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China deals

A wind of change for China-Europe M&A

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Foreword

Six months can be a long time in M&A. In our first edition of China Deals last autumn we focused on how the volume gap in deal flow between Europe and China and vice versa was closing fast and how we expected this trend to accelerate. Six months later, that gap has not just closed – the tide of deal flow has reversed.

The global economy continues to keep people guessing but there are positive developments in Europe and China – albeit at two very different rates of change. In Europe, concerns have abated somewhat about the woes of the region's more peripheral economies leading to wider problems. Though growth remains anaemic, the efforts to address sovereign, fiscal and financial risks could begin to bear fruit in 2013. In November 2012, the world was introduced to China's new leadership, who lost no time in making it clear that they are committed to the continued reform and opening up of the country's economy. Their growth goals (including doubling China's 2010 GDP level by 2020) are underpinned by a focus on industries, such as advanced manufacturing, services and networked information technology, and on raising incomes to boost domestic consumption, in rural and urban areas. This bodes well for the likelihood of more outbound investment, as Chinese companies are encouraged to acquire technology, expertise and market access overseas. It also bodes well for European companies looking East to seek new markets as rising per capita income brings financial security and greater spending power to a billion people.

The tide has turned for Chinese deal flow

Given the changes and uncertainties in the East and West, it is perhaps unsurprising that 2012 was a lacklustre year for global M&A. China's M&A activity for 2012 actually fell to a five year low in volume terms. However, looking into the figures, two very significant stories emerge. Firstly, though volumes were down by 7% on those of 2011, China's outbound deal value actually rose by an impressive 54%. Moreover, European companies were among the biggest beneficiaries of that rise, with Chinese investments in the region up by 25% (from 44 to 55), representing 29% of all of China's outbound deals. The second element is that in 2012, China's Europe-bound investment flows were five times greater than European China-bound investments by deal value. This sets a new benchmark for Chinese investments into Europe and, as we discuss in this edition, one that we believe heralds a shift in direction for M&A flows over the coming years.

More European sectors attract new Chinese suitors

In this issue, we bring you a fresh round up of the China-Europe-China deals completed for 2012, by whom, for what and in which countries, and consider how they compare to recent trends. Looking behind the big numbers, we explore how the nature of the investors and the targets involved is changing. In the deal flow update, it is interesting to note that many of the sectors marked out as critical to future growth by China's new leadership are already seeing increased M&A activity by Chinese investors. It is also encouraging to see that they are sectors where many European companies have world-class operational, managerial and innovation expertise. Hence why we see deals for Retail and Consumer and Utility targets in the UK or for Industrial Products firms in Germany.

The changing face of China Inc

A look at the deal-makers and conversations with our own deals partners in China and Europe reveals some promising changes. Even with lower deal volumes, it is clear that Chinese privately owned companies (POEs) are following in the wake of China's state-owned and sovereign wealth fund investments overseas. This dynamic is one that we see generating more deals with European companies – in both directions. A second, more nascent change, which we discuss in the second article of this edition, is the shift happening in China's private equity (PE) sector. Having risen on the back of rapid growth in the number of domestic IPOs, softer conditions in that market mean that some Chinese PE houses are now shifting their focus to returns through overseas M&A. As the article shows, though very early days, we can see this shift having a big influence on deal-making between Chinese and European companies in the years ahead. It may make the M&A arena even more competitive but it should also bring more investment opportunities to those watching out for them.

Once again, China Deals would not have been possible without the insight and on the ground knowledge of PwC's global network. It is the ideas and first-hand experience of our partners and deals teams in China, the UK and Europe that really reveal the drivers and trends to watch beyond the deal data. Our global PwC network contributors would be happy to respond to any questions or points you would like to raise, you can find their details in every edition. We hope that this report helps you in your thinking about your own investment plans and potentially points you to some future deals.

