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CHINA BRIEFING

From Dezan Shira & Associates

Understanding Mergers & Acquisitions in China

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Introduction

Alberto Vettoretti
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The environment for mergers and acquisitions (M&A) in China has fundamentally changed in recent years. Affected in part by the global economic crisis and wavering Chinese growth, the rate of foreign acquisitions in the country has fluctuated considerably over the past ten years, going from 42 deals worth approximately RMB 30 billion in 2008, to 39 worth 78 billion in 2013, to 61 deals worth 35 billion in 2015.

Conversely, Chinese outbound acquisitions have experienced an unprecedented upsurge in the last two years. A sharp rise in capital outflows resulted in Chinese outbound investment surpassing that of major developed economies in 2015, while Q1 2016 saw China record its largest ever quarterly share of global acquisitions, making up a sixth of all M&A activity.

The contrasting dynamics of outbound and inbound M&As in China has served to transform the M&A market landscape in the country. While the acquisition is still undoubtedly a swift and effective means for foreign companies to enter the Chinese market, there are now a host of new considerations for firms to take into account prior to committing to any investment, including uncertain market conditions, bigger domestic players, and new regulatory frameworks.

In this issue of China Briefing magazine, we set out to guide foreign investors through the mergers and acquisitions process, from initial market research, to set-up procedures and regulatory hurdles, and finally thorough important due diligence considerations. With experience in China's M&A market since 1992, Dezan Shira & Associates is perfectly positioned to ensure that the M&A is the right investment vehicle for your company's venture into China.

With kind regards,

Alberto Vettoretti

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Understanding Mergers & Acquisitions in China

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An Introduction to China's M&A Market

By Dezan Shira & Associates
Editor: Zolzaya Erdenebileg

2015 was a transformative year for mergers and acquisitions (M&A) in China. During the first half of last year, China's outbound M&A volume exceeded its inbound, with 382 deals worth US$67.4 billion by the year's end, making the country a net capital exporter. Inbound foreign M&As, meanwhile, have continued their upward yet slow expansion. Their piecemeal development is due in part to China's ostensibly complex regulatory framework surrounding acquisitions, foreign apprehension about slower growth, and strong domestic players.

While inbound M&A growth in China has not been keeping pace with its outbound, the M&A remains one of the key investment vehicles with which foreign companies can enter the Chinese market. However, there are many potential pitfalls when conducting a company acquisition in China. Failure to flag operational, financial and legal problems in the acquired company, as well as a lack of understanding of the Chinese market, can prove extremely costly. Conducting a thorough due diligence is therefore essential.

Latest M&A Market Trends

The number of inbound M&A deals in China increased 39 percent from 2010 to 2015, with total deal value increasing by approximately 141 percent. The environment for M&As continues to be dynamic, with China particularly interested in projects that can help reform state-owned enterprises (SOEs) and improve national technological capabilities.

The majority of M&A activities in China are domestic, making up 89.5 percent of all M&A transactions in 2015. However, foreign outbound M&A transactions are on the rise, making up 8.2 percent of all transactions and 18.6 percent of deal value in 2015. Foreign inbound M&A made up 2.3 percent of total M&A transactions in 2015.

Advantages & Disadvantages

The effectiveness of an acquisition hinges on the makeup of both the acquiring company and the acquired company. If the two are compatible, then the acquiring company stands to gain a quick and strong foothold in the Chinese market; if not, it can quite easily prove to be unsustainable within its first year of operations.

After committing to the M&A, foreign investors should be prepared and willing to use different acquisition structures, sometimes in several parts, to ensure that the process runs smoothly. Provided all of these conditions have been met, the M&A has the potential to be the best means for a foreign firm to enter the Chinese market.

