Breaking New Ground in Beijing

by Catherine Gelb

In the context of record-setting worldwide M&A activity, large numbers of investors are looking at China. The future of M&A activity, in investors' eyes, may hinge on the outcomes of several high-profile deals, according to Mark Roppel, managing partner of Cadwalader, Wickersham & Taft LLP's Beijing office.

Roppel says that foreign investors have been following closely the investment by The Carlyle Group in China's Xugong Construction Machinery Co., and the recently approved Citigroup investment in Guangdong Development Bank. If these deals are successfully completed, "there will be more comfort among both strategic and financial investors that they can close transactions in China." Already, some sectors are experiencing significant activity, such as real estate, particularly in the hotel space and in Macau. "You may also see interest in basic materials

as a result of China's construction boom," Roppel predicts. He cautions, however, that "it will be a few more years before private equity activity in China really takes off, because there is still uncertainty about exit strategies."

M&A uncertainties, investigating fraud

Cadwalader's Beijing office, opened last year, will assist clients with cross-border M&A and capital markets transactions and related investor concerns. "We have been involved in everything from registering foreign corporations and inbound investment, to structured finance, to advising Chinese companies considering listing in the U.S. and advising state-owned companies considering buying assets in North America," says Roppel.

Some uncertainty has arisen among investors in recent months, since China enacted a regulation in September that requires central Ministry of Commerce (Mofcom) approval for foreign acquisition of Chinese companies that own famous Chinese brands, or that operate in industries that would affect "national economic security." Approval is also needed for acquisitions by foreign companies of Chinese enterprises with affiliated shareholders. "Navigating between provincial and central government approval is always difficult," says Roppel.

The local government may assure a potential investor that central government approval for a proposed deal is unnecessary. The central government, however, may assert its authority. Though it will take some time to assess the effects of the new rules, they are unlikely to drive away investors, Roppel says.

Another uncertainty investors encounter concerns foreign exchange conversion. Some deals have folded because of the inability of foreign investors to obtain assurances about the ability to convert foreign exchange from the State Administration for Foreign Exchange, known as SAFE. Foreign investors operating in China need approval to convert foreign exchange to pay bills—or to convert dividends. "The problems aren't unique to China; Japan and South Korea until recently had similar difficulties," Roppel says.

In addition to M&A work, Cadwalader's Beijing office has been assisting with the "active and sizeable business fraud practice" coming out of the firm's Washington, D.C. office. The firm has advised clients that are conducting investigations into their China operations to ensure compliance with the U.S. Foreign Corrupt Practices Act. The FCPA rules regarding interaction with government employees can be complicated in China by the fact that the U.S. government defines employees of state-owned enterprises as government officials. In addition, the FCPA holds companies responsible for transgressions that occurred in an acquired company before the acquisition.

Leading the way in structured products

In addition to the work of the Beijing office, Cadwalader, as a pioneer in structured products, is well positioned to assist China's efforts to develop more sophisticated investment options. With its foreign exchange reserves now topping $1 trillion and a savings rate that is one of the highest in the world, China is under increasing pressure to provide more investment opportunities for its citizens. So it should come as no surprise that the Chinese government is rapidly establishing a regulatory framework to allow a wider variety of investment instruments—including structured investments.

"Securitization in China is in its initial stages," explains Cadwalader partner Angus Duncan. "There have been a few small domestic deals by Chinese banks, but in the next few years there should be more opportunities, especially once rating agencies get more comfortable rating these products."

Cadwalader recently advised Hua An Fund Management Co. Ltd, one of China's largest asset management companies, in its first investment product making use of China's new Qualified Domestic Institutional Investor system, known as QDII. The QDII system enables Chinese institutions to convert renminbi (RMB, or yuan) into foreign currency for overseas investments. According to press reports, domestic banks and fund managers as of early November had won approval to invest $12.6 billion overseas under the QDII scheme.

Hua An was the first Chinese fund management company to receive QDII status from the China Securities Regulatory Commission. Currently about 14 banks, both domestic and foreign, have this status, according to Cadwalader associate Yong Kai Wang. More are rushing to gain approval, but Hua An was the first investment company to undertake such a transaction; those prior to the Hua An deal were investments in fixed income products, he explained.

The Hua An transaction was a "groundbreaking" deal not only because of Hua An's participation but also, Duncan explains, because the deal was for a secured hedge-fund-linked note.

"This is a significant opening up of China's capital markets," Duncan says. "There is potential for further sales into China of structured products off the backs of this transaction." Lehman Brothers, together with Hua An, offered U.S. dollar-denominated principal protected notes to a Hua An-managed domestic fund. The notes are linked to the performance of investments that are jointly managed by Hua An and Lehman.

Another significant element of the deal is the fact that it was undertaken as a pilot measure while China's regulators are still finalizing the rules to guide these types of transactions. "This is the first time regulators took a positive step to allow a pilot scheme involving outward investment," Duncan points out. "The experience of this deal will be directly relevant to China's regulatory drafting process." The deal was relatively small—$200 million—but the result will prove to be a model for future, larger deals. Standard Chartered recently projected that up to $75 billion could be invested through the QDII in the next two years.

Duncan also points to the Chinese willingness to involve hedge funds in the deal as the possible start of a trend. Lehman and Hua An were co-managers and agreed to investment in Lehman-managed hedge funds. This raises prospects for other hedge funds to tap China as a source of funds.

Looking ahead

Though China's financial reforms are far from complete, the QDII effort is just one example of the Chinese leadership's interest in developing a world-class financial sector. The IPOs of three of China's big four commercial banks over the past couple of years is another example.

The runup in the stock prices of these banks has led to unrealistically high P/E ratios, Roppel points out. Yet the banks have undeniably large and attractive assets, and the yuan is sure to appreciate in the future, he says. The key may be whether China can create a sufficiently robust legal and regulatory framework to ensure stability for the financial sector. The expertise Cadwalader brings to China is thus particularly well timed.