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VOICE FROM CHINA

UPDATE ON THE M&A MARKET IN CHINA

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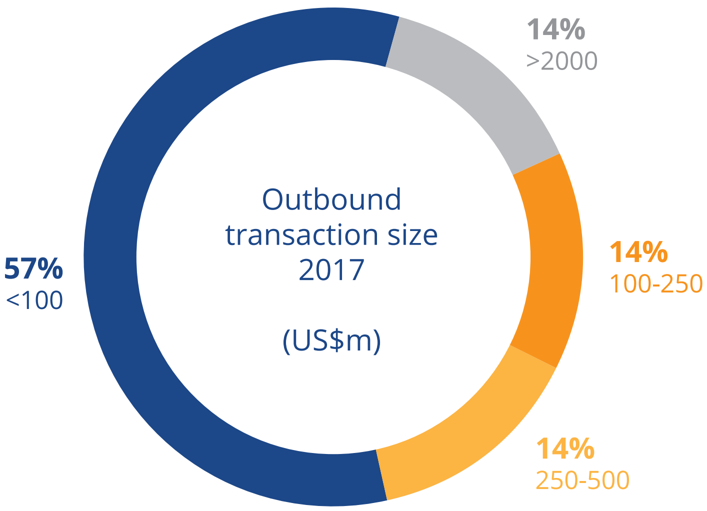
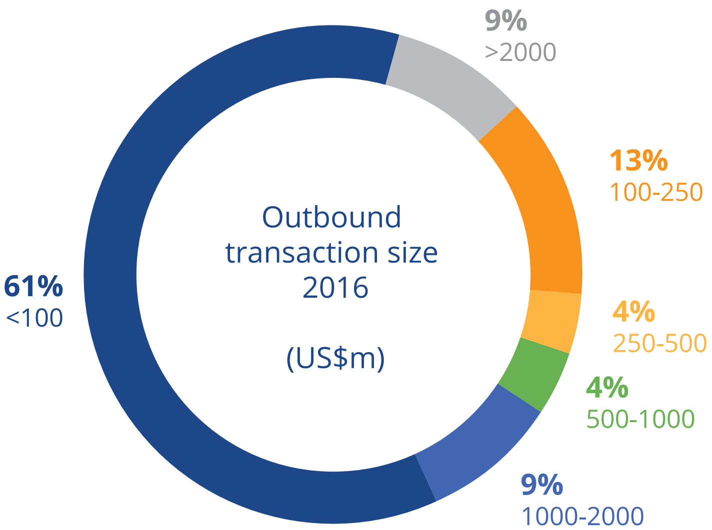
INTRODUCTION

Met with the pressures of the ongoing depreciation of the Chinese Yuan[1] and the record lows of China's foreign currency reserves[2], the Chinese government has recently released a series of policies designed to restrict capital outflow, which has made a considerable impact on Chinese outbound cross-border M&A activity. Transactions that create synergies and enhance China's core competency and global presence will be in favorable positions to obtain approval from the State Administration of Foreign Exchange (SAFE). Meanwhile, regulatory authorities will apply stricter supervisory measures on transactions that have the purpose of capital arbitrage or financial statement consolidation.

Restrictions on capital outflow will impact chinese outbound cross-border M&A activity





[1] The US Dollar to Chinese Yuan exchange rate went up to 6.875 at the end of February 2017 from 6.5359 a year ago.

[2] China's foreign currency reserves fell to US$2.998 trillion and reached the lowest level since 2011.

REGULATIONS AFFECTING CHINA'S CROSS-BORDER M&A

Notable Chinese regulatory changes

In December 2016, the National Development and Reform Commission (NDRC), the Ministry of Commerce of the People's Republic of China (MOFCOM) along with the People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) jointly announced that regulatory authorities intend to pay close attention to future Chinese overseas investments with regards to arbitrage or financial consolidation purposes[3]. An intensified vetting process will make it less likely for Chinese enterprises to obtain regulatory approval if an investment falls under any of the following categories:

- Investments in areas that are not related to the core business of the Chinese enterprise
- Investments in restricted industries, such as real estate, hotel, cinema, entertainment and sports clubs
- Outbound investments from a limited liability partnership
- Overseas investments that exceed the parent company's registered capital in China
- Newly established Chinese entities without continuous operations in the invested business
- Use of high leverage to acquire foreign targets
- Minority investments in overseas companies

On 18 January 2017, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) issued Notice Order No.35[4], which restricted state-owned enterprises from overseas investments in non-core businesses. The government is taking a prudential approach towards capital outflow from state-owned enterprises.