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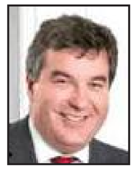


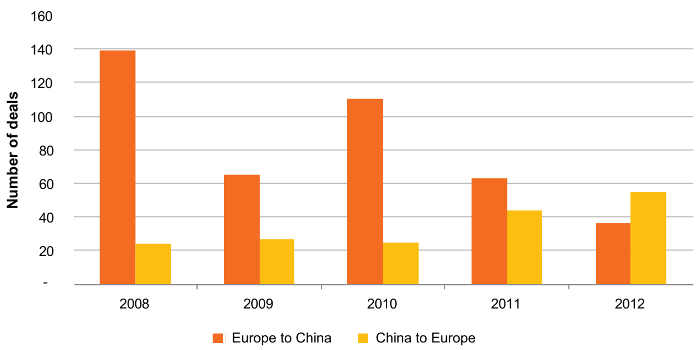
Philip is a partner in our Transaction Services business, based in London. He leads our UK Transactions team focused on China and has worked with PwC China since 2008/09 when he led the firm's work in support of Chinalco's proposed joint venture with Rio Tinto. Philip has focused exclusively on the transactions market for over fifteen years.

Deal flow update: is the M&A tide turning?

The year of the Dragon brought highs and lows

2012 was a year of uncertainties. China's economy slowed for successive quarters and the world waited for its leadership transition. Overseas, fears of a major Eurozone crisis dominated the first half of the year and the region's governments continued their austerity drives. Though China's GDP growth rate was lower than in previous years and fell over successive quarters, the final quarter of 2012 saw a renewed rise in growth, bringing full year on year growth to 7.9%, far from the hard landing some had predicted. Global M&A activity in 2012 was down on previous years and China's M&A activity mirrored that, falling to a five-year low in volume terms for domestic and outbound deals. But, if outbound deal volume dropped by 7% on 2011, China's outbound deal value grew by robust 54%. 2012 value was boosted by a number of very large deals, with each of the top ten China outbound deals being in excess of US$1 billion. European companies attracted 29% of those outbound investment dollars. Mainland Chinese companies paid over €7.9 billion for 55 European acquisitions in 2012, investing a record five times more in Europe than European companies invested in China.

Figure 1: China to Europe deals outpace those from Europe to China



Source: PwC analysis of Thomson Reuters and China Venture data

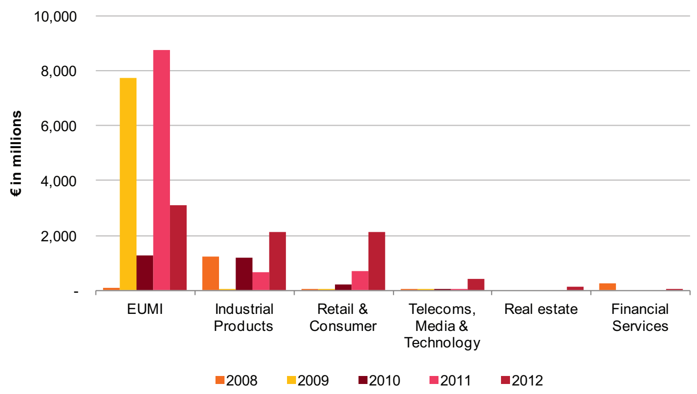
Flow reversal: China's European-bound investment pulls ahead

If Chinese companies' Europe-bound deals rose considerably from 2011, European investors were in less buoyant mood. With only 36 deals for mainland Chinese targets, down from 63 in 2011, European M&A spend in China was just over €1.5 billion. Again, with deal volume and value down on 2011, European outbound M&A figures reflected the global trend for 2012. The data for 2012 reflects a pattern that has emerged over the last 3 years. Through discussions with our clients, we can see a number of factors putting a brake on European investments into China. It is the combined effects of these factors – rather than their individual impact – that we believe has resulted in this continued decline in activity and they include:

- A shortage of capital and more constrained debt-raising ability due to weak financial performance in home markets;
- Levels of valuation expectations of Chinese sellers that many foreign buyers cannot justify in the current environment;
- Some concerns that China is facing a period of slower growth, coupled with uncertainty regarding the future direction of policies and regulation as China undergoes a leadership transition;
- Rising labour and other direct costs resulting in European investors looking elsewhere than China for their low cost exports manufacturing.

