Mergers and Acquisitions in China

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I. Introduction – Background to M&A in China
II. Structuring the Optimum China M&A Deal
II. Structuring the Optimum China M&A Deal (cont’d)

i. Direct Acquisition

- purchase all or part of the non-listed equity interest
- subscribing for increased capital of the target company
ii. Indirect Acquisitions

• acquire or increase control of the target company via purchasing offshore some or all of the shares held by the target company’s foreign parent(s)

• available if the PRC target company has foreign investors’ equity
II. Structuring the Optimum China M&A Deal (cont’d)

iii. Asset Acquisition

- investor uses a new foreign invested enterprise or an existing foreign invested enterprise as an acquiring vehicle
- allows a foreign investor to select the preferred assets and businesses of the target company
II. Structuring the Optimum China M&A Deal (cont’d)

iv. Acquisition of corporation with State-Owned Interests

• usual process for direct equity and asset acquisition applicable

• certain special regulations governing acquisitions of State-owned interests
III. Current Government Policy
III. Current Government Policy (cont’d)

i. Resolutions of CPC Central Committee

“further strengthen the vitality of public ownership, actively develop a mixed sector of the economy and realize the diversification of investment sources, making the joint-stock system one of the major forms of public ownership”
III. Current Government Policy (cont’d)

ii. Support from SASAC

iii. Entry into WTO
IV. Laws and Regulations and the Opportunities Created
1. First comprehensive regulation aimed at making all types of mergers and acquisitions involving foreign investment subject to consistent standards

2. Represent another step toward the overall modernization and rationalization of China’s foreign investment laws and regulations
A. Scope

(a) Share Acquisition

(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
(b) Asset Acquisition

(i) establishment of a new foreign invested enterprise and its acquisition by agreement of the assets of a domestic company and operation of the assets; 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
B. Foreign Investors' Qualifications

(i) all foreign investments must follow the Foreign Investment Industry Guidelines

(ii) delineate the categories of encouraged, permitted, restricted and prohibited industries for foreign investment
C. A New Type of Foreign Invested Enterprise

(i) foreign investment of less than 25% in a company is permitted for all transactions covered

(ii) but not able to take advantage of any preferential treatment available to a foreign invested enterprise with 25% or more foreign investment
D. Asset Appraisal

(i) transfer price based on an asset appraisal

(ii) transactions involving state-owned equity interests or assets must comply with special regulations on the management of state-owned assets
E. Creditors’ Rights

- equity transaction does not affect debts and creditors’ rights of a domestic enterprise
F. Payment of Consideration

(i) general rules

- the seller must pay the consideration within three months after issuance of the business license of the foreign invested enterprise
(ii) equity merger or acquisition leading to an increase of the registered capital

• if provide for a one-time payment, then make payment in full within six months

• if payment in installments is provided, then must pay at least 15% of the full subscription price as the first installment, remainder in full within three months of issue of the new business license
G. Registered Capital

(i) an acquisition of equity interests from existing domestic shareholders, registered capital remains the same

(ii) subscribing for the increased portion of registered capital

• registered capital will be the sum of the original registered capital and the newly subscribed capital

• relative ownership percentages will be negotiated between the parties based on the appraised value of the assets
H. Ratios Between Registered Capital And Total Investment

- sets forth the upper limits for total capital based on the registered capital of the resulting foreign invested enterprise
I. Application, Examination and Approval Procedures

- similar to those currently required for the conversion of a domestic entity into an FIE
- Documents including:
  - shareholder approval
  - application for conversion
  - joint venture agreement and articles of association of the resulting FIE
  - equity transfer agreement
Provisional Regulations on the Merger and Acquisition of Domestic Enterprises (‘‘M&A Rules’’) (12 April 2003) (cont’d)

• increase capital or asset transfer
• corporate and creditworthiness documents
• corporate documents of the domestic entity
• plan of disposition of employees
• additional requirements
• timeframe for approval and the requirements for registration with the SAIC are similar to existing rules
J. Anti-Competition