Key Market Trends in China's M&A Market

Top 10 M&A industries in 2015

Counted in Number		Counted in Amount
IT	1	Internet
Internet	2	Real estate
Finance	3	Finance
Machine manufacturing	4	Automobile
Biotechnology /healthcare	5	Entertainment
Electronic devices	6	Biotechnology /healthcare
Real estate	7	Energy and mineral
Clean technology	8	Clean technology
Energy and minerals	9	IT
Entertainment	10	Machine manufacturing

Distribution type of China's M&A market in 2015

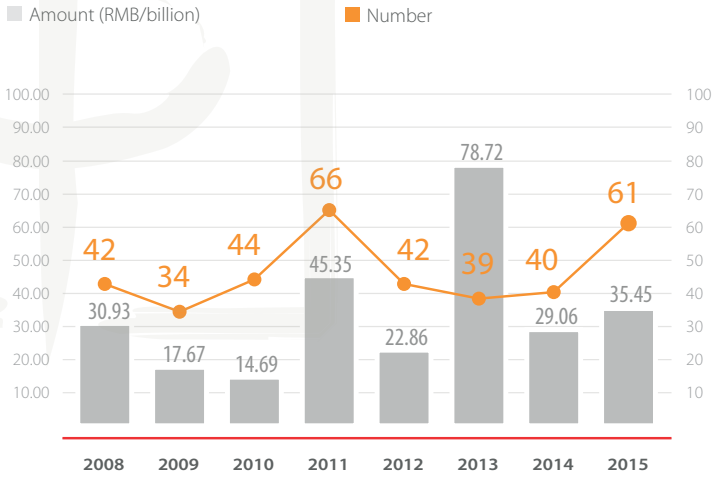
Share of the acquisition market

8.2% Overseas acquisitions

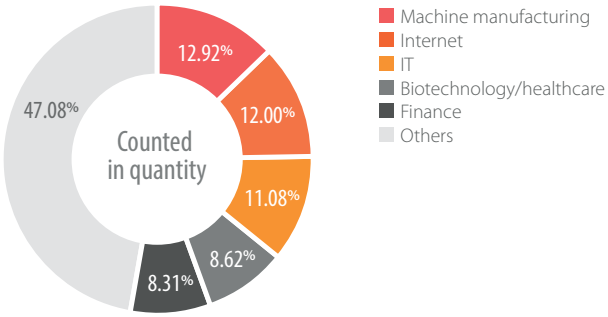
2.3% Foreign invested acquisitions

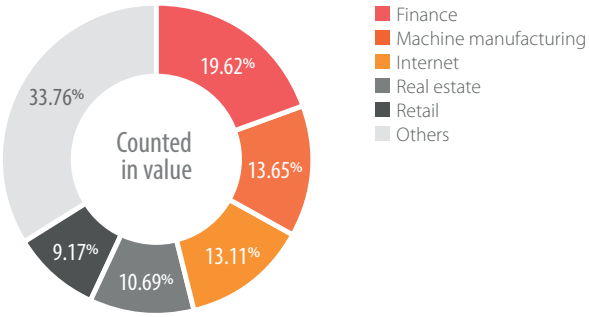
89.5% Domestic acquisitions

Amount of foreign company acquisitions from 2008-2015



Proportion of acquisitions in each industry (as of April, 2016)





Anatomy of a Takeover: Conducting a Company Acquisition in China

By Dezan Shira & Associates
Editors: Zhou Qian

The increase in both inbound and outbound M&As in China has led to its legal apparatus becoming much more sophisticated. Since the turn of the century, the Chinese government has progressively been introducing new taxation and regulatory frameworks to govern how company acquisitions are conducted, which has alternatively served to simplify, complicate, and convolute the acquisition process. In order to ensure that an M&A complies with these new frameworks and to maximize its effectiveness as an investment vehicle, understanding the relevant laws and conducting a thorough due diligence is essential.

Chinese Legislative Framework for Company Acquisitions

Although large company acquisitions will by necessity undergo a painstakingly long and in-depth approval process, the Chinese government has been making efforts to make the process simpler. Nevertheless, there are still contradictions and legislative gaps in the country's company acquisition law, mostly due to the conflicting goals of the government with regards to investment. While China is aiming to protect domestic enterprises from an influx of strong global competitors, it also wants to take advantage of the opportunities that Western businesses and technologies can offer.

