



# CHINA OUTBOUND

## M & A O U T L O O K

**PAUL**  

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**HASTINGS**



# Contents

3	Foreword
4	<b>Deal Trends</b>
8	Paul Hastings Perspectives Outbound Real Estate Investment: The Next Phase
10	<b>Financing Growth</b>
12	Paul Hastings Perspectives The Path to Finance: Policies, Procedures, and Potential Challenges
14	<b>Regulatory Approval</b>
16	Paul Hastings Case Study Shuanghui International's Acquisition of Smithfield Foods
18	<b>Common Hurdles</b>
21	Concluding Remarks: Critical Success Factors
22	Paul Hastings Perspectives Access to Technology: Deal-making Options Amid Complex Regulations
24	About Paul Hastings
26	About Mergermarket

# Methodology

In the second and third quarters of 2013, Paul Hastings commissioned Mergermarket to interview 150 corporate executives, investment bankers, private equity practitioners and sovereign wealth fund managers based in Greater China regarding the prospects and procedures of outbound M&A. Results are presented in aggregate and reported anonymously.

## Research notes:

- Where percentages add up to over 100%, respondents were asked to choose all applicable answers.
- Greater China includes: China, Hong Kong, Macau and Taiwan.

# Foreword

**The inaugural edition of *China Outbound M&A Outlook* published by Paul Hastings and Mergermarket looks at some of the significant challenges and opportunities faced by China's companies as they increase the pace of their international investment and expansion.**

For today's Chinese acquirers, market potential reflects both the factors that are drawing investments outwards as well as the realities they have encountered in entering new markets, however attractive. Our study examines the investment question from both perspectives – the structural factors shaping Chinese attitudes towards outbound investment and their reaction to on-the-ground realities. It offers readers a current pulse of the Chinese outbound M&A market as well as in-depth insight on specific opportunities and challenges of such investments.

Chinese M&A activity has continued throughout the very volatile and uncertain markets of the past few years. For Chinese acquirers, this market volatility has represented a rare opportunity to make acquisitions or build market share in regions they had long targeted. It is no surprise that we have seen both the value and volume of outbound investment increase as a consequence. Moreover, it is an investment landscape that is continually evolving and reshaping, with new players, deregulation and improving accessibility to finance adding their own dynamics.

During the recent global recession, China played a key role as a motor of economic growth. Through considerable public investment as well as the considerable energies and commitment of its industries and workforce, China kept its growth story – and its role as an engine of both global supply and demand – intact despite very challenging international circumstances.

With the global economy beginning to recover its poise, the Chinese government is adjusting some of the stimulus measures that supported growth in troubled times. Official policy has shifted to encouraging domestic manufacturers and investors to increase their focus on longer term value creation, as well as on domestic investment to develop and expand consumption. At the same time, the government is and remains deeply supportive of companies' overseas expansion, most

particularly in areas that will move the Chinese economy further up the value chain in terms of technology, resources, market positioning and brand value.

Chinese companies have always been exceptionally alert to the growth potential of overseas development, but it is fair to say that there was a lot of initial caution about the associated challenges – often as much cultural as compliance-related. While the government can clearly only help the former by supporting more dialogue between Chinese companies and their foreign counterparts, the government has taken more concrete steps in practical areas such as finance. These include allowing commercial banks to support outbound M&A and working to streamline its regulatory process.

So what is driving today's Chinese outbound investment? The results of our survey suggests some fascinating shifts in priorities. The common perception is that China's international expansion is dominated by its need to secure natural resources, but our respondents were much more focused on gaining entry points to new markets and securing access to technological know-how as key strategic objectives. While transactions in the natural resources sector are still a significant portion of outbound acquisitions, the volume is decreasing compared to other areas, including consumer goods and telecommunications, media, and technology (TMT).

Chinese acquirers have to be determined, as well as dedicated. Their success depends on successfully navigating restrictions in both domestic and in target markets. As the past few years have shown, through both good times and exceptionally difficult ones, Chinese businesses have reached out, and into, global markets with increasing success. As our survey shows, this positive commitment is setting a very clear path for the next phase of China's international growth.

**David Wang, Partner, Paul Hastings, Beijing and Shanghai**

# China Outbound Deal Trends



**China's appetite for foreign acquisitions is growing, as is the breadth of strategic objectives driving outbound M&A.**

## **Regional Focus**

Respondents are making the Asian countries outside of Greater China their top priority for outbound M&A. Chinese companies and investors believe that these countries will experience similar levels of economic growth and development to those achieved in China. Europe and North America round out the top three regions (in that order), a result Mergermarket research supports. The data shows that, this year to date, 37% of outbound targets were based in Asia, followed by 36% in Europe and 17% in North America.

“Europe is a lucrative destination for Chinese investors, not only due to a relatively weak European economy and opportunities to acquire high-end brands and technologies at an attractive price, but also due to lower administrative and regulatory approval requirements, and a seemingly more open sentiment towards Chinese investments compared to other jurisdictions.”

Christopher Wolff, Partner, Paul Hastings, Frankfurt



# China Outbound Deal Trends

## Sector Specifics

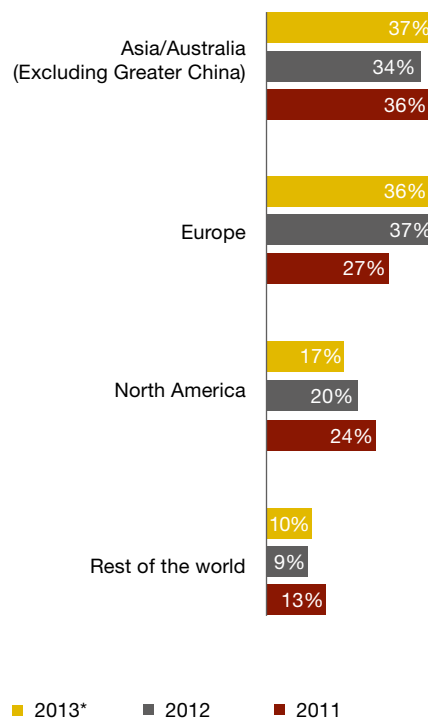
Aggregate results globally indicate that TMT and industrials and chemicals are clear industry priorities for respondents followed by the energy and consumer goods sectors.

