC") has issued a Provisional Regulations on the Administration of the Transfer of the State-owned Assets stating various regulations in relation to sale of any state-owned interests, effective from 1 February 2004. This is the latest issue of regulations and certain formalities (including important procedures) governing the transfer of state owned assets.

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1. Approval Procedures and Documents

The decision shall be made by SASAC regarding any transfer of State-owned asset. Documents need to be submitted to the SASAC in relation to any transfer of State-owned assets for approval are as follows:

(i) Relevant resolutions of the transfer of State-owned assets;

(ii) Proposal on transfer of State-owned assets (normally including basic information of the target company, contents of announcement of the transfer, proposal on the treatment of revenues resulting from the transfer, etc.);

(iii) State-owned assets Registration Certificate of the target company and its shareholders;

(iv) Legal opinion from a PRC lawyer;

(v) Documents related to the basic requirements of the purchaser; and

(vi) Any other documents requested by the relevant approval authorities.

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2. Procedures on Transfer of State-owned Assets

The provisional regulations set forth certain procedures for transferring any State-owned assets. Although this is not specifically for acquisition by foreign investors, some of the procedural requirements for transferring State-owned assets are very important for acquisition of SOEs or any assets with State-owned interests by foreign investors. The following are the highlights of the more important procedures in these regulations:

(i) adequate research on the feasibility on transfer of State-owned assets shall be done in accordance with any internal regulations;

(ii) an asset appraisal should be conducted and the result shall form as the basis of the consideration of the transfer. In the event during the course of the transaction the consideration is lower than 90% of the result of the asset appraisal, the transaction shall be suspended until approval from the relevant approving authorities;

[Again, as mentioned earlier, foreign investors are likely to appoint their own valuer to assist in the regulation of the state valuation.]

(iii) the vendor of such transfer of State-owned assets shall announce the transfer in the press and the website of the asset and disclose the details of the transfer in order to

induce potential purchasers for such assets. The vendor can set out certain criteria for inviting potential purchasers such as financial situation, goodwill, management capability, etc.;

(iv) in the event that there are two or more potential purchasers interested in such State-owned assets, the vendor shall discuss with the relevant authorities and shall according to the situation of the target company organize auctions or biddings to determine the purchaser;

(v) generally, the payment for consideration shall be an one-off payment. However, the payment can be made by instalments. The first tranche of the payment must be at least 30% of the total consideration and shall be made within five days from the effective date of the sale and purchase agreement. The purchaser shall provide legally binding guarantee for the outstanding of the consideration and pay interest to the vendor in accordance with the lending rate at that time. All consideration has to be paid within one year.

These regulations set forth more complicated procedures and formalities for transferring State-owned assets by the government. Therefore, it lays heavier burden on acquisitions of companies or assets with State-owned interests.

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4. I will just mention briefly the Qualified Foreign Institutional Investors ("QFII Regulations")

A relevant set of regulations in the M&A market and investment in China is the Qualified Foreign Institutional Investors Regulations. The QFII Regulation represents a groundbreaking move by the central government to permit foreign investors to directly invest and trade in publicly **listed domestic securities, i.e. A Shares**. The QFII Regulation covers the following topics in great detail: (i) the eligibility standards of a Qualified Foreign Institutional Investor ("QFII"), (ii) the foreign exchange aspect of the transactions, including the qualification and operation of the depositary banks and the management of the special QFII accounts at such banks, and (iii) controls and restrictions regarding the investment transactions.

The QFII Regulation deals specifically with the publicly traded s hares of a domestic company. The QFII Regulation will make it applicable to only a select group of very large foreign institutional investors. The impact of the QFII Regulation will likely be mainly on China's securities markets and the banking and foreign exchange industries.

V. Reducing Acquisition Risks – Due Diligence

1. Reasons For Conducting Due Diligence Exercises

One can analyze the need for due diligence based on statutory penalties imposed on persons with a legal obligation to know about another company (sellers of shares, purchasers of companies, etc.). One can also use the methods of due diligence investigations as a means of simply finding out about a company in advance of a transaction or tightening of a corporate relationship. In so many respects the risks of a transaction or series of transactions are significantly reduced with adequate knowledge of the parties involved. The need to know one's opposite partner will be the key reason for the exercise and the techniques discussed here. The normal optimism and enthusiasm of the businessman must be supported by a fair amount of hard knowledge of the other partners in the deal.