Different regulations for acquiring different forms of enterprises

Before taking a closer look at acquisition regulations, it's important to note that different provisions apply to acquiring different forms of enterprises, among which "Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors" (MOFCOM Order [2009] No.6, hereinafter, Order No.6) plays an essential role. While this regulation mainly focuses on acquiring domestic companies that are established according to PRC Company Law, it's also the one to be referred to for matters not addressed by the specific provisions, including:

- "Several Provisions on Changes in Equity Interest of Investors in Foreign Invested Enterprises" (MOFTEC Announcement [1997] No. 267) for acquiring firms that already enjoy Foreign Invested Enterprises (FIE) status in China
- "Administrative Measures on Strategic Investment in Listed Companies by Foreign Investors" for acquiring listed companies;
- Special rules for acquiring state-owned enterprises (SOE), which is sometimes inconsistency with each other and thus rely on a case-by-case analysis

Foreign investors that acquire a domestic company will need to convert it to a foreign invested enterprise (FIE). Consequently, all FIE rules and regulations must be observed, including restrictions on investment, qualifications of investors, and scope of business.

Generally, the Catalogue of Industries for Guiding Foreign Investment (2015) is the basic piece of market entry legislation relating to all foreign investment. According to article 4 of Order No.6, company acquisitions cannot result in:

- Foreign investors holding 100 percent shares of the acquired company in industries that aren't encouraged in the Catalogue;
- Foreign investors becoming the controlling party of the acquired company in industries that are restricted;
- Foreign investors acquiring companies in industries where foreign investment is prohibited

Additionally, if the target company of the acquisition deal is located in Central or Western China, investors may refer to the Catalogue of Priority Industries for Foreign Investment in Central and Western China (2013), which grants incentives to foreign investment in these areas. Special rules are also applied to foreign investment in certain sectors, including but not limited to real estate, the commercial sector, and advertising.

Regulations on acquisition filing and approval

Foreign investors must apply to the right examination authorities to obtain approval. The following regulations clarify the bureaus in charge and materials required:

- Notice on Issues Relating to Administration of Foreign Investments (Shang Zi Han [2011] No. 72)
- Notice on Relevant Issues Concerning the Delegation of Approval Authority for Foreign Investment (Shang Zi Fa [2010] No. 209)
- Measures for the Administration of Approval and Filing of Foreign Investment Projects(Decree of the NDRC No. 12)
- Local documents to further Delegation of Approval Authority, such as Lu Zheng Fa [2009] No.7

Regulations on security review and anti-monopoly investigation

The Chinese government has been careful in weighing the risks against the benefits of foreign enterprises acquiring domestic companies, particularly in what are considered key sectors. In addition to the anti-monopoly investigations stipulated in the PRC Anti-Monopoly Law and the Order No.6., an additional security review by the joint ministerial conference has been required since March 3, 2011, as indicated in "Notice on Establishment of Security Review System Pertaining to Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (Guo Ban Fa [2011] No. 6)". More details can be observed in another legal document released later in 2011, the "Provisions on Implementation of Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (Ministry of Commerce Announcement [2011] No. 53)".