TMT is the most favored sector for respondents who indicate Asian countries as their primary target, followed by industrials and chemicals and energy, resources and mining. Investors are particularly looking at early-stage opportunities in technology and resources, as well as steadily growing demand in Singapore and in the rapidly urbanizing Thai market.

In both Europe and North America, TMT and resource-based industries are top targets. However, opportunities in the consumer goods and retail space in Europe are the most sought after by respondents. Chinese acquirers have made nearly double the number of acquisitions in the consumer goods sector as compared to the energy sector in Europe this year.

According to Mergermarket data, energy deals still dominate in terms of aggregated value of deals completed. But the consumer goods sector is increasing its profile in terms of overall value of deals, receiving a boost from the US\$7.1 billion acquisition of U.S.-based Smithfield Foods by China's Shuanghui International Holdings.

## Regional breakdown of Chinese outbound M&A



\*Year to date

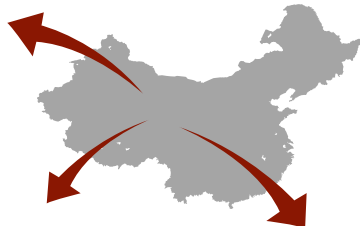
Source: mergermarket.com. Includes all outbound M&A outside of Greater China, where the bidder is China, Hong Kong, Macau or Taiwan

Energy deals as a percentage of overall outbound deal activity fell from 30% in 2010 to 24% in 2012, according to Mergermarket data.

## Principal strategies behind the growth of outbound M&A

61%

Access to new markets



46%

Access to technology and know-how



### Deal Drivers

China outbound M&A activity is expected to be driven by privately-owned companies, according to 45% of respondents. While they expect state-owned companies and private equity to continue to be active, private companies are expected to have the strongest appetite to pursue international expansion more aggressively.

Gaining access to new technology and acquiring or increasing market share are the most commonly cited driving forces. Nearly three-quarters of respondents who say that access to technology and know-how is key to their strategy, identify the Asia-Pacific region as their main target.

Chinese acquirers with their eyes on new markets also favor staying close to home, as two-thirds of respondents rank the Asia-Pacific region as their number one priority. Mergermarket data, however, suggests acquirers are more far-reaching than respondents give them credit for, with 66% of outbound M&A activity taking place outside of Asia this year.

Respondents expect to see the most significant and transformational deals take the shape of majority stake transactions driven by the desire to achieve global expansion in non-resource industries. Indeed, as outbound investments grow rapidly, so has the variety of sectors beyond energy and industrials.

Energy deals as a percentage of overall outbound deal activity fell from 30% in 2010 to 24% in 2012, according to Mergermarket data. Not surprisingly, a subtle policy shift was also laid out in the 12th Five-Year Plan and other government initiatives where the Chinese government empowered companies to compete as leaders and innovators of technology and commerce.

In addition, China is also looking to make its mark on the global landscape by increasing real estate investments in key cities and beyond.

## What types of deals are Chinese acquirers focusing on?

### Transformational



### Minority stake



### Specific target markets



### Resource



# Outbound Real Estate Investment: The Next Phase



Joel H. Rothstein,  
Partner,  
Paul Hastings

**News of upwardly mobile Chinese individuals scouring the markets around the globe and purchasing high-end residences in places like London, New York, and Paris has made headlines. Outbound investment from China into real estate, however, is not a new phenomenon and it is by no means limited to individuals dabbling in residential real estate. Mergermarket spoke with Joel Rothstein, a partner at Paul Hastings, about the rise of institutional investors and their motives for overseas acquisitions and joint ventures.**

China's efforts to "go global" in the real estate arena commenced a number of years ago. In China's rapidly evolving economy, there are a number of key trends to watch in the next phase of China's outbound investment into real estate.

## The Sovereign Wealth Funds

Sovereign wealth funds have become important forces around the world in cross-border real estate investment. To date, China Investment Corporation (CIC) has historically been China's most active fund investor in cross-border real estate investment. Examples of early high profile CIC deals included, among others, a strategic investment of US\$800 million in a Morgan Stanley real estate fund and a position in the company that is the majority owner of London's Canary Wharf.

In the next phase of China's outbound real estate investment push, it is expected that additional

Chinese institutional investors will join CIC as active players and will likely bring to the table substantial capital to deploy into global real estate.

## The Real Estate Developers

China's policy response to an overheated domestic real estate market has been a mix of restrictive measures designed to cool the market and to gently deflate speculative bubbles. Chinese developers, finding it difficult to source domestic deals and get approvals, have started to look abroad for opportunities.

Broadly speaking, Chinese real estate developer investors fall into two categories. The first is the entrepreneurial developer focusing primarily on residential development projects that are relatively small in scale. These developers see themselves as creating a product for their existing Chinese customers albeit located in a foreign country.

A second category is the large established Chinese real estate developer. These players will more likely team up with a local player and complete projects through a joint venture. They recognize that it is necessary to work with a local partner who can help navigate complex governmental approvals, environmental reviews and labor issues to complete a large-scale project in a foreign country.

China's commercial real estate market is still relatively new in comparison to developed markets in North America and Europe. Forward-looking Chinese real estate developers are completing deals in developed markets now because they desire to learn how real estate projects are developed, operated and marketed



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Outbound investment from China into real estate is not a new phenomenon and is by no means limited to residential purchases by upwardly mobile individuals.

in developed markets in preparation for the next phase of the real estate market's growth in China.

#### **Contractors and Debt Providers**

Major Chinese building contractors like China State Construction Engineering Corporation and China Railway Construction Corporation Limited have completed large scale infrastructure and development projects around the world, from South America, to Africa to Southeast Asia. In the next phase of China's outbound real estate investment, we will likely see these contractors increasingly bidding for and winning major projects in developed real estate markets.