- turnover of a party exceeds RMB1.5 billion in the current year
- foreign investor acquired more than 10 domestic enterprises in related industries within one year
- China market share of a party exceeds 20%
- China market share of a party reaching 25%
2. Provisional Regulations on Reforming State Owned Enterprises with Foreign Investment ("SOE Reforming Regulations") (1 January 2003)
Applicability and Scope

i. Acquiring all or part of the State interest in an SOE

ii. restructure a “company with state interests” into an FIE by acquiring all or part

iii. Acquire from domestic creditors debt owed to them by the SOE

iv. Acquire all or the majority of the assets of a SOE and subsequently establish a FIE

v. Purchasers of an equity stake become shareholders in an SOE and convert such SOE into an FIE
Required Reorganization Plan

i. in many respects similar to the “feasibility study report” required for all FIEs

ii. highlighting information about the foreign investor, its financial status, its business scope and equity structure, and plan for settlement of staff

iii. introduction of sound corporate governance into the target SOE
Employee Protection

i. First seek the opinions of the staff and worker’s congress of the SOE

ii. Reorganizing party of the SOE must formulate a plan for settling the staff, and such plan is subject to the staff’s approval
Approvals

i. Mirror in many respects existing foreign investment rules

ii. The same US$30 million threshold used in establishing an FIE is used
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.
3. **Provisional Regulations on Administration of the Transfer of State-owned Assets** (1 February 2004)
1. Approval Procedures and Documents
   • Submitted to State-owned Assets Supervision and Administration Commission
Provisional Regulations on Administration of the Transfer of State-owned Assets (1 February 2004) (cont’d)

2. Procedures on Transfer of State-owned Assets

• Research on Feasibility
• Asset Appraisal
• Announcement
• 2 or More Purchasers – Auctions or Bids
• Payment of Consideration
Qualified Foreign Institutional Investors
(“QFII Regulations”)
V. Reducing Acquisition Risks – Due Diligence
V. Reducing Acquisition Risks – Due Diligence

Reasons for Conducting Due Diligence Exercises

1. Protection
2. Regulatory Compliance
3. Investigation of the Company
4. Assess the Risks and Understand the Parameters
Case Study
Case Study of Acquisition of Steel Plant
Due Diligence
Shoreline Issues
Valuation Issues
Practical Structuring Factors

Case Study (cont’d)

PRC Listed Cement Plant

• Acquisition by Strategic Investor
• US $30 million Investment
• Listed shares
• Approximately 25 per cent of issued share capital

Source: WFE, SGX (as at end of 2011), HKEx, Dealogic
Case Study (cont’d)

Time Frame:

• 2/3 years
• 1 year of intensive professional involvement

Source: Blomberg, WFE, WEF, WSJ
Importance of Understanding:

• the legal/business environment

• the industry

Source: Hong Kong Exchanges and Clearing Limited
Note: Trading of 35 issuers (including 8 GEM companies) is suspended as of Jan 2010
Case Study (cont’d)

PRC

• Legal Norms
• Business Practices
• Management Behaviour
• “Neibu” Information
Understanding the Cement Industry

- capital intensive
- long-term view required
- long-term finance essential
- title to land/mining/building rights crucial
Professionals

- Lawyers (Hong Kong and PRC)
- Technical experts
- Accountants
- Valuers
Case Study (cont’d)

Business Approach

• “Partnership”
• Ensure all legal formalities effected
• Business Planning
• Human Resources Planning
• Capital Investment Planning
Case Study (cont’d)

Regulatory Application

- China Securities Regulatory Commission
- Shanghai Stock Exchange

Source: Hong Kong Exchanges and Clearing Limited
Case Study (cont’d)

Initial Meetings

Site Meetings

Information Gathering
Due Diligence Areas

Huaxin’s Operations
History and Overview
Shareholdings and Capitalisation

Relationship with Major Shareholders and the Municipality
Management Structure

Intellectual Property

Land Use Rights and Building Ownership Certificate
Products and Production Arrangements

Particulars of Kiln Project

Raw Materials Supply
Energy Supply

Transportation

Distribution
Market Position and Competition

Financing Arrangements and Indebtedness

Insurance
Labour and Welfare Arrangements

Taxation

Environmental Compliance

Miscellaneous
Legal Due Diligence Report
Major Issues

Land
Mining Rights
Asian Development Bank
Tax
A. Subsidiaries and Joint Ventures
B. Questionnaire
C. Summary of further information required
D. List of documents relating to Huaxin’s operations supplied and inspected and reviewed
E. Assumptions and Qualifications
   • Assumptions
   • Qualifications
F. Summary of Articles of Association
G. List of assets in excess of RMB • in value
H. List of International Equipment Purchase Agreements using ADB Loan
I. List of local environmental protection rules and regulations

J. PRC Legal System
   • Overview of the PRC Legal System
   • PRC Company Law
   • Securities Law
   • Tax Laws and Regulations
   • Foreign Exchange
   • The Mineral Resources Law
   • PRC Environmental Protection Law
Further Process

Tax Laws and Regulations

• Review
• Negotiation
• Solutions
• Finalisation
Importance of Legal Opinions
The Final Outcome
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