1.1 ***PROTECT THE CLIENT*** - Because the client is owed a duty of care and to fulfil that duty and, one hopes retain the client, offer the best advice and service all the details and information relating to the nature and target of the transaction must be understood.

1.2 ***REGULATORY COMPLIANCE*** - Because a regulatory authority requires it (a stock exchange, other). Much of the legal due diligence investigation work related to China will focus on compliance with China's multitude of legal and regulatory requirements. Because Chinese laws and regulations are not catalogued, the process of ascertaining what the requirements are as well as the degree of compliance with those requirements is difficult for businessmen to do on their own. Naturally the requirements are slightly different for different industries. Some of the more common regulatory issues are set out below.

(i) the design and level of detail must meet regulatory requirements

(ii) there may be either requirements or an established practice concerning how to structure the investigation itself and the questions to be answered in the course of the investigation

(iii) nevertheless, this would still be a good time to answer all the questions which have arisen concerning the target of investigation

1.3 ***INVESTIGATION OF THE COMPANY*** - Because there is a need to know more about a party in order to assess the risks of a business transaction

(i) the design and level of detail can suit the party requesting the investigation

(ii) issues of particular interest can be focused on, even to the exclusion of any of the usual areas of due diligence investigation.

1.4 ***ASSESS THE RISKS AND UNDERSTAND THE PARAMETERS*** - Because one must explain a business transaction to others (board of directors, shareholders, a prospective merger partner, etc.)

(i) it is important to be comprehensive and thorough and to avoid making mistakes or oversights in collecting or reviewing information or mistakes in interpretation of the information

(ii) the investigation may be limited to a particular question or business area

I will now look at a case study to illustrate how the diligence reduces risk on PRC M&A transactions.

1.5. For other reasons

(i) it is important to know why the investigation is being undertaken in order to design and carry out the investigation with the appropriate level of detail, and in the appropriate subject areas

(ii) ***ASSESS THE RETURN*** - Because any sound assessment of the returns cannot stop at the financial models. A true assessment of the returns must be based on both qualitative and quantitative data relating to the position and status of the business.

2. Key Areas For Due Diligence

(i) ***PERSONNEL*** - It is obviously vital to know the personnel involved but in particular their qualifications and their experience. This information needs verifying as records can easily be lost or falsified particularly in the situation where the personnel are not just managers but fundamental to research and development or product designers. Care must also be taken in the PRC environment as many people do not wish to lose face by admitting that they do not have the qualifications and experience they previously professed to.

(ii) ***CORPORATE DOCUMENTATION*** is obviously vital and no more so in the PRC environment where there are numerous national and local government authorities which must grant their approval before operations of any sort can be started. These can be difficult to find as Chinese directors may feel that such certificates are confidential and not to be disclosed to foreign parties.

(iii) ***THE RETRIEVAL OF FINANCIAL RESULTS*** can suffer from the same problems as the corporate documentation above. However there is the added problem that once such documents have been disclosed they may not be complete or prepared by any recognised procedure or treatment.

(iv) ***R&D*** - As with the information relating to personnel, information relating to R&D must also be confirmed particularly if the target's future business strategy depends on it. Other information must also be collected to support any initial statements such as the level of R&D compared to previous years, the stage of the R&D and the pay back period.

(v) ***RELATIONSHIPS*** - Finally there should be a review of both business relationships between other organisations and other people such as political figures.

3. **Issues relating to Taxation**

I have mentioned the importance of reviewing the tax information and payments but of equal importance is ***GAINING AN UNDERSTANDING AND REVIEWING THE TAX EXEMPTIONS AND WHETHER THE TAX EXEMPTIONS CAN BE CARRIED FORWARD*** after the transaction has been completed. ***TAX EXEMPTIONS IN THE PRC*** have to be approved and unlike the UK and Hong Kong where one a seeks clearance from the Revenue the documentation relating to this approval must be checked and verified. The next question must be whether the preferences can be continued and the answer to this will obviously not only rely on the continued existence of the exemption but also the continued circumstances of the target which allowed it to receive the benefit of the exemption. The accountants are expected to review this and estimate under what circumstances the benefits would continue. ***A TYPICAL EXAMPLE*** of this is for a state-owned company to enjoy the benefit of certain tax exemption which it would not receive if the business was to leave state ownership.