A key strategy of the Chinese building contractors is and will be to team up with Chinese banks. Their construction bid may come wrapped with a proposal for financing from a Chinese policy bank. Select the building contractor on the deal and the Chinese bank will provide construction financing on very attractive terms. These deals are a win-win for all parties involved. China has a surplus of foreign currency reserves, so channeling those reserves into foreign real estate loans will help China earn more attractive returns. At the same time, the arrangements will help support the Chinese economy by enabling contractors to win major deals. Finally, the real estate developer and investor will benefit by receiving construction financing on attractive terms.

#### **The Insurance Companies**

In the next phase of outbound real estate investment from China, the universe of outbound real estate investors from China is set to expand significantly. One key emerging institutional player is likely to be Chinese insurance companies. Reforms in the

regulatory framework governing where and how China's insurance companies can invest have opened the door to outbound investment into real estate. For example, China's Ping An Insurance Group agreed to buy the Lloyd's building in London for approximately US\$388 million in July of this year. This deal marks the first major high-profile foreign real estate acquisition by a Chinese insurance company, but it is unlikely to be the last. Amid domestic reforms, these companies are now actively searching for income-producing, stabilized real estate assets around the globe.

#### **The Journey Has Only Begun – What is Next?**

Chinese financial institutions, investors, contractors and developers have embarked on the long journey around the globe in search of opportunities in real estate. In the coming years, market participants in developed markets in North America, Europe and elsewhere should expect to meet many new travelers from the Middle Kingdom.

# China Outbound Financing Growth

As Chinese companies expand their global footprint, there are a number of parties willing to fund the growth, pending government approval.

Deal valuations are situational but there are common and significant factors affecting valuation analysis for Chinese cross-border acquirers, respondents say. Over 60% of respondents agree that they approach valuing a foreign target by considering both its potential future cashflow and overall barriers of entering a specific industry as a whole.

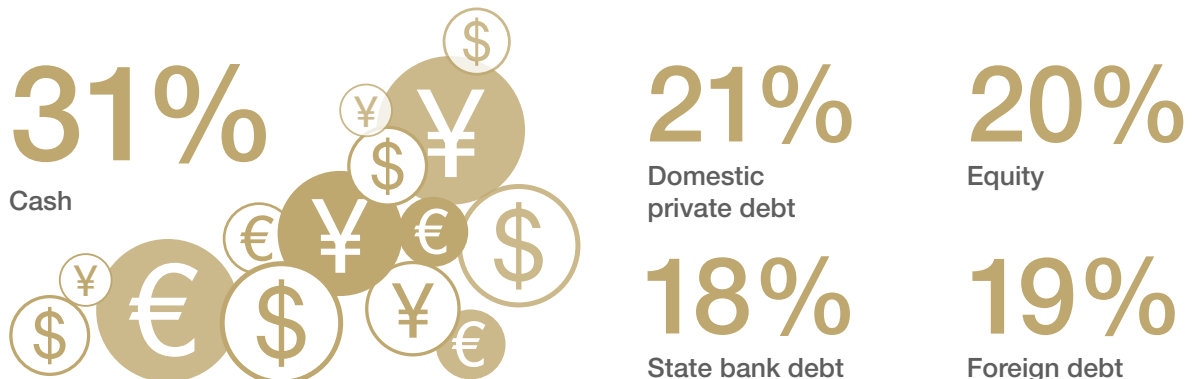
## Availability Versus Accessibility of Finance

Once bidders settle on a valuation, they need to arrange financing. Over the past five years, Chinese banks have gone from being prohibited to finance outbound M&A deals to being encouraged to do so. While this suggests that funding is more readily available, regulatory approvals mean accessibility can still be a challenge. These two factors leave respondents to this survey to be cautiously optimistic about the financing environment.

“The earning potential of the target is a prime factor of our valuation approach and pricing of outbound M&A deals.”

China-based private equity managing director

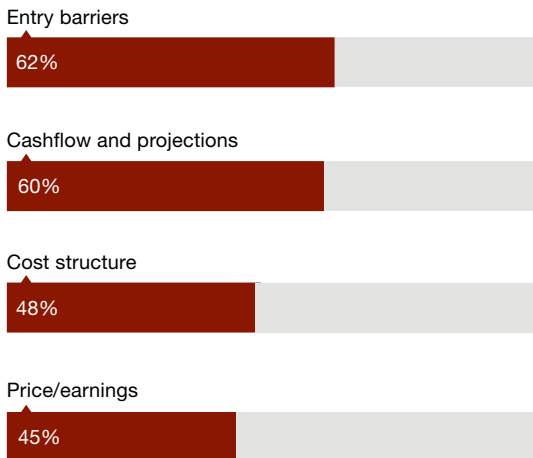
## Average breakdown of financing



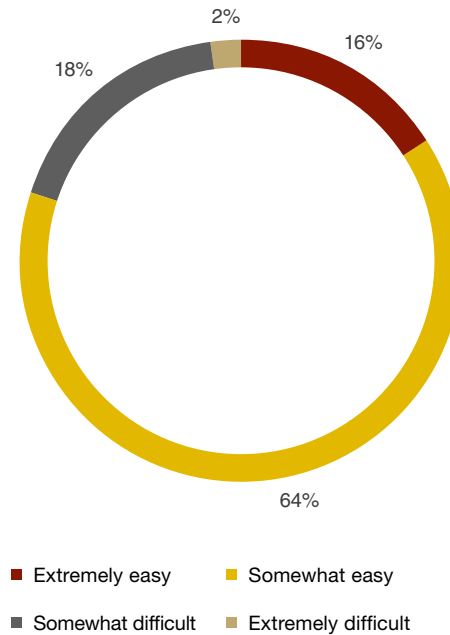
“Chinese enterprises need foreign currencies to make outbound acquisitions and convincing local or state banks to provide foreign currency acquisition finance can be difficult. Due to lending quotas, major acquisitions such as Shuanghui International’s acquisition of Smithfield Foods in the U.S. require large scale acquisition financings from a syndicate of banks.”