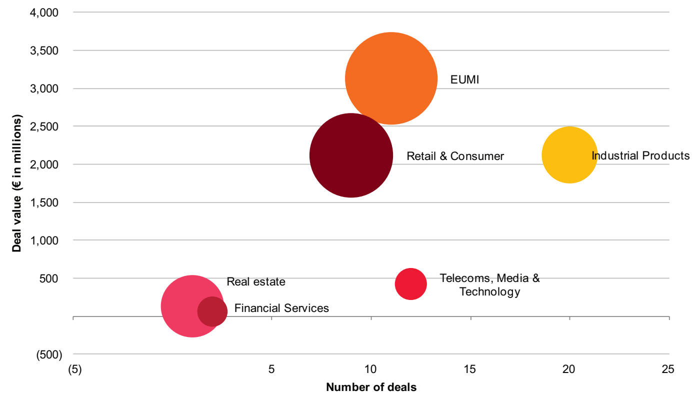
A further element in this mix is that many foreign investors, particularly larger European multinationals, have already established broad platforms in China. Much of their ongoing investment is via the expansion of manufacturing facilities or in establishing research and development hubs and these "greenfield" investments are not included in the M&A data we analyse in this report.

Figure 2a: China to Europe deal value by sector, 2008 - 2012



Source: PwC analysis of Thomson Reuters and China Venture data

Figure 2b: China to Europe M&A deals by sector in 2012



Note: Value based on publicly disclosed deal amounts only

Europe's EUMI targets retain their appeal but deals in IP and R&C are on the up

Europe's Energy, Utilities, Mining and Infrastructure (EUMI) sector once again attracted more Chinese investment than any other sector, though at €3.1billion, deal value was down on the €8.7billion achieved in 2011. British companies captured the top deals in the sector, with China Investment Corporation (CIC) buying 9% of Thames Water for €1.4billion and Sinopec International Petroleum Corporation (SIPC) buying a 49% share in Talisman's UK operations in the North Sea for over €1.1billion.

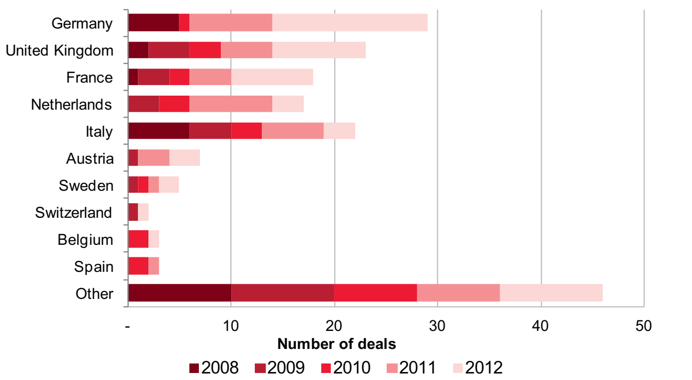
In a shift that we see as indicative of what is to come, the European Industrial Products (IP) and Retail and Consumer goods (R&C) sectors saw a significant increase in Chinese investment in 2012. Both sectors achieved over €2.1 billion in M&A value over the year: a new high for each of those sectors. Bright Food's acquisition of 60% of UK brand Weetabix was the star European deal of 2012 across all sectors. We see this type of deal as an example of a new direction in Chinese outbound M&A. As well as looking for access to technology and channels, more Chinese companies will seek to leverage established international brands to meet the evolving tastes and demands of China's swelling middle class.

New targets, new investors

The Industrial Products sector remains appealing to Chinese buyers, particularly companies with advanced industrial technologies and strong sales and distribution channels. 2012 Europe-bound Chinese investment in this sector was triple that of 2011. One of the largest of those deals was Sany's full buy-out of the German construction equipment maker, Putzmeister Holding. As a stalwart of Germany's Mittelstand, and family-owned, some media reports suggested that this deal could mean that more such targets might open up to Chinese investment. This deal was also interesting because Sany's €317 million investment involved the domestic Chinese Private Equity house, CITIC PE. As we will discuss in the next article, softer conditions in their domestic Initial Public Offering (IPO) market could mean we see more Chinese PE involvement in deals in the future.