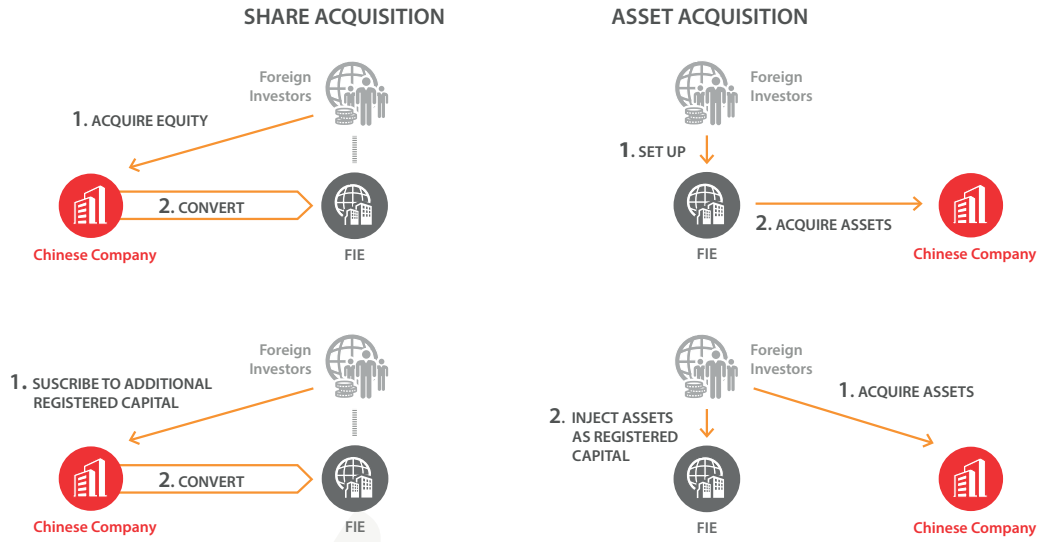
Types of acquisitions and their procedures

In China, one company can acquire another in several ways, including purchasing some or all of the company's assets or buying up its outstanding shares of stock. For share acquisitions, investors can acquire the equity or subscribe additional registered capital of a domestic company and convert it into an FIE. For asset acquisition, investors can establish a new FIE and either acquire the assets of a domestic company or directly acquire the assets of a domestic company and then inject those assets as registered capital into an FIE.

Negotiation, Letter of Intent and Due Diligence

Usually, foreign investors will draft either a "letter of intent" (LOI) or a "memorandum of understanding" (MoU) after initial investigation and negotiation of the targeted company, outlining the matters that the two parties are going to discuss and laying out the complete procedures for doing so. To better understand the targeted company and to avoid potential risks, it's very important for investors to conduct a comprehensive due diligence investigation.

Types of acquisitions and their procedures



When determining the transaction price of shares or assets, the parties should use evaluation results concluded by an asset evaluation agency established under Chinese law as the basis, adopting internationally accepted common evaluation methods. Shares or assets cannot be transferred at a price significantly lower than the evaluation results.

Approval and verification

Upon signing the acquisition agreement, investors should apply for the "Certificate of Approval for Foreign Investment" from MOFCOM or its local level branches according to the investment amount, type of enterprise, and the industry to be invested. In addition, verification by the National Development and Reform Commission (NDRC) is required in big projects, including encouraged and permitted industry projects with a total investment of US$100 million or more, and restricted industry projects with a total investment of US$50 million or more. While the verification is required prior to the approval process, in practice the two can be conducted simultaneously. Approval of other specialized administrative agencies may be required in certain industries, as mentioned in the legislative framework.

For the approval process with MOFCOM, certain documents are required to be submitted, which differ depending on whether the transaction is an equity or asset acquisition. An equity acquisition will require the following documentation:

- The unanimous shareholders' resolution of the target domestic company on the proposed equity acquisition
- Application for the conversion to an FIE
- Contract and articles of association of the FIE to be formed after acquisition
- The agreement on the foreign investor's acquisition of equities of shareholders of the domestic company, or on its subscription of the capital increase of the target domestic company
- Audit report on the financial statement of the previous fiscal year of the target domestic company
- The notarized and certified documents for the foreign investor's identity, registration and credit standing
- Description of the enterprises that the target domestic enterprise has invested in
- Duplicates of the business licenses of the target domestic enterprise and its invested enterprises
- Plan for employees in the target domestic enterprise
- Documents relevant to the agreements on liabilities of the domestic company, appraisal report issued by an appraisal institution and disclosure and explanations for the associated transaction, if applicable