Vivian Lam, Partner, Paul Hastings, Hong Kong

**Most commonly used approaches to valuations and pricing**



**How do you expect access to financing for M&A deals will be over the next 12 months?**



As one private equity respondent explains: “Debt from state banks is relatively easily available for outbound acquisitions. State banks have been instructed by the government to extend financial support to Chinese companies that want to make outbound investments. Thus availability of financing is much better than it used to be.”

With readily available financing and large warchests, Chinese companies and SOEs are among the most well-resourced in the world. After flexing their muscles to a record outbound flurry in 2012, the pace has been steady with outbound transactions totaling US\$36.5 billion through the first half of 2013. Respondents note that, as investment interest continues to grow, accessibility to financing will continue to ease.

# The Path to Finance: Policies, Procedures, and Potential Challenges



Vivian Lam,  
Partner,  
Paul Hastings

**Shifting Chinese government policies in line with the country's 12th Five-Year Plan are relaxing restrictions in an attempt to simplify acquisition financing for Chinese companies investing overseas. To discuss this trend, Mergermarket sat down with Vivian Lam, a partner at Paul Hastings.**

The expected slowdown in China's economic growth has done little to stall the country's wave of outbound M&A. If anything, domestic companies are becoming increasingly ambitious as they "go out", as part of the Chinese government's plan to see domestic companies become global brands. Yet, despite year-on-year increases in activity, acquiring the funds necessary to complete these deals continues to pose challenges.

## **Given the Green Light, but Hurdles Abound**

Historically, Chinese banks were prohibited from lending to companies for M&A purposes. That, however, has changed. In 2008, the China Banking Regulatory Commission issued the Risk Management Guidelines which allow domestic Chinese banks to finance outbound transactions. With the implementation of China's 12th Five-Year Plan in 2010, Chinese companies are encouraged to invest offshore and state banks are directed to finance these investments. This government support results in rising outbound activity: 92 deals in 2010, 116 in 2011, and 126 in 2012, with 2013 on track to maintain this momentum.

While government support has been strong, Chinese companies must still overcome considerable structural and regulatory issues before raising financing.

The government's approval process is lengthy and requires the consent of numerous government bodies. When investing overseas, Chinese companies must first win approval from the National Development and Reform Commission (NDRC) for deals of more than US\$100 million. The Ministry of Commerce is also involved in the process, and for state-owned enterprises, the State-Owned Assets Supervision and Administration Commission also plays a key role.

The implication from these regulations is that the approvals could become hurdles to overcome before a deal can be signed. This leaves Chinese companies at a competitive disadvantage, especially in heated bidding situations against domestic buyers in foreign markets. For instance, a local company in the United States would not have to go through a similarly arduous approval process. Even if a Chinese company makes a higher bid, it might go overlooked in favor of a bidder who can bring the deal to completion sooner, and with more certainty.

## **Acquiring Foreign Currencies**

Over and above the rigorous approval process, Chinese companies need to worry about how they will acquire foreign currencies, be it U.S. dollars or euros, for the acquisition. Since these companies have all, or most of their assets in China and manage revenues using the renminbi (RMB), convincing a bank, even local or state banks, to finance an acquisition using foreign currencies can prove difficult. The RMB is a non-

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While government support has been strong, Chinese companies must still overcome considerable structural and regulatory issues before raising financing.

convertible currency and when used offshore requires administrative approval.

The State Administration of Foreign Exchange's (SAFE) issue of Circular 39, officially called the Circular on the Administration of Security Provided to Foreign Entities by Domestic Organization, has helped expedite the approval process for authorizing the movement of RMB outside China. Under the circular, onshore Chinese entities are allowed to create security over their onshore assets in favor of onshore banks to obtain offshore borrowings.

However, even Circular 39 has its limits. SAFE has set quotas on banks in terms of lending — once that quota has been reached, it cannot provide lending to prospective borrowers. In the case of major acquisitions requiring large scale acquisition financing such as Shuanghui International's acquisition of Smithfield Foods in the U.S., the financing may have to be raised from a syndicate of banks because individual banks do not have sufficient quota left to lend. This takes time, results in increased overall costs, and can ultimately, and sometimes negatively, affect the outcome of the deal.

### **SOEs and Privately Owned Companies**

While state banks have been directed to provide broad financing to acquisitive Chinese companies, preference has been shown for SOEs. This preference is present despite the fact that many privately-owned companies are as big as or even more competitive than state-run enterprises. This is happening for a number of reasons: SOEs are generally more established and have direct government backing; many private enterprises lack investing experience

and expertise in managing foreign acquisitions, all of which present risks to lenders.

This too is changing. In 2012, SAFE with the Ministry of Commerce, the NDRC and 10 other departments issued the Opinions on Encouraging and Guiding the Active Outbound Investment by Private Enterprises, which is a regulation that pledged to adopt favorable policies with respect to loans from Chinese banks to facilitate outbound investments by private enterprises.

However, detailed implementation rules have yet to be adopted. In the meantime, privately-owned companies may have to resort to alternative structures, for example, making the acquisition with an offshore partner with access to funds, with a right to buy out the partner at a later stage, or negotiating with the target for staged acquisitions and payments. These structures may not fully serve the company's corporate objectives, but will have to be considered if financing proves difficult to acquire.



# China Outbound Regulatory Approval

**Outbound M&A is a heavily regulated process for Chinese acquirers, both domestically and in foreign jurisdictions.**

Regulatory hurdles surround every step of outbound M&A. The majority of respondents rank regulation, whether foreign or domestic, as the major challenge for foreign expansion. Additionally, 42% of respondents cite the related area of political risk. As an executive vice president of a sovereign wealth fund explains: “Domestic and foreign regulations are significant hurdles for Chinese companies, approvals are often time consuming affairs which can affect the momentum of a deal.”