Citing a reliable source, SAFE is limiting the amount of capital outflow from a cross-border M&A transaction to a threshold of RMB 1 billion (approximately US$145 million). Outbound acquisitions with a transaction size under RMB 1 billion (US$145 million) are eligible for SAFE's approval despite a prolonged investigation process, while those above the RMB 1 billion (US$145 million) threshold are subject to suspension for an unspecified period of time.

The impact on China's cross-border M&A

As a result of these recent developments, a number of ongoing transactions that are backed by Chinese financial investors have been suspended following the December 2016 policy revision, which amounts to an estimated US$5.81 billion. Should the current regulation stay in place, cross-border buy-out funds might be subjected to hefty reverse termination fees as stipulated in the M&A agreement. Faced with increased uncertainty, some Chinese financial investors will inevitably postpone their interest in overseas investments.

The government is taking a prudential approach towards capital outflow from state-owned enterprises

For Chinese strategic investors, SAFE, NDRC and MOFCOM will jointly evaluate the authenticity and purpose of outbound investments[5]. If the outbound investments do indeed help Chinese enterprises acquire advanced technologies and industrial innovations, the capital outflow will stand a higher chance of obtaining regulatory approval. On the other hand, Chinese businesses will be facing stricter regulatory procedures if authorities deem the investment as one with speculative motives, especially those in the aforementioned restricted industries.

Nonetheless, Chinese enterprises will be able to invest offshore if they have an existing overseas subsidiary with adequate capital or if they can obtain overseas loans under domestic guarantees to finance the cross-border acquisition.

RECENT M&A TRANSACTIONS

The number of closed outbound M&A transactions is decreasing significantly

Under the tightened regulatory policies, it is not surprising to see a significant decrease in the number of closed outbound M&A transactions during the first two months of 2017. There were only 19 closed outbound transactions in 2017, compared to 35 in the corresponding period in 2016[6].

- The top three industries Chinese buyers have invested in so far in 2017 are information technology (26%), consumer discretionary (21%) and healthcare (16%), followed by industrials, real estate, consumer staples and materials.
- The top four geographical areas Chinese buyers have invested in so far this year are the United States (five closed deals), Germany (four closed deals), Hong Kong (two closed deals) and Italy (two closed deals), followed by Canada, Ireland, Israel, the Netherlands, New Zealand and Sweden.
- 10 out of these 19 closed outbound transactions disclosed the total transaction value. Six were below US$100 million, three were between US$100 and US$250 million, and the largest deal was US$2.75 billion.

Geographical areas Chinese buyers have invested in this year

We can see that the majority of outbound M&A transactions in the first two months of 2017 were relatively small in size, which is consistent with the introduction of the stricter approval requirements.

Only two transactions disclosed the valuation multiples:

- Innotech Capitals, a Shanghai-based private equity group, acquired US advertising automation firm Ad-Juster for US$18 million, with an implied P/E multiple of 9x.

- China Loncin Motor acquired a 67% stake in Italy's Costruzioni Motori Diesel for US$43.5 million, with an implied EV/EBITDA of 7.38x and an implied P/E multiple of 31.56x.

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3 A joint interview with NDRC, MOFCOM, PBOC and SAFE on *"Strengthening Supervision on Outbound Investment in the Current Situation"*, 6 December 2016.

4 SASAC's Order No. 35, *"The Measures for the Supervision and Administration of Overseas Investments by State-Owned Enterprises"*, 18 January 2017.

5 SAFE publication, *"Circular of the State Administration of Foreign Exchange on Further Advancing Foreign Exchange"*.

6 Source: Capital IQ, 28 February 2017

SPOTLIGHT ON AN ACQUISITIVE CHINESE BUYER

In spite of tightening regulatory policies, many Chinese enterprises are actively seeking overseas acquisition opportunities in line with their corporate development strategies. For example, Heilan Home, a well-known Chinese clothing company with a focus on menswear, is actively seeking Western targets in fast-fashion brands that will provide a presence in America and Europe. Oaklins' team in China has a good, long-standing relationship with Heilan's ownership. The optimal transaction size ranges from US$1 to US$1.5 billion, reflecting a higher market share in America or Europe. Potential targets should be well-established fashion brands for men and/or women, preferably fast-fashion brands.

KEY OUTBOUND M&A CASE STUDY

On 19 January 2017, China Loncin Motor Co., Ltd. (Loncin) completed the acquisition of a 67% stake in Italy's C.M.D Costruzioni Motori Diesel S.P.A. (CMD) for US$44.10 million. Following the acquisition, Loncin plans to expand into the general aviation engine industry, leveraging CMD's advanced technology in this field. This transaction is a good example of Chinese buyers acquiring advanced technology through an outbound investment.

About the buyer

Founded in 1993, Loncin is engaged in the design, development, manufacturing and distribution of various land vehicles, such as motorcycles, motorcycle engines and general power machinery.

