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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Turmoil In The Chinese Capital Markets And Related Trends

Law360, New York (November 3, 2015, 10:30 AM ET) --

David K. Cho Phoebus Chu

For the first three quarters of 2015, market research reported a strong trend of merger and acquisition activity in the Asia-Pacific region, where there was an increase in the number and aggregate value of deals. Deal values of both outbound and domestic M&A activity for that period achieved record highs, driven in large part by fervent activity in the technology, industrials and chemicals sectors, in particular.

The depreciation of the renminbi (RMB) in August led many to predict at that time that on the one hand, overseas acquisition plans of small and medium-sized Chinese enterprises might be adversely affected by higher deal cost (in RMB terms), and, on the other hand, U.S.-based strategic and financial buyers would turn to China for possible investment opportunities. As it turns out, the devaluation has not had as significant an effect as some had speculated (or feared), especially with the concurrent depreciation of other major currencies, such as the euro, the Australian dollar, the New Zealand dollar, the Korean won, the Japanese yen and the Canadian dollar. As such, the adverse effect of exchange rates on investments by Chinese companies into these countries is likely to be minimal.

Overall, the depreciation of the RMB seems to have had little impact on the sentiment of Chinese acquirers to pursue overseas acquisitions or their strategic investment plans. In fact, ultrahigh-net-worth individuals appear to have hastened their overseas investments, especially in real estate, to protect against further depreciation of the RMB.

Acquisition opportunities in the U.S. and in Europe, in particular in the consumer-related and health care sectors, have been targeted by Chinese enterprises of different sizes and also, increasingly, by Chinese funds (both RMB and offshore funds). While the depreciation of the RMB may have resulted in higher prices in RMB terms, valuations of investment opportunities appear to be driven by basic investment fundamentals rather than exchange rate concerns. There is a general observation in the market that

Chinese investors, driven by the desire for market access or technical capabilities, tend to take a much more long-term view than those, for example, in Europe and the U.K. In any event, sophisticated Chinese investors have elected to finance offshore acquisitions with offshore debt and hedging exchange rate risk with derivatives, which has had the impact of virtually eliminating the impact of the depreciation of the RMB to Chinese investors.

In addition, it remains true that a significant part of China's outbound M&A activity continues to be driven by government policies or direction, as evidenced by President Xi Jinping's recent state visit to the U.K. that is expected to be followed by Chinese investments of billions of Sterling pounds into the U.K. market.

In terms of inbound investment into the China market, while there was a significant drop in aggregate value after the Shanghai stock market crashed in August, investment opportunities still exist in a number of Chinese companies, such as those in the technology and e-commerce sectors, which are still actively seeking offshore funding from strategic or private equity investors. For these transactions, the depreciation of the RMB has had a positive impact on foreign investment activity in China, but probably not to the extent initially thought when China first devalued the RMB, as the appreciation of the greenback relative to other currencies has provided U.S. dollar-denominated investors with alternative investment opportunities in other Asian countries. In fact, historical figures suggest that exchange rate issues were not a primary concern for U.S. foreign direct investment into China: the total value of investments rose from 2010 to 2014 amid the rise of the RMB against the U.S. dollar during the same period.

Indeed, the depreciation of the RMB has had a negative impact on the equity markets. From an inbound investor's point of view, however, there could still be significant opportunities in, for example, the domestic service-driven industries, notwithstanding the slowing economy and weaker currency in China. It is believed that the recent downward adjustments on the global stock markets, in particular the Chinese stock markets, would likely result in a corresponding adjustment in the stratospheric valuations previously demanded by enterprise owners, hopefully leading to more reasonable levels. Further, given prevailing market conditions, an initial public offering is, at least in the near term, no longer an attractive exit option for many private equity investors with investments in late-stage Chinese companies. As a result, they may prove to be attractive sellers for strategic investors or private equity funds looking for bargains in China.

Anticipated reforms to the state-owned enterprises (SOEs) have been stalled and privatization of these SOEs will likely be delayed as China scrambles to get its growth back on track. With latest economic data indicating that China's growth is at its lowest levels since the post-global economic global crisis, it is likely that the myriad agencies in charge of China Inc. will be implementing various agendas and initiatives, and it remains to be seen whether these measures foster or hinder investments, whether inbound or outbound.

Another trend in investments relating to China is noteworthy. 2015 has seen the emergence of an increasing number of small to medium-sized RMB-denominated funds. These RMB funds, mostly invested and managed by Chinese nationals, focus on actively investing in venture capital deals in China. Unlike the typical venture capital investment in the U.S., these RMB funds normally demand (and achieve) higher levels of protection for investors, and the underlying legal documentation is not as form-driven as in the U.S., resulting in greater negotiation time and efforts. Clearly, these funds, with funds domiciled within China, enjoy an advantage in terms of speed of execution and regulatory hurdles as they do not need to receive foreign exchange procedures to convert from foreign currencies to RMB. For

the time being, these RMB funds, not the least because of their size, are still focusing primarily on venture capital deals. For the larger, more traditional private equity investments in China, offshore funds remain very common and the predominant source of private funding, and will continue to be so long as the stock markets continue to flounder.

—By David K. Cho and Phoebus Chu, Dechert LLP

David Cho is a partner in Dechert's Hong Kong and Los Angeles offices. Phoebus Chu is a consultant in the firm's Hong Kong office.

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