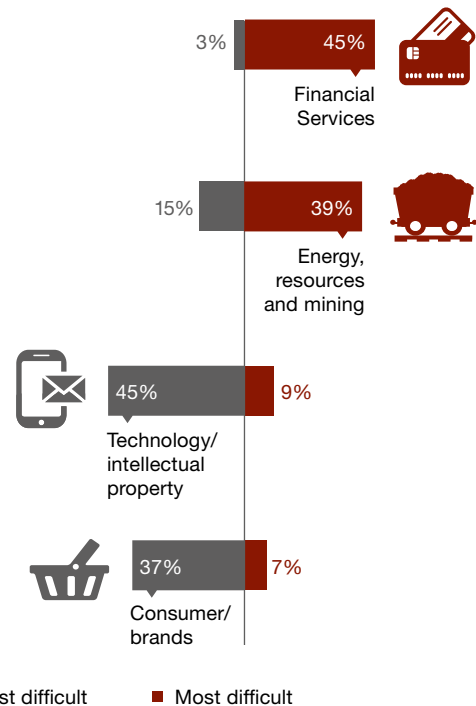
## Approval From Home

All outbound M&A must be approved by three Chinese regulatory bodies including MOFCOM, NDRC and SAFE. Although progress has been made to help expedite the approval process, some respondents note that Chinese investors are still at a competitive disadvantage given the regulatory uncertainty.

## Sector Specifics: Domestic Approvals

Respondents indicate that financial services and energy, resources and mining are the industry sectors where it is most difficult to gain domestic regulatory approval. As a CFO of a Chinese financial services company explains: “Our government is very sensitive when it comes to financial services companies going abroad as they are concerned with capital going out of China.” Similarly, another respondent comments that, due to the strategic importance to China, every energy-related deal involves some government influence.

**Which sectors are most and least difficult to gain domestic regulatory approval for outbound M&A?**

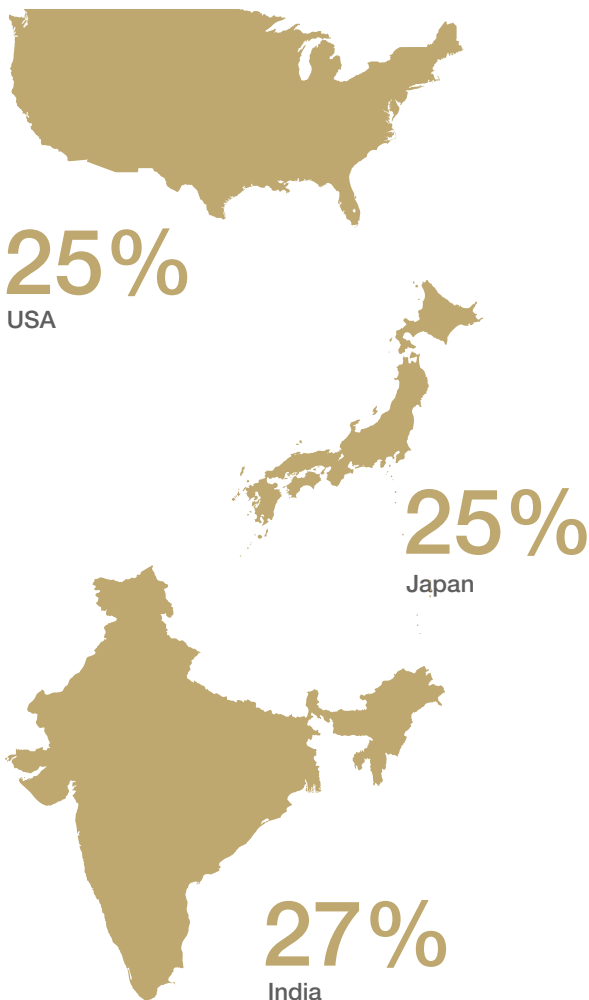


Conversely, respondents agree that consumer- and technology-related industries experience smoother regulatory approval processes. This is because global expansion of Chinese consumer and technology companies fuel export growth, increase domestic production and ultimately can help boost domestic consumption.

“Despite the fact that domestic governmental approvals for Chinese entities to go outbound are still significant, deregulation in general is the trend. SASAC may scrutinize SOEs closer due to concerns of corruption and value leakage, but NDRC, MOFCOM and SAFE have already made it easier for Chinese companies to obtain the necessary approvals to make foreign acquisitions.”

Jia Yan, Partner, Paul Hastings, Beijing & Shanghai

### In which countries is it most difficult to gain regulatory approval?



### Target Country Approvals

India is narrowly chosen as the most difficult country to gain regulatory approval for Chinese bidders, over the U.S. and Japan. Majority stake acquisitions are prohibited and foreign direct investment is not supported by the central government, significantly limiting potential Chinese interest.

Recent developments in India suggest that there is little short-term upside for investment there. In the U.S., the Committee on Foreign Investment in the United States (CFIUS) is a significant concern for foreign acquisitions. CFIUS reviews all acquisitions or control investments where national security concerns may be present. In one recent case, CNOOC's US\$15.1 billion takeover of Calgary-based Nexen, the U.S. and Canadian governments required a number of concessions from the state-owned Chinese oil corporation, including forfeiture of operating control of oil assets. Another saw the successful acquisition of Smithfield Foods by Shuanghui International despite many political constituencies raising concerns (see page 16 for a detailed insight on the success of this deal).

### External Advisors

In such an environment, the value of hiring external and local expertise is apparent: the majority of our respondents agree that legal advisors are key to getting the deal from negotiation to completion more smoothly. Professionals with experience clearing the difficult legal hurdles can help overcome what many consider the most difficult part of the M&A process. Indeed, one respondent comments that, in any outbound deal, there are regulatory issues that Chinese companies are not able to solve without the help of external advisors.

# Shuanghui International's Acquisition of Smithfield Foods

**Largest acquisition of a U.S. company by a Chinese company, paving the way for increased China outbound M&A.**

## **Setting the Scene**

Shuanghui International is China's largest pork producer. Paul Hastings represented Shuanghui in a US\$7.1 billion deal to acquire the biggest U.S. pork processor and hog producer, publicly-traded Smithfield Foods. The deal – announced in May 2013 and completed in September 2013 – is the largest acquisition of a U.S. company by a Chinese company to date, and has garnered enormous attention in political, press, and industry circles.