4. Approval Requirements

APPROVALS FOR NEW ENTITIES - Anyone familiar with the PRC business framework will be aware of the plethora of approvals that must be obtained before business operations can be commenced. It is the task of the both the lawyers and the accountants to determine what approvals will be necessary and estimate the likelihood that they will be granted. This exercise is not only part of the feasibility study as it

determines whether the project is actually viable but is also an extremely important part of the due diligence process both in establishing if the current business has the right to operate as it has been, whether it can continue to do so and what further approvals must be sought after the transaction has been concluded.

APPROVAL DOCUMENTATION - The accountant's job must be to identify whether the current target business has the necessary approvals to operate as it has been and what approvals will be needed for the post-transaction entity to operate as is intended. Again this documentation must be verified and not just assumed to exist because a Chinese official claims that it does.

Joint Ventures

Sino-foreign joint ventures must be approved by an organization within the jurisdiction of the Ministry of Commerce ("MOFCOM") (the successor of the Ministry of Foreign Trade and Economic Cooperation, established in 2003). The specific level within this organization depends primarily on the amount of investment (the registered capital) to be made in the joint venture. There are Commissions within MOFCOM at provincial, municipal and district levels (usually called Commission for Foreign Trade and Economic Cooperation, "COFTEC"). The investment amounts which fall under the jurisdiction of the different levels of COFTEC's are determined by the State Council, and the determinations are disseminated in both internal and published directives and regulations.

If the joint venture requires allocations of raw materials to be made by the government, or will otherwise significantly affect the national resources of fuel, power, transport, or foreign trade, it might be necessary to obtain approval from a higher level of COFTEC.

A joint venture is organized as either an "equity joint venture" or a "cooperative (or contractual) joint venture". The distinction is relevant to the contents of the joint venture contract and the method of corporate governance, but not relevant to the approval process. The regulations pertaining to the two types of joint ventures are worded differently but the differences are attributable to the issues of concern to the

legislative drafters at the time of issuance of the regulations, rather than to differences of treatment as between the two types of joint ventures.

The published regulations indicate that joint ventures with registered capital in excess ofUS$100 million must be approved by the State Council, joint ventures with registered capital in excess of US$30 million must be approved by the State Planning Commission and MOFCOM (its central ministry), joint ventures with registered capital in excess of US$10 million must be approved by the provincial COFTEC (or in the case of autonomous regions and centrally administered municipalities and zones, through the COFTEC at that level) and the similar level of the Planning Commission. Joint ventures with registered capital of less than US$10 million maybe approved by the local level COFTEC and Planning Commission.

The government agencies involved all claim to have received subsequent internal directives varying these levels, however. Many joint ventures have been approved in violation of the above threshold figures. Because of the inconsistency between the published regulations and the internal regulations (which cannot be checked by due diligence investigators), it is extremely difficult to verify the due incorporation of many sino-foreign joint ventures.

Approved Industries for Foreign Investment

A long list of subject matter approval criteria has been published by the State Planning Commission and is updated from time to time. This list divides possible foreign investment into the categories of: encouraged industries (further broken down by industry as agriculture, forestry, animal husbandry are related industries, light industry, textile industry, communications, transportation, and post and telecommunications industries, coal industry, power industry, ferrous metallurgy, non-ferrous metallurgy, petroleum, petrochemical and chemical industries, machine building industries, electronics industry construction materials and equipment, and also other non-metallic ores industry, pharmaceuticals industry, medical apparatus industries, aerospace and aviation industries, ship building industry, "new industries", service industry), and industries in which foreign investment is restricted (divided into an "A" list and a "B" list, the "A" list constituting industries falling within the

following categories: light industry, textile industry, coal industry, ferrous metallurgy, nonferrous metallurgy, petrochemical and chemical industries, machine building industry, electronics industry, construction materials and equipment industry and products of non-metallic ores, pharmaceutical industry, medical apparatus industry, service industry; and the "B" list including businesses falling within the following categories: agriculture, forestry, animal husbandry, fisheries and related industries, light industry, textile industry, coal industry, nonferrous metallurgy, petrochemical and chemical industries, machine building industry, electronics industry, construction materials and equipment industries, and manufacturing products of non-metallic ores, pharmaceuticals industry, communications, transportation and post and telecommunications industries, domestic and foreign trade, tourism, real property, service industries, financial and related industries, and other miscellaneous industries). There is a further category of industries in which foreign investment is prohibited.