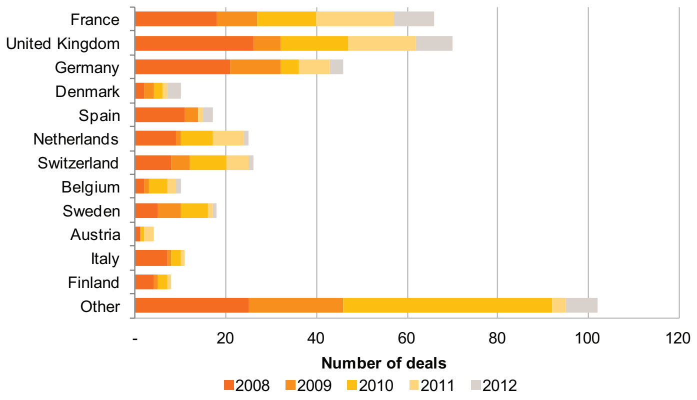
Figure 3. British, French and German companies continue to generate Chinese deals – in both directions

Figure 3a: China to Europe deal volume by country



Source: PwC analysis of Thomson Reuters and China Venture data

Figure 3b: Europe to China deal volume by country



Source: PwC analysis of Thomson Reuters and China Venture data

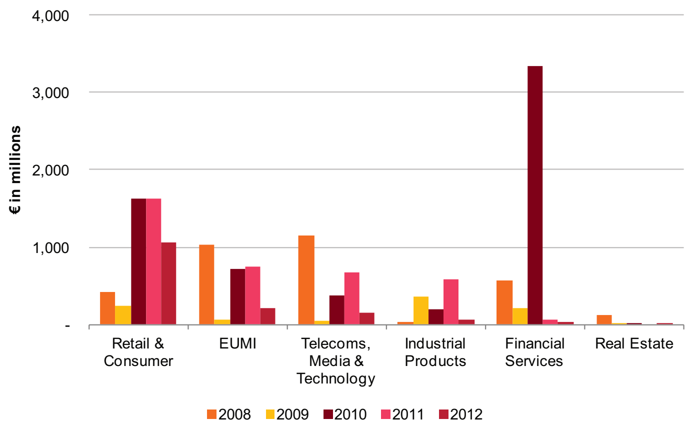
UK companies attracted high value deals but Germany was still ahead on volume

As mentioned above, UK companies were the targets for several of the biggest Chinese acquisitions in 2012 but Germany still holds the lead in terms of total deal volume, with fifteen deals, up from eight in 2011. Chinese investors completed nine deals with UK companies in 2012, again up from five deals in 2011. France followed, with eight deals and the Netherlands, Italy and Austria each saw three deals involving Chinese buyers.

Europe to China deal flow: European buyers were less acquisitive in 2012

While Chinese investors went forth and did deals last year, European companies were more reticent. European China-bound M&A activity had already slowed in 2011, following a good year in 2010 with 110 deals for a total value of over €6.2 billion. In 2011, European investment into China fell to just 63 deals, for approximately €3.7 billion. But that level declined again in 2012: by the year end, European buyers had only made 36 deals in China for a total of €1.5 billion, less than half of 2011's value.

Figure 4: Europe to China deal value by sector



Source: PwC analysis of Thomson Reuters and China Venture data.

Note: Value based on publicly disclosed deal amounts only

Buying into China's growing domestic market

If the value of Europe's China-bound deals was down considerably on 2010 and 2011 levels, the deals that happened suggest that European investors have not lost their faith in China's growth story. European dealmakers continued to target China's R&C sector, with 10 deals, totalling over €1 billion. The value of European M&A activity in China's R&C sector has consistently outstripped that of deals in other sectors over the past few years, with the exception of a spike in deals in the financial services sector in 2010. That spike was attributable to the acquisition of the Asian business of Axa Asia Pacific Holdings Ltd., a Melbourne based insurance company owned by AMP Ltd., by the French company Axa SA for over €2 billion. Concurrently, AMP Ltd. agreed to acquire a 53.92% stake in Axa Asia Holdings and an investor group comprised of AMP and Axa agreed to purchase the remaining 46.08%. The potential of China's growing middle class is clearly the draw for companies from mature markets and this should be boosted by China's continued focus on raising per capita income and spending power.