In early September 2013, the deal reached a key milestone, when the parties received clearance from the Committee on Foreign Investment in the United States (CFIUS). Shuanghui also secured US\$4 billion in debt financing from a consortium of banks comprising Bank of China, Rabobank, Credit Agricole, DBS, Natixis, The Royal Bank of Scotland, Standard Chartered Bank and Industrial & Commercial Bank of China. In addition, Shuanghui, through its U.S. affiliate, raised US\$900 million of public bond financing in connection with the deal.

The deal is arguably one of the most challenging and innovative deals of the year, not only due to its size and breadth, but also because of several structuring elements devised to bring the deal together, including a time-sensitive offer, a “qualified pre-existing bidder” provision, a unique alternative debt financing structure, and a strategic approach to the CFIUS review process.

## **Deal Highlights**

### *Time Sensitive Offer*

A key element of the deal was making Shuanghui's offer time-sensitive. We devised a creative strategy to help get the deal signed and to avoid a potential bidding war, while at the same time providing Smithfield's board with the fiduciary latitude it needed to accept our client's offer. We delivered a draft merger agreement to Smithfield's counsel on May 13 and received the company's comments 11 days later on May 24. At that time it became known that at least two other bidders had approached Smithfield. So on the same day we received Smithfield's response, we delivered Shuanghui's response to Smithfield's counsel - a revised draft of the merger agreement, marked up to achieve a quick agreement and an ultimatum: if the parties did not reach agreement and sign the merger agreement by 6:00 p.m. Eastern Time on May 28, Shuanghui's offer would be withdrawn and Smithfield potentially would be left without a deal.

### *Qualified Pre-Existing Bidders*

Another interesting element was the creation of a “qualified pre-existing bidder” provision. This provision allowed Smithfield to continue discussions with the two existing bidders for a period of 30 days from the date of signing the merger agreement with Shuanghui. The provision differed from the standard “go-shop” because it did not permit Smithfield to actively “shop” the company by seeking additional bidders, but restricted Smithfield's discussions to the two existing bidders. The merger agreement also contained a customary no-shop provision which generally prohibited Smithfield from entering into negotiations with other persons, subject to customary fiduciary outs.



### *Financing*

The deal also featured a unique alternative debt financing structure that was not originally considered when the deal was signed. Our team worked with Shuanghui, Smithfield and their advisors on the deal financing to optimize Smithfield's post-closing debt capital structure. This presented an unusual challenge. Our lawyers had to put in place the new alternative financing, without affecting the existing committed financing available to Shuanghui or financing certainty. Effectively, we had to structure two parallel financing plans to achieve the objectives. In addition, our lawyers, working with Shuanghui's financial advisors, tapped the U.S. debt markets to raise US\$900 million of financing to help fund the acquisition.

### *Two-Tier Smithfield Termination Fee*

In addition to the "qualified pre-existing bidder" provision, the merger agreement also provided for a two-tier company termination fee, with a reduced termination fee payable in the event a deal was transacted with one of the two pre-existing bidders. Specifically, if Smithfield terminated the merger agreement with Shuanghui to pursue a transaction with one of the two pre-existing bidders within 30 days of signing the merger agreement with Shuanghui, the termination fee would be US\$75 million. This is significantly lower than a typical company-side break-up fee, and US\$100 million less than the ultimately agreed upon company-side break-up fee of US\$175 million that would have been payable by Smithfield if any other potential transactions took place or if there was any transaction with the two existing bidders more than 30 days after signing the merger agreement.

### *No CFIUS Risk for Shuanghui*

Another interesting aspect of the deal offered Smithfield protection through a reverse break-up fee. Under the terms of the merger agreement, Smithfield would receive US\$275 million from Shuanghui if the deal fell apart because it failed to secure certain U.S. or foreign regulatory approvals, but this provision excluded CFIUS clearance. Specifically, because of the intense political interest anticipated for this transaction and the fact that certain previous acquisitions of U.S. companies by Chinese companies have been blocked by CFIUS, Shuanghui was unwilling to agree to pay a reverse break-up fee should CFIUS block the transaction. Shuanghui's refusal to bear CFIUS risk was an unusual aspect of the deal.

The deal was seen as a significant test of whether the CFIUS review process can be applied fairly to Chinese investment in the U.S., in light of several high-profile rejections of past deals. Passing this test not only paved the way for the two companies to consummate the transaction, but should foster goodwill between China and the U.S. and may encourage more companies and finance parties that the U.S. is increasingly welcome to Chinese investment. CFIUS's approval thus represents an important turning point for the flow of investment between China and the U.S.

### **Conclusion**

This substantial and high-profile Chinese investment in a U.S. publicly-traded company, in the politically-sensitive food and agricultural sector, required careful navigation. The CFIUS process, while theoretically separate from politics, invariably is influenced by a host of political considerations. We had to manage this charged political climate, and we worked closely with Smithfield's advisors to reach out to constituents on Capitol Hill, the Administration, state and local governments, unions, employees, shareholders, and commentators. So the CFIUS process was not only a political challenge, but a "diplomatic" endeavor of communicating and reassuring stakeholders at every level of seniority. Shuanghui received CFIUS approval of the transaction on September 6.

Our proactive approach ensured that the deal was evaluated on its merits as a merger driven by economic fundamentals, including growing pork demand in China, and not depicted as a strategy to export pork to the U.S. or otherwise permit a Chinese "takeover" of the U.S. food supply. We also addressed antitrust concerns by demonstrating that it doesn't give Smithfield – already the world's largest hog farmer and pork producer – a larger share of the U.S. pork market.

The Shuanghui/Smithfield transaction is, by a long measure, the most talked-about and focused-upon acquisition of the year.

Our global team of lawyers at Paul Hastings advised on all legal issues relating to M&A, employment, labor and unions, finance, CFIUS, global trade, antitrust and tax in connection with Shuanghui's acquisition of Smithfield.