An asset acquisition will require the following documentation:

- The resolution of the property rights holders or governing body of the domestic enterprise on consent of the sale of the assets
- The application for the establishment of the post-acquisition FIE contract and articles of association of the FIE to be established
- The asset purchase agreement signed by the foreign-funded enterprise to be established and the domestic enterprise, or by the foreign investor and the domestic enterprise
- The articles of association and the business license (duplicate) of the target company
- The creditor notification issued by the target company and the creditor's statement on the contemplated acquisition
- The notarized and certified documents for the identity, registration and credit standing of the foreign investor
- The proposal to arrange employees in the target domestic enterprise
- The documents relevant to the target company's liabilities arrangement, appraisal report and disclosures and explanations made by the parties to the acquisition

MOFCOM announces its acceptance or rejection of the application within 30 days of receipt of the application documents. Where successful, MOFCOM will present a certificate of approval.

Renewal of business license

Upon receipt of the approval certificate from MOFCOM, foreign investors engaged in asset acquisitions have 30 days to register the acquired domestic enterprise as an FIE with the SAIC or its local branches. In the case of equity acquisitions, the acquired domestic company will be responsible for the modification of its registration with the original registration authority and for obtaining an FIE business license. If the original registration administration authorities do not have jurisdiction for registration, the application documents are forwarded to the authorities within 10 days from the date of receipt of the application documents. Within 30 days of receiving the FIE business license, the investors need to complete subsequent registrations with the tax, customs, land administration and foreign exchange control bureaus.

Payment requirements

The foreign investor should pay the full amount as stated in the Equity Purchase Agreement within three months of the receipt of the FIE business license. Under special circumstances and subject to the approval of the Ministry of Foreign Trade and Cooperation (MOFTEC), or the provincial examination and approval authority, the foreign investor can pay a minimum of 60 percent of the price within six months, with the full balance to be paid within one year of the issuance of the FIE business license.

If the foreign investor conducts the acquisition through subscription to the capital increase of a domestic enterprise, they will pay no less than 20 percent of the amount of registered capital to be increased at the time of application for the FIE business license. The time limit for payment of the remaining increased registered capital is subject to the provisions of China's Company Law, FIE laws and regulations, and regulations on the registration of companies.

Foreign investors can pay the considerations in foreign currency, property, intellectual property, and with approval of the State Administration of Foreign Exchange (SAFE), in RMB. In addition, share swap is a new alternative to the traditional payment method, but is subject to stricter rules and requirements.

General Procedure for Company Acquisitions

Taxation

Under PRC Corporate Income Tax (CIT) Law, which applies to both domestic enterprises as well as foreign and foreign-invested enterprises, income arising from the transfer of equity and assets (both fixed and intangible) is subject to CIT. The taxable income equals the gross income (i.e., transaction price) subtracted by the net value of the shares or assets:

Taxable income = Gross income – Net value of shares or assets

For resident enterprises, a standard 25 percent CIT rate applies; for non-resident enterprises, the withholding tax rate on capital gains is 10 percent. The CIT Implementing Laws further provide that, when undergoing restructuring, gains or losses arising from the transfer of assets should be recognized at the time of the transaction, and the tax base of the assets should be re-determined based on the transaction price. Caishui [2009] No.59 (revised by Caishui No.109 in 2014) clarifies the general CIT treatment of a company acquisition:

- The acquired company should confirm the incurred income or losses in the acquisition;
- The tax base of the equity or assets obtained by the acquiring company should be determined on the basis of fair value;
- The income tax payments of the acquired company should, in principle, remain unchanged.