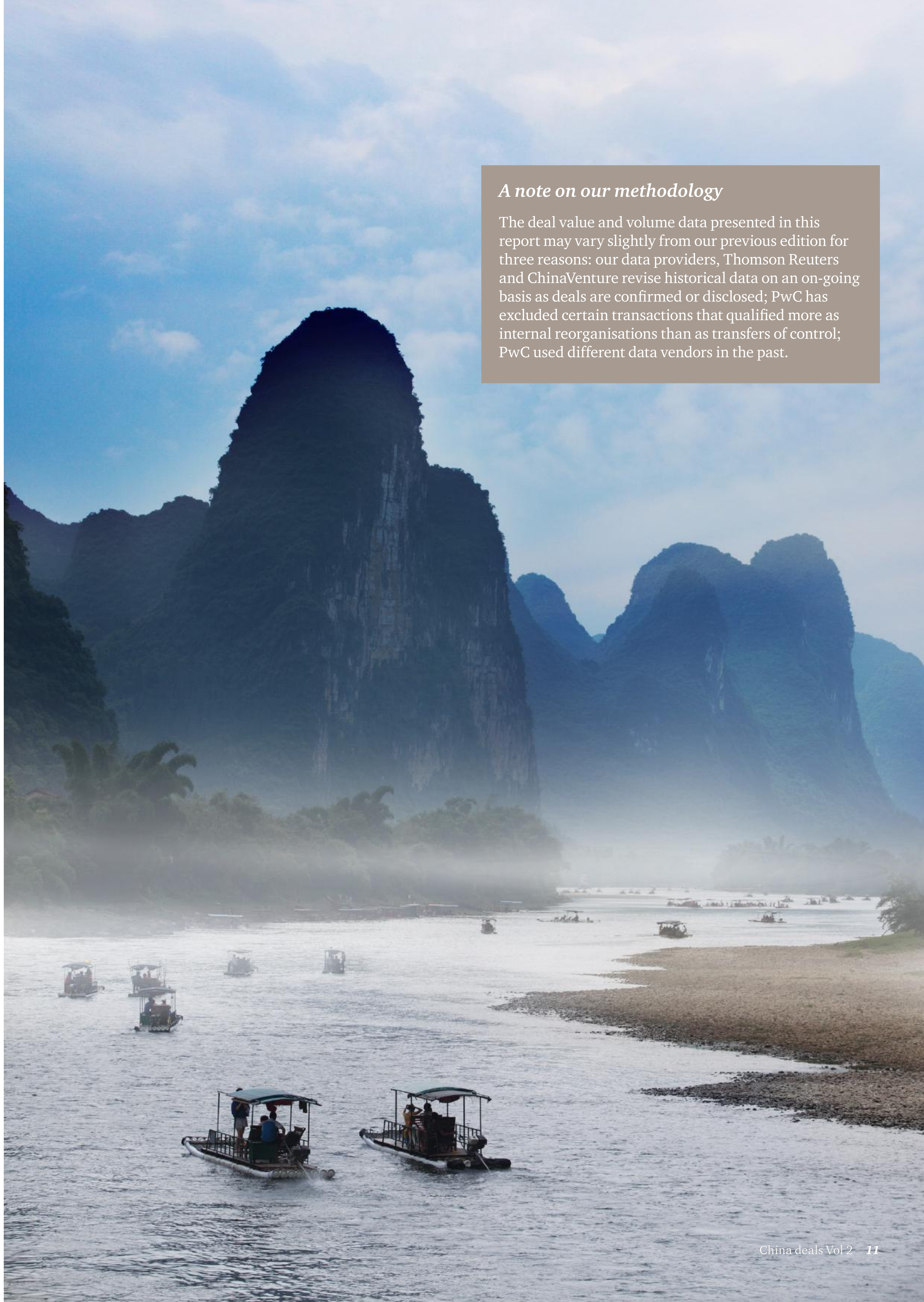
Looking at deals in other sectors, eight went to the EUMI sector and nine to Telecommunications, Media and Technology (TMT). Healthcare companies also featured among the top deals in 2012 by European investors in China. The Luxembourg subsidiary of US pharmaceuticals company Pfizer and Getinge AB, a medical supplies company, both did deals that will bring them access to China's healthcare market, which is expected to develop greatly as China reforms its healthcare system and as the population begins to age.