The details remain officially in force, but, as so often happens, appear in practice to have been superseded by internal directives in some cases. Investors are left to consult directly with government officials concerning what is and is not a permitted industry for investment. The statements made by the government officials often cannot be checked, and, unfortunately, are not always reliable. Investors have no further feasible way to check what they are told. Applying to the central government officials to check the accuracy of statements made by local officials creates plenty of ill will among the local officials, and it is the local officials with whom an investor must get along in the long term. This difficulty extends to persons attempting to check the propriety of local approvals for purposes of due diligence investigations.

The approval to set up a joint venture will be based primarily on the information contained in the joint venture contract, the articles of association for the joint venture company, and a feasibility study for the joint venture company. (There will also be a preliminary approval, which gives the Chinese party the authority to negotiate and execute the above documents. However, the preliminary approval is superseded by the final approval, so for purposes of due diligence investigations, the preliminary approval is only of interest if the final approval has yet to be handed down.)

After Approval to Establish a Company in China

A due diligence investigator may check a variety of formalities which a newly organized company should complete after approval and issuance of the business license, for example, details such as registration with the tax bureau, registration of the company stamp with the local Public Security Bureau, and immigration procedures applicable for foreign employees.

Payment in of registered capital is checked through the Annual Foreign Exchange Inspection of Foreign Investment Enterprises Provisional Regulations, issued by the State Administration of Foreign Exchange on April 1, 1994. The procedures undertaken pursuant to these regulations result in issuance of a Foreign Investment Enterprise Foreign Exchange Registration Certificate, which in turn is a pre-requisite to the opening of a foreign exchange bank account for the year. Renewal of the Foreign Investment Enterprise Foreign Exchange Registration Certificate is an occasion for an annual check on the status of the registered capital of the company, and is a pre-requisite for continuing the foreign exchange bank account. This annual inspection also covers other foreign exchange activities of the company, such as export of products. If the company has an export ratio, compliance with this will be reviewed during the annual investigation. If export requirements have not been met, the company may lose its access to the foreign exchange swap centers, or have such access limited.

5. Land Use Rights

Under Chinese Law there is no private ownership of land. All land is either owned by the State or by collectives. State ownership normally applies to land in urban areas, while collective ownership applies in rural areas. Although individuals and companies cannot own land it is possible to acquire land use rights which basically amount to a leasehold interest in the property.

***LAND USE RIGHTS* initially granted by the state**

Under the present system all land use rights must initially be granted by the State. Thus, collectively owned land must be converted to state owned land before land use rights may be granted. Under the previous administrative system land could be allocated to specific users without compensation. Such land is now known as "allocated" land.

Grant procedures

To be granted a land use right certificate the acquiring entity must pay an initial premium plus an annual fee for the period of the grant. There are maximum terms set out in the legislation for land use right grants, which apply to the intended use of the land. These are given overleaf:

- residential user — 70 years
- industrial user — 50 years
- commercial, tourist or recreational user — 40 years

The holder of a land use right may normally assign, transfer, lease or mortgage that right provided proper grant procedures have been carried out and the grant fee paid. Allocated land use rights may not be assigned, leased or mortgaged until approval has been obtained from the land administration department and a grant fee paid.

Contribution of land to a joint venture

The contribution of land to a joint venture is considered to be an assignment and thus proper grant procedures must be carried out prior to such assignment. Frequently, upon enquiry, the China partner is found to be occupying allocated land which, for the purpose of considering value to a third party, that is the joint venture, cannot have value attached to is until the correct procedures have been followed.

All structures included in land use rights

Land use rights include all structures on the land. Thus, if the land is assigned, all structures on it will be assigned. If the right to use a structure is to be transferred, the underlying land use right must also be transferred.

Market value of land

The amount of the premium is now usually based on the laid-down rates of premia for different land uses in that locality. These are determined by the Land Administration Bureau. To some extent these have now formed a benchmark for market value of land in certain popular areas. In more rural districts the premia are based on the cost of land, after compensation has been paid for resumption, loss of crops and provision of services.