IIn addition to the general method, Caishui [2009] No.59 offers special CIT treatment to acquisition transactions that are paid by equity, subject to the following conditions:

- The transaction should involve reasonable commercial objectives, and the main objective cannot be reduction, exemption or postponement of tax payment;
- The original substantive business activities of the restructured assets cannot be changed within 12 consecutive months following the enterprise restructuring;
- The original key shareholders who obtain the equity in an enterprise restructuring cannot transfer the equity obtained within 12 consecutive months following the restructuring;
- The assets or equity acquired must be 50 percent or more of all assets or equity of the acquired company, and the payment of equity must be 85 percent or more of the total payment amount

For transactions involving a domestic party and an overseas party, the following requirements must also be satisfied in order to qualify for special tax treatment:

- If the non-resident enterprise transfers the equity of an acquired resident enterprise to another non-resident enterprise that it fully controls, it must write to the tax authorities assuring that it will not transfer the equity of the non-resident enterprise again within three years;
- The non-resident enterprise transfers the equity of an acquired resident enterprise to another resident enterprise that it fully controls.

If these conditions are met, the tax base of both the acquiring and acquired company will be determined according to the original tax base of the transferred equity or assets.

For equity acquisitions, the tax base of the various original assets and liabilities of both the acquiring and acquired company, as well as any other related income tax matters, will remain unchanged. It's important to note that when utilizing this special CIT arrangement, companies can only defer their CIT payment rather than totally avoid it.

Taxation in a company acquisition

	Company income tax	Value-added tax	Land appreciation tax	Stamp tax	Deed tax
Asset seller	√	√	√	√	×
Equity seller	√	×	×	√	×
Asset acquirer	×	×	×	√	√
Equity acquirer	×	×	×	√	×

The Importance of Due Diligence in the M&A Process

By Richard Cant
Editor: Jake Liddle

Richard Cant
Director
Dezan Shira & Associates
Boston Office

Due diligence is an essential element of a successful acquisition. Allowing a buyer to identify potential future liabilities and to assess the net value of a target entity, it can both challenge and substantiate assumptions made in an acquisitions deal. There are many aspects to an M&A due diligence that a company should consider, including operational, market, reputational and cultural due diligence. Here, we present a case study from Dezan Shira & Associates that addresses the importance of conducting financial and legal due diligence.

An American company (Company A) was considering the acquisition of a Chinese competitor (Company B), and approached Dezan Shira & Associates with the aim of conducting a due diligence on target Company B. Company A wished to thoroughly examine Company B's financial position and the state of their internal operations ahead of completing the acquisition. Company A was specifically intent on ensuring that Company B's financial position was clearly and fairly represented.

During the due diligence process, Dezan Shira made some concerning findings: while inspecting Company B's financial statements, there were discrepancies between some transactions. A portion of the company's business transactions were found in one of the owners' personal accounts, verifying the mixing of personal and company transactions. In addition, information found on the inventory management system was inconsistent with that of the accounting department's books.

In particular, the mixing of company and private assets was the main cause for concern. Firstly, this violation of the Economic Entity Assumption principle means that Company B's financial statements were not presented fairly. Secondly, if a shareholder is receiving private payments for products or services provided by the company, they could potentially be withholding gains from the company and other shareholders. Revenue will also still be subject to tax.

If a shareholder has been making personal transactions under the company's name, the company could be found liable for those transactions. In this case, a company or shareholder can charge for losses perpetrated by the shareholder in question, but the legal process may take months before a result is reached, at which point damage may already have been done..

In the case of Company A, Dezan Shira & Associates notified the client of the legal and tax risks discovered during the course of the investigation, and recommended measures that the company could implement to reduce inconsistencies in its accounting books. Company B fully disclosed its financial information, allowing Company A to thoroughly evaluate the risks involved and to get a comprehensive view of the company's inner working, and as a result, was able to make a well informed decision on the acquisition.

As evident from this case study, due diligence not only serves to pre-empt risks in the acquisition process, but can also provide leverage to negotiate the best deal. There is a litany of risks associated with acquisitions beyond those demonstrated in this scenario, and if any compromising information is left unfound, a buyer will inherit hidden liabilities of the target company after acquisition. For this reason, it is of utmost importance for investors to conduct in-depth due diligence before acquiring any substantial part of a Chinese company.