About the seller

Established in 1971, CMD is a leader in the design, prototyping and development of diesel engines. It offers engineering services in the automotive industry through patented advanced technologies. Recently CMD successfully developed micro-chip technology to control wooden biomass power generation that can be applied in aviation. It also industrialized two aircraft engines for Very Light Aircrafts (VLA).

Market trends and deal drivers

China's general aviation industry is in an early stage of development, with the majority of aviation piston engines imported from overseas. Therefore, there is a strong demand for independent providers of general aviation engines with R&D and manufacturing capabilities.

Valuation

Loncin employed a comparable company and discounted cash flow approach to get CMD's total equity value of US$47.6 million. Ultimately, Loncin paid US$43.5 million for 67% of its shares, which implied a total equity value of US$64.9 million and a P/E multiple of 31.56x (CMD generated US$33.2 million in revenue and US$2 million net income in 2015). The valuation premium mainly came from the following synergies the transaction brought to Loncin[7]:

- CMD's core technology in general aviation piston engines
- Access to a first-class R&D team in Europe
- Certification issued by the European Aviation Safety Agency (EASA)
- An established sales channel and customer base in the European market

[7] Source: China Loncin Motor Co., Ltd. 2016 Annual Report

Appendix: 19 closed outbound transactions in January and February 2017

NO.	Date closed	Buyer(s)	Target	Target headquarters
1	2-Jan-2017	Shanghai Turin Robot Co.	RRRobotica s.r.l.	Italy
2	4-Jan-2017	Tian Ying Medical Instrument Co., Ltd.	elexxion AG (XTRA:E8X)	Germany
3	12-Jan-2017	An Xin Capital LLP	Norstel AB	Sweden
4	17-Jan-2017	Fosun International Limited	Office building on Theodor-Heuss-Allee 44	Germany
5	17-Jan-2017	MSouth Equity Partners; Heartland Media Group	Five TV Stations	United States
6	18-Jan-2017	Innotech Capitals	Ad-Juster, Inc.	United States
7	19-Jan-2017	Resolution Property Plc; Fosun Property Holdings Limited	30,000 m2 Estrella Building in Frankfurt	Germany
8	19-Jan-2017	Loncin Motor Co., Ltd.	C.M.D. Costruzioni Motori Diesel S.p.A.	Italy
9	23-Jan-2017	China National Machinery Industry Corporation	FINOBA AUTOMOTIVE GmbH	Germany
10	1-Feb-2017	Beijing Byte Dance Telecommunications Co., Ltd.	Flipagram, Inc.	United States
11	1-Feb-2017	Bosai Minerals Group Co., Ltd.	Reunion Gold Corporation, Matthews Ridge Manganese	Canada
12	2-Feb-2017	China Diamond Holdings Company Limited	The Better Health Company Limited	New Zealand
13	4-Feb-2017	Nanjing Xinjiekou Department Store Co., Ltd.	Home & Health Care Holding Limited	Hong Kong
14	7-Feb-2017	Weihai Weigao Equity Investment Management Company Limited	RAD Source Technologies, Inc.	United States
15	7-Feb-2017	Beijing JianGuang Asset Management Co., Ltd.; Wise Road Capital Ltd.	Nexperia	Netherlands
16	9-Feb-2017	Midea Group Co., Ltd.	Kollmorgen Servotronix Ltd.	Israel
17	14-Feb-2017	Shangtex Holding Co., Ltd.	Luen Thai Holdings Limited	Hong Kong
18	23-Feb-2017	Virtuos Ltd.	Black Shamrock Ltd	Ireland
19	28-Feb-2017	Samson Holding Ltd.	Kohler Interiors Group, Ltd.	United States

Target industry	Transaction value (US$m)	Stake acquired (%)	Remarks
Industrial Machinery	-	-	
Healthcare Equipment	-	55.0	
Semiconductors	-	100.0	
Real Estate Operating Companies	54	100.0	
Broadcasting	115.0	100.0	
Internet Software and Services	18	100.0	P/E: 9x
Real Estate Operating Companies	-	100.0	
Auto Parts and Equipment	43.5	67.0	EV/EBITDA: 7.38x P/E: 31.56x
Auto Parts and Equipment	-	100.0	
Application Software	-	100.0	
Diversified Metals and Mining	10.0	100.0	
Personal Products	-	80.0	
Healthcare Services	93.13	84.0	
Healthcare Equipment	-	100.0	
Semiconductors	2,750.0	100.0	
Industrial Machinery	170	-	
Apparel, Accessories and Luxury Goods	255.24	74.5	
Home Entertainment Software	-	100.0	
Home Furnishings	29.5	100.0	

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