No guidance for valuation of land

The Asset Valuation Procedures do not provide any guidance for the valuation of land and in the past there was also no guidance note provided in Hong Kong. This resulted in a spate of valuations of land based on the residual approach, whereby a 'greenfield' site could instantly attain dramatic value by the valuer making certain assumptions on what might be developed on it. The residual approach is based on the premise that land is worth its completed development value, less the cost to develop it. This includes the cost of construction, cost of finance, developer's profit and so on. The residue, after all such items have been deducted, can be attributed to the value of the land.

The above situation became of major concern to the Stock Exchange of Hong Kong ("SEHK"), who eventually felt compelled to issue a Guidance Note to the Exchange Listing Rules. This is known as Guidance Note 5, portions of which have relevance to valuations for Joint Ventures.

Guidance Note 5

In September 1993 the SEHK published Guidance Note 5 to the Listing Rules entitled 'Valuations of Property Situated in Developing Property Markets'. The Note is of particular significance to all valuations undertaken for listing purposes in the PRC and is also of significance for valuations prepared for joint venture purposes.

Bench mark for valuation

The Note does not define what a developing property market is, but it infers that for example, China is one whereas Hong Kong is not. The Note was published following consultation with the RICS, HKIS and valuers in Hong Kong, reflecting concern by the Securities and Futures Commission ("SFC") and the SEHK that several valuations had appeared in listing prospectuses suggesting either a high value to land which was typically a 'greenfield' site, or attributing value where property title either had not been or could not be properly established. In short it suggests that the regulatory bodies were displeased with the use of the residual valuation approach and want this to be used only as a method of last resort, and then only under highly qualified criteria.

Although the note has no jurisdiction over joint ventures per se it has become a benchmark by which valuers may approach joint venture valuations in China and would be a mandatory requirement if it were the eventual intention to list the joint venture in Hong Kong. Valuers, therefore, should be encouraged to accept the requirements of the Guidance Note as the minimum standard by which they would approach a joint venture valuation,

6. Valuation

DIFFERENCES IN PRC AND INTERNATION - In the PRC there are several difficulties relating to valuation. First is the difficulty of actually agreeing a method for valuing assets and once that is agreed there is the problem of agreeing the actual value. More specifically there are problems with land valuations which I have already mentioned with the valuation of plant and machinery, intangible assets and contributions in kind.

Valuation of Plant and Machinery

A machinery valuer does not so much require detailed knowledge of the locational market in which he operates, but more a knowledge and understanding f the industry in general and of how the equipment in question relates to the process being considered. In a plant and machinery valuation report it is therefore common practice to give a fairly detailed description both of what the company in question does and all the process by which this is achieved, before considering the value of individual assets.

The Valuer

At present there is no recognised professional discipline for plant and machinery valuers in Hong Kong. Of the few who are practicing this art, the majority are mechanical engineers who have received further training in valuation techniques. There is little substitute for experience however, as the valuer has to gauge the degree of physical, functional or economic obsolescence of the equipment they encounter. To do this the global market in which it is available and the local market in which it operates must be known.

PRC valuers lack resources to check pricing

Continuous research of pricing of new or equivalent models is of fundamental importance when considering the replacement cost approach, the normal method used when there is a lack of a market. This is an ongoing problem for PRC equipment valuers, who do not have the resources to check pricing, particularly of any imported machinery.

Basis of Value and Methodology

The basis of value is fair market and the normal methodology used is the depreciated replacement cost approach. Wherever possible, this would be supplemented by the market approach.

Valuation Of Intangible Assets

Intangible assets have been defined as:

“non-machinery assets without physical substance which include, but are not restricted to, brand-names and trademarks, copyrights, franchises, intellectual property, licences, mastheads and patents.”

The asset approach does not provide a methodology for the valuation of what may loosely be termed ‘goodwill’. The Chinese are, however, becoming increasingly aware of the value of intangible assets which they will be providing to the joint venture. Thus, it may appear to the discerning foreign party that the suggested value of a joint venture’s tangible assets has been deliberately overstated to take account of these, whereas if the intangible assets had also been included as part of a total business enterprise, the suggested value might then appear quite reasonable.

Basis of Value

Like other tangible assets the value of intangibles should be their value in the marketing-place at the relevant date. It is thus appropriate to use the term Fair Market Value as previously defined as a basis of value.

Methodology

The most commonly used approach is to first establish the business enterprise value of a company.

Business Enterprise Value is defined as:

“the combination of all tangible and intangible assets that comprise a going business concern, the value of which is equivalent to the fair market value of the company’s total stockholder’s equity plus long-term debt obligations.”