The top deal in terms of value was Diageo's (a global UK drinks company) acquisition of Sichuan Swellfun, better known as Shuijingfang in China, a distiller of popular Chinese spirits or "baijiu". Accounting for half of all the deal flow from Europe by value, the deal took some time to complete as Swellfun produces a very well known drinks brand and the deal required state approval. By completing this deal, Diageo can now use a well-established Chinese brand name to reach the country's large spirits market. Though three of the top European deals into China in 2012 were UK led, French companies just pipped UK ones for the top spot for volume with nine deals to the UK's eight.

What direction will deal flows take in the year ahead?

As 2012 was a softer year for M&A globally, we expect that overall deal levels to be stronger in the year ahead. China's new leadership have signalled their commitment to further economic reforms and opening up, and have identified several "darling" industries and the need to boost domestic consumption as pillars of their growth strategy. China's POEs will be encouraged by these commitments and can use overseas deals as a way to access technology, expertise or channels that they can employ to grow their business at home and abroad. With their expertise in sectors such EUMI, IP, R&C and Technology, European companies are well positioned to attract Chinese investors. In addition, European governments have generally being more open to inward investment from emerging market players. The on-going restructuring we see in certain industries in Europe, particularly in financial services, could also generate interesting investment opportunities for some Chinese investors, as companies divest parts of their business to focus on core activities. Equally, the new Chinese leadership's objective of raising incomes, and thus the spending power of Chinese consumers, should motivate more European companies to invest in China. M&A is a route to the growth market they need to expand their customer base and increase returns on existing and new products and services. However, European companies may need to accelerate their thinking. After a year of uncertainty in the US and Europe, more companies may return to the M&A arena in search of deals in China. And, as we discuss in the following article, we expect a rise in deals by Chinese PE firms – at home and abroad. In sum, there are many indications that we may have a very active M&A year ahead.

Included Deals	Excluded Deals
Acquisitions of private/public companies resulting in change of control	Property/real estate for individual properties
Investments in private/public companies (involving at least 5% ownership)	Rumoured transactions
Mergers	Going private transactions
Buy-outs/buy-ins (LBOs, MBOs, MBIs)	Any purchase of brand rights
Privatisations	Land acquisitions
Tender offers	Equity placements in funds
Spinoffs	Stake purchases by mutual funds
Split off of a wholly-owned subsidiary when 100% sold via IPO	Open market share buyback/retirement of stock unless part of a privatisation
Divestment of company, division or trading assets resulting in change of control at parent level	Options granted to acquire an additional stake when 100% of the shares has not been acquired
Reverse takeovers	Balance sheet restructuring or internal restructuring
Re-capitalisation	Investments in greenfield operations
Joint Venture buyouts	National Social Security Fund acquisitions
Joint Ventures	
Receivership or bankruptcy sales/auctions	
Tracking stock	



A note on our methodology

The deal value and volume data presented in this report may vary slightly from our previous edition for three reasons: our data providers, Thomson Reuters and ChinaVenture revise historical data on an on-going basis as deals are confirmed or disclosed; PwC has excluded certain transactions that qualified more as internal reorganisations than as transfers of control; PwC used different data vendors in the past.