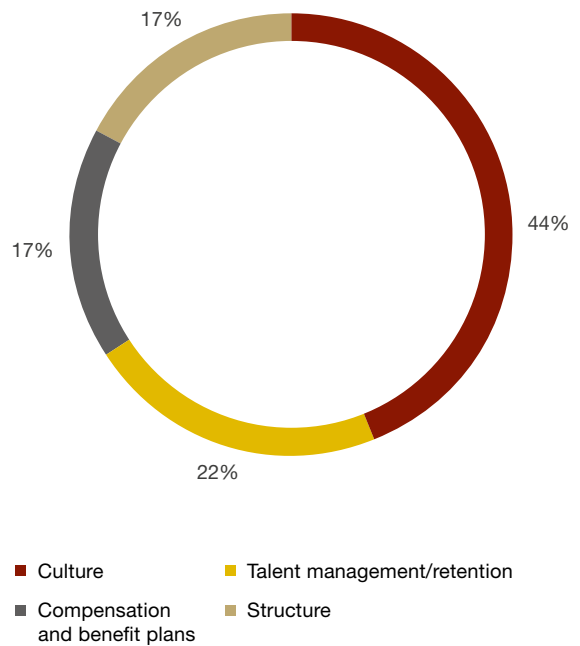
# China Outbound Common Hurdles

Respondents report that the timeframe for M&A deals, from the start of negotiation to completion, on average, lasts over 10 months for Chinese acquirers. While this is reportedly a longer period compared to acquirers from other jurisdictions, this can partly be explained by the relative inexperience of Chinese acquirers and the significant hurdles they face along the way.

## Culture and Human Resources: From Due Diligence to PMI

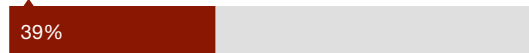
In due diligence, assessing culture and talent are top priorities. As one respondent comments, cultural differences, if allowed to persist, can create long-term harm and loss of value. Instead, the acquiring company should often look to build a new culture as a basis to unite employees, another respondent adds. The importance of talent retention is also stressed, with the majority of respondents aiming to retain all employees after deal completion.

## Top priorities for HR due diligence

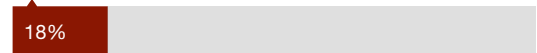


## Employees most typically retained post-acquisition:

### Senior leadership



### Front-line experts



### Mid-level



### All employees



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“Prices, Policies and Protection are the three “P’s”. They are the key issues that arise when acquiring international technology and IP rights.”

China-based Head of Investment Banking

Just over half of respondents say human resources (HR) is a significant factor in the success of a deal and often requires external expertise. HR issues should be a focus at the due diligence stage and should extend into post-merger integration. Appointing advisors to handle HR concerns at the due diligence stage provides a head start to integration planning, respondents note.

A number also comment that the internal HR departments of Chinese companies do not have the experience, and therefore knowledge, required in dealing with HR challenges of foreign companies.

### Technology and Intellectual Property (IP)

In line with the principal strategies outlined on pages six and seven, respondents unanimously say that technology and IP assets are very important when identifying potential targets. Outbound M&A is preferred by 75% of respondents as compared to licensing and joint ventures. However, legal issues surrounding the transfer and licensing of IP in foreign countries is an area of difficulty for technology-hungry Chinese acquirers. While internal regulatory requirements are relatively easy, thanks to Chinese government support, the complexities and mechanics of IP law vary widely from country to country. It is essential that Chinese acquirers understand the ownership of the IP assets as well as their enforceability and transferability in the target country.

Respondents also vocalize that accessing technology can sometimes be one part of the puzzle, and that often the bigger issue is the transfer of skills and know-how to use, maintain, and upgrade the technology.

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### Top industry targets for technology transfer to China

High-end manufacturing

48%



Information technology

42%



Environmental protection

33%



New energy

28%



# China Outbound Common Hurdles

## Post-Merger Integration

Post-merger integration is a key feature in the success of an M&A deal, respondents say. Once the bid for a foreign asset is won, the next steps taken should ensure the seamless coming together of two entities, a task that Chinese companies have had variable success in. Respondents point to the lack of a clearly defined execution and communication plan at the outset of the merger as the main culprit for the mixed results.

Post-merger regulatory compliance and cultural integration are the two most important factors that lead to a loss of company value following a Chinese takeover, according to 67% and 63% of respondents, respectively. As one China-based head of finance explains: “Chinese investors are very aggressive in foreign acquisitions and they tend to overlook key issues that ultimately affect value creation.”

Another issue in post-merger integration is related to the strategic objective of accessing technological expertise. Developing a plan for knowledge transfer and employee training at the outset is critical to achieving goals.

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“The closing of a major cross-border transaction is always a milestone event for the companies involved. However, for such a deal to be successful, how the parties approach and deal with post-merger integration is arguably just as important as getting the transaction closed. This is particularly important where the companies and individuals bring to the table different cultures, values and norms of business practice. The companies that are successful in navigating the PMI phase are the ones most likely to reap the rewards of the transaction.”

Carl Sanchez, Partner, Paul Hastings, San Diego

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## Most common issues that lead to post-merger value loss:

Post-merger legal/regulatory compliance



Cultural integration



# Concluding Remarks: Critical Success Factors

Throughout this report, respondents have expressed a strong desire to invest and make acquisitions abroad while, at the same time, acknowledging the challenges related to outbound M&A. There are a number of moving parts and unique issues to consider for the relatively inexperienced Chinese bidders.

## Think About Integration at the Outset

Respondents wish they had dedicated more time and thought to post-merger integration and cultural issues during the initial due diligence stage and they identify attention to both factors as a critical component to the success of an outbound deal. Taking a holistic approach from the beginning of the process is best practice, survey respondents say.

The ability to integrate, of course, is based on gaining regulatory approval from both domestic and foreign jurisdictions, which 70% of respondents identify as the key to being able to execute foreign investments and acquisitions.