Residual value

The method attempts to derive the value of intangible assets as a whole by first estimating the total business enterprise value based on foreseeable income-earning prospects, which are then

capitalized by either using an appropriate risk/rate of return for the industry, or an appropriate price-earning ratio ("P/E"), or both. The current-day values are then deducted from the net tangible assets (land, buildings, plant & machinery), Whatever differential remains after the deduction of net working capital required to support turnover, that is, the residual value, is then attributed to the intangible assets as a whole

Tests to isolate intangible assets

Further tests cannot be conducted depending on which intangible asset it is required to isolate. Quite frequently this will be a service mark (for example "Tsingtao", which obviously carries a high intangible value). The 'freedom from royalty' approach considers the different margins that might be paid on branded and unbranded products, and hence suggest value for brand names.

By performing tests a more accurate valuation of the intended joint venture entity may be obtained, providing the underlying information is accurate. If this exercise were systematically undertaken it might prevent accusations from the foreign party that the Chinese party is constantly over-valuing tangible assets in order to achieve a considered fair value for their total entity. On the other hand, it may also show to the Chinese party that, at the date of valuation the total value of its share was little more than the value of its tangible assets and that it will be the catalyst of the incoming foreign party (whether by injection of capital, cash or technology) that can create additional value.

PRC intangible valuation methodology unreliable

It is not uncommon for PRC valuers to conduct an intangible valuation as part of their general valuation of a company. However, their current methodology varies from adopting a certain percentage of the share capital of the company – which not surprisingly produces illogical results – to a cost approach basis, whereby the cost of developing a distribution network or brandname is considered to represent the minimum value of this asset. This can only be correct if the return on the investment produces a yield in line with market expectations.

Contributions in kind to registered capital must be valued, but the accuracy or otherwise of the valuations is not ordinarily a matter which is subsequently challenged, so long as there is

a valuation report prepared by an organization authorized conduct official valuations in China. So long as such a document exists and appears on its face to be in good order, it would not usually be necessary for due diligence investigators to recalculate the contents or otherwise question the findings. If the document appeared to be fraudulent or forged, of the course the matter should be dealt with as such.

Conclusion on Valuation

The valuation process in China is still in a state of infancy. Government departments issue regulations to valuers with little or no market experience and no access to comparable data. Departments which should work together are in conflict with each other, wresting to be the ultimate body in control of valuation of land and equipment respectively. Until a hierarchical open market for land is developed and title clarified, land value will depend more upon its cost of production or related government premia.

Until industrial buildings are bought and sold openly, or leased to produce an income stream, their value will depend primarily on their depreciated replacement cost and until the concept of marketing becomes more sophisticated, and control of intellectual property rights properly established, brand names and other intangibles will not realize their potential worth.

All of the above have made the preparation of valuation reports in China something of a minefield for the foreign valuer. From the joint venturer's point of view, however, an independent valuation can be of great benefit in that it will quickly highlight missing bits of the jigsaw puzzle. In particular, documents supporting land use rights, which are often "unavailable" until a valuer's report specifies that no value can be attributed while such are not produced.

The equity joint venture has now become more established and the mechanism for instigating the initial valuation is commonly know to the Chinese party. As Chinese valuers and their foreign counterparts work more closely together, a better acceptance of commonly used techniques will develop. Valuation methodology will become more sophisticated, meaning that possible diminution of state asset values by this route will generally cease. The two-valuer system for the joint venture is in principle a good one, as it should mean that a fair

compromise can be reached – valuation is not an exact science, and to reach a negotiated settlement is, after all, the purpose of the exercise.

7. Liabilities

One of the primary reasons for conducting the due diligence exercise is to establish the liabilities of the target. I have divided these into five categories:-

(i) COMPANY'S LIABILITIES

These are the current liabilities which range from everything on the balance sheet to outstanding invoices from suppliers and tax liabilities. In most organisations with a strong accounting department where paper can be traced from the balance sheet all the way to the sales ledger establishing such liabilities is fairly easy. However in the PRC context this work may require more investigation and relentless requests from the PRC party for further information.

(ii) HIDDEN LIABILITIES

Discovering hidden liabilities is really one of the main purposes of the due diligence process. Such liabilities and obligations will arise out of the provisions of the agreements made by the company and relevant regulatory compliance.