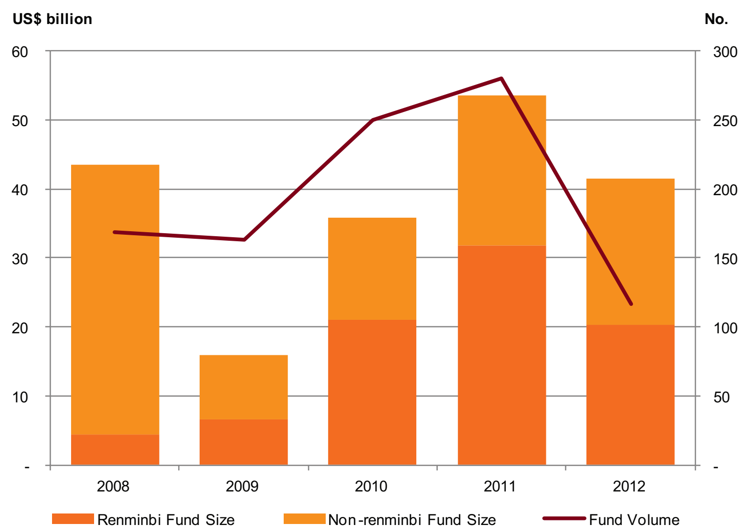
What the evolution of Chinese PE will mean for global M&A

China's domestic private equity (PE) sector has a relatively short history, having only started to take off meaningfully in 2005. Over the last five years, we have seen more than US$190 billion of funds raised with a geographic focus on China (see figure 1), more than the aggregate fund raisings for all other territories in Asia during the same period.

As the IPO market cools, PE competition is heating up

The private equity market in China has started to mature and during the last five years, a truly domestic market has emerged. However, the process of maturation has been far from smooth. Many China-related funds are growth capital funds, targeted at relatively short-term pre-IPO minority stakes. At the start of China's PE boom, when funds were entirely retail backed (i.e. mostly funded by high net worth individuals (HNWIs)), the capital markets had the capacity and relative strength to absorb the first wave of private equity backed IPOs. This led to an explosion of new funds established by "connected" individuals, backed by wealthy investors looking for quick returns from the over-heated capital markets. That landscape looks very different now and there is a considerable backlog of companies with plans to list which have no realistic chance of doing so in the short to medium term. Furthermore, the "commitments" obtained when some of these funds were established are not all they seemed to be and many funds are struggling to get their hands on the monies that were pledged – particularly funds without good track records.

Figure 1: PE/VC fund raising for China investment



Historically, the multiples achieved via domestic IPOs typically far exceeded those of placements to PE funds or secondary/trade sales. This was a barrier to PE funds and strategic investors making investments in the first place – as founding shareholders preferred the valuations achievable from an IPO. For the same reasons PE funds have preferred IPO exits to trade/secondary sales. This is further compounded by the fact the growth capital deals are minority stakes and it is harder to achieve trade sales where the fund cannot offer a controlling stake.

Despite this turmoil, China focussed fund raisings have held up reasonably well in terms of values raised, with a further US$41bn announced last year. The composition, however, has changed. The number of individual funds is decreasing as the bigger, better funds raise large amounts from institutional investors and smaller, retail-backed funds fall away.

What does this mean for the PE market in China and the broader M&A landscape?

We have already seen a flight to quality. Funds with better reputations for achieving exits, whether via IPO or secondary/trade sales, are emerging as preferred bidders on new deals. The relatively depressed state of the capital markets is already affecting valuations. Sellers' expectations are being slowly managed downwards to more realistic levels, though as always the buyers are adjusting downwards more rapidly! There is also a much greater focus on buy-out deals as investors build a stronger platform to enable future trade sales.

We believe this is a positive development for China's private equity industry and strategic investors because it has taken some of the heat out of the market. Certain foreign investors, whether PE or corporate, seeking investment opportunities in China have found themselves priced out of the market by the less risk averse domestic PE funds. This, combined with the need to add value, and the long history of value enhancement that global PE funds can demonstrate as part of their strategic offering, gives them a stronger platform to compete for deals than has been the case in recent years.

Chinese PE widens the net in the hunt for returns

We are starting to see more active management by the better domestic funds of their portfolio companies in order to achieve required returns. In the early days making a decent return on an investment was largely about ensuring the IPO launched. With an IPO a much less certain outcome, private equity funds are having to take steps to help management enhance the value of the portfolio companies in ways that are very familiar to funds in more mature markets but had not been actively pursued in China previously. These include further investment in production, product innovation, new markets, and driving efficiency and cost reduction. The strong local funds that build these capabilities will start to look a lot more like their global counterparts over the next few years.