## Global Perceptions

Generally, respondents think that U.S. and European players are wary of Chinese investments because of the potential of Chinese acquirers to dominate a market, particularly in the oil and gas sector. However, China's cash-rich acquirers believe their investments actually benefit the countries they are investing in because of the strategic, well-planned and long-term nature of their activity. At the same time, these acquirers have built-in limitations given that many countries are restricting Chinese investments for fear they will lose market share relative to China.

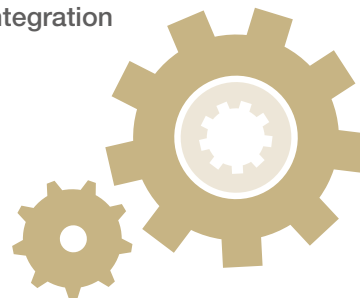
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### Main critical success factors:

Regulation  
Approval



Post-Merger Integration



Due Diligence



# Access to Technology: Deal-making Options Amid Complex Regulations



Matthew D. Berger,  
Partner,  
Paul Hastings

## How would you describe the attitude towards outbound M&A and deal-making in China?

There is still a strong desire for acquisitions in the technology sector, but obstacles are considerable, especially in the U.S. with the need to obtain CFIUS approval. Instead of outright acquisitions, we have

seen a number of significant joint ventures, strategic licenses and joint development deals, and this should continue in the future. Even the Shuanghui - Smithfield Foods deal was subjected to scrutiny and domestic politics in the U.S. As a result, while interest by Chinese companies in outbound acquisitions of technology and IP will continue, such interest probably will be implemented and completed in substantial part through vehicles other than outright acquisitions and traditional M&A.

## Are these issues unique to the US or do Chinese companies still have to use M&A alternatives in other countries with valuable tech assets?

Chinese companies have had more success acquiring technology and IP in Europe and within Asia. Some of those deals have even provided access to technology and IP originating from the U.S. But there are approval hurdles in those regions as well. Further, technology and IP acquisition opportunities in Europe and Asia generally are not the same as those in the U.S. In addition, in the past at least part of the

motivation in acquiring technology and especially IP is competitiveness and protection against competition, respectively, in the U.S. market, which still is by far the most important single market. However, recent developments in China and a new focus on driving internal consumer demand may change this.

## You mentioned that joint ventures and strategic licenses have their own issues. What are some of these?

In 2002, China revamped its technology transfer regulations. There are now three primary areas of compliance that entrants to the Chinese markets must consider. The first is the warranties an inbound licensor has to make to the licensee. These include warranties that the licensor is the legitimate owner of the inbound technology or has the right to assign or license the inbound technology and the inbound technology will be complete, accurate, effective and capable of achieving the agreed technical objective.

The second area relates to antitrust and includes fairly typical prohibitions on restrictions of the market that is the subject of the license. The third area is ownership of any improvement to the licensed technology and restrictions on use of the same. It is this area that historically has caused and still causes most of the concern. Previously, the PRC regulations said that once the license term is over, the licensee has the right to continue to use the licensed technology unless decided otherwise by the examining and approving authorities. With the

revisions to the technology transfer regulations, the licensee does not automatically have the right to continue to use the licensed technology after the expiration of the technology import contract. Instead, after the technology import contract expires, both parties may negotiate the continued use of the licensed technology “according to the principle of justice and equity.” However, there still is an issue with regard to improvements to the licensed technology. The licensee potentially owns and has free use of such improvements.

Some other concerns are as follows: First, as mentioned in connection with improvements to licensed technology, ownership of new technology remains with the creator. Second, if technology is re-exported out of China. Although recent revisions to the PRC Administrative Measures on Prohibited and Restricted Technology Exports in 2009 may have changed this, it still may be the case that the export approvals process includes, among the usual requirements that technology not be exported for use in weapons of mass destruction and the like, the requirement that the technology is fully developed, meaning it is widely used in China. We had a case where servers were designed in the U.S., the components for such servers were designed and manufactured largely outside of China, and the servers were only assembled in China. Despite the origins of most of the technology being outside of China, export approvals were required to re-export the assembled servers from China.

#### **How do you work around those restrictions?**

One solution is to establish a joint venture through an entity, usually based in China, with significant checks and balances between the joint venture partners, and then have ownership of any improvements or newly created technology and any IP rights in either of the foregoing vest in that entity. With joint venture ownership, there can be clearly defined rules regarding separation and use of technology for different projects. These structures typically use Hong Kong law as the governing law for the joint venture documents, primarily because Hong Kong law is quite well developed, the Hong Kong courts and arbitration forums are quite sophisticated and judgments under Hong Kong law and by Hong Kong courts generally are enforceable in China.

There are other things that can be done to work with the Tech Transfer Regulations. One is to try to impose restrictions on the use of any licensed technology past the term of the license. As noted previously, this wasn’t possible before. Another is to have joint ownership of improvements or newly developed technology. Finally, a third is to have ownership vest in the creators but then have the creators assign that ownership back to the licensor. There is no clear guidance that these measures will work but there also is no clear guidance that they won’t work.

#### **How do you see this playing out in the near future?**

I think the way this evolves is going to be on a sector-by-sector basis. You’ll see more successful technology transfers in less cutting edge areas of technology, for example, manufacturing for bulk processing plants such as drinking water bottling plants. However, I don’t think there will be a lot of M&A deals in areas such as pharmaceuticals, semiconductors, servers or software in the near future.

#### **Is there an effective way to do traditional M&A in technology or IP-related industries?**

Aside from a few extreme exceptions, the substance of a deal can get done if two parties are committed to it and willing to be flexible and creative. A straight acquisition or stock deal may not work, but there are other ways the deal can be repackaged to work within the rules. In the DreamWorks deal, the parties devoted a lot of thought at the outset of the deal on protecting DreamWorks’ intellectual property interests so that DreamWorks would be comfortable in helping create a state-of-the-art animation studio in China, which requires a significant transfer of software and other technology into China. That kind of planning ensured that the terms will be mutually beneficial.

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