(iii) CONTINGENT LIABILITIES

Such liabilities arise under current obligations in existing contracts. These can only be identified by a rigorous review of all the agreements and an understanding of whether post completion strategies and operations will trigger any liabilities under the provisions.

(iv) PENDING LIABILITIES

Every target business will have pending liabilities most notably tax due. Generally pending tax liabilities are subject to numerous indemnities from the vendors but this still requires the accountants to determine all the tax liabilities likely to arise. During the acquisition of a

company the purchasers will obviously be asking for a reduction in price for each liability they will have to meet post completion.

(v) POTENTIAL LIABILITIES

Such liabilities are not dependent on the provisions of current agreements but rather on general obligations such as product liability or a change in law. For example a change in law requiring greater expenditure eg environmental safety requirements or tax clearances for a possible restructuring.

7. Warranties And Indemnities And Due Diligence

The limitations of due diligence

We must remembering that every due diligence investigation depends to a largeextent on the quantity and quality of data supplied by and on behalf of the Seller which can be a problem in the PRC. This heavy reliance by the Buyer on the Seller exposes the Buyer to potential non-disclosure and misrepresentation by the Seller.

These limitations on the due diligence process make it important for the buyer to support the due diligence investigation by securing warranties from the Seller, wherever possible, on those issues that are impossible or uneconomic for the Buyer to check. It is also import that the Seller warrants that the data supplied by it to the Buyer is complete and accurate.

The trade-offs between due diligence and warranties

DUE DILIGENCE STILL VITAL AS EXTENT OF WARRANTIES AND INDEMNITIES UNCERTAIN UNTIL AFTER COMPLETION

The ideal situation is for a Buyer to carry out extensive due diligence and simultaneously obtain comprehensive warranties and indemnities.

However, trade-offs will arise between whether a particular area should be protected by good due diligence or by warranty and/or indemnity, because:

MATERIALITY, BEST KNOWLEDGE, DE MINIMIS, TIME LIMITS AND FINANCIAL POSITION

Warranties and indemnities may only be acceptable if they are qualified by levels of materiality or to the best of the warrantor's knowledge. Other positions which can be taken are setting minimum levels after which the warranty will be triggered, time limits and financial position of the sellers as there is no point bringing an action against a party who cannot pay.

Some Sellers will attempt to exempt from the warranties those matters which have been disclosed in the course of the investigation or which would be apparent to the Buyer's due diligence teams. On the other hand, the Buyer will be concerned to ensure that there is certainty as to what items are being exempted from the warranties. This dilemma is not likely to arise where the Seller is selling the business with limited warranties from the beginning since, in this situation, the Seller is usually prepared to allow the Buyer to do extensive due diligence.

The cost of conducting the due diligence may, in smaller transactions, outweigh the potential benefits of the due diligence exercise. The Buyer's right to claim under a warranty may be affected by its knowledge concerning that issue as a result of its due diligence exercise.

The real problem with warranties in a PRC transaction is if the state is the seller as the chance of getting a judgement against the state is very low.

Concluding Comments on Due Diligence

Other industries have their own special rules, procedures and approval requirements for foreign investment. The local department in charge of a proposed Chinese joint venture partner can steer investors in the direction of the authorities whose support is needed for a project.

The due diligence investigator has a somewhat more difficult time, as the authorities will not ordinarily discuss matters. This means that the due diligence investigator must obtain the

relevant regulations on his own, and independently establish compliance. Since Chinese regulations proliferate unceasingly and remain stubbornly uncataloged, the task of ascertaining just what the regulatory requirements are, let alone the matter of compliance, is particularly complex. It is essential to use the help of persons familiar with the Chinese regulatory system and its practice.

V. Overall Conclusion on the Seminar

With the new issued regulations in mergers and acquisitions in China, there will definitely provide foreign investors with new and exciting opportunities to enter the domestic Chinese market. The ability to purchase the shares of State-owned enterprises and other domestic enterprises provide a much wider scope of M&A activities for foreign investors.

If anyone of you would like to discuss further on the mergers and acquisitions market in China, I would be very grateful to answer your queries. Here are my contact details:

Ms Julia Charlton

Charltons, 56th Floor, Bank of China Tower, 1 Garden Road, Hong Kong

Email: juliacharlton@charltonslaw.com

Telephone number: 2905 7688

Thank you very much.