We believe it is the need for these Chinese funds and portfolio companies to focus on new markets that will have the most impact on the international M&A scene in the short term. Historically, Chinese outbound investment has been dominated by the large State Owned Enterprises (SOEs) and more outward facing Privately Owned Enterprises (POEs). The need for Chinese PE funds and their portfolio companies to focus on areas where they can add value is pushing them to join the outbound investment party.

The future is another country

This shift in the strategy of Chinese PE firms is not yet borne out by the figures in the data presented elsewhere in this document. But historical figures are not always a good indicator of the future and this is an area where we believe change is afoot as a result of our knowledge of ongoing deals and discussions with dealmakers both in China and in the markets at which the Chinese are looking.

We hear from a number of our Chinese PE clients that they are increasingly including international opportunities as part of their domestic strategy. They consider themselves best placed to deliver on a China growth story for a Western business that is well established in its home market but struggling to grow quickly enough in China by itself.

The basic hypothesis is for the Chinese fund to identify a foreign company with the following characteristics: good management team, financially stable business, strong brand and, crucially, strong potential for China that has currently not been realised. The China fund would rely on the incumbent management team to run the existing footprint but work with that team to leverage the Fund's China market expertise to deliver on the China growth story. The opportunity for value enhancement if this can be achieved is obvious, and the platform for exit via IPO, either in Hong Kong/China or the original home market, or trade/secondary sale is also relatively strong. We expect this will unlock some portfolio company disposals for European PE funds who would otherwise find it difficult to build a convincing investment rationale for any new investors.

Fresh openings for MNCs and European-funds

We expect this theme to be of particular interest to European based funds with no, or only very limited, coverage in Asia. It should lead to some natural partnerships between funds in the different jurisdictions. This is particularly true as partnership does not mean exit. We believe there is a strong case for joint venture arrangements where the existing European fund does not fully exit in phase one but instead sells down part of its interest to the Chinese fund. They can then build value by working with the Chinese PE partner to start to deliver on the China story before fully exiting as a second step.

Multinationals (MNCs) could also benefit from such opportunities. Typically, MNCs have focussed on Chinese M&A openings that they can control, or on partnering via joint ventures in China with fellow Chinese companies. Looking ahead, we expect to see more joint venture deals where the Chinese party is a PE fund or its portfolio company.

Partners who understand both sides of the story

We believe the emergence of Chinese PE funds as outbound investors is a natural step in the evolution of the M&A market in China and one that will lead to some very interesting cross-border developments. It is one where in most cases the funds on either side of the opportunity have a blind spot – being very familiar with their own side of the equation but unfamiliar with their potential counterparties. This is an area where the strength of the PwC's global network can be brought to bear and in the coming months we look forward to working with clients on both sides to help bridge the gap.

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While in our Beijing office, Malcolm led the China Outbound initiative for PwC in China, overseeing the firm's focus on Chinese clients that are investing overseas.

Malcolm is a Fellow of the ICAEW and has a BEng (Hons) degree in Civil and Structural Engineering.

Drawn to new M&A horizons?

Based on the experience of our deals partner networks in the UK and China, here are a few questions to bear in mind, and that we can help you answer, as you consider embarking on M&A in China. We will explore these and other issues in future editions of China Deals.

Working Capital

If your sales/purchasing mix is shifting east, and to China in particular, what will be the impact on working capital and how can you manage it better?

Capital flows

What is the most effective investment holding structure? How do you best get money in and what do you need to watch out for when planning capital or dividend repatriation?

Regulation

Which approval processes are relevant for your China strategy? What are the best ways to navigate them? What taxes will apply to your China business and can these be mitigated?

Currency

What is the impact of the internationalisation of the Renminbi? What should your treasury team be thinking about?

Brand valuation

If you are bringing a brand to a Joint Venture with a Chinese partner, how should you value that contribution?

China outbound

If approached by a Chinese investor, how can you assess their credibility? How might you identify other potential suitors or partners?

Market Entry

What does the Chinese market for your product/service look like and how is it likely to evolve? Who will be your main competitors? What is the best entry point and business model?

Risk

What risks should be on your radar when establishing and then overseeing your China business? How can you determine if your diligence, governance, oversight and audit processes are robust enough?

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