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ACQUIRING LISTED COMPANIES – THE NEW ROUTE TO TRANSFORMATIVE DEALS

Using public markets to make a landmark deal will become more common as multinationals scale up their Chinese operations, says Eduardo Morcillo.

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October 2021

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Strategy | Corporate Finance

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Chinese market becomes even more critical

Because of its huge size and continued mass consumption growth, China today accounts for an ever-increasing percentage of global sales for most multinationals, representing a critical platform. And it's a trend that is only going in one direction. As the chart below shows, based on recent interviews we have conducted with leading executives in China, more than 80% of multinationals think that China will be their top priority by the end of this decade.

From these interviews the biggest fear that multinationals have is that as the size of their businesses gets larger in China, they may still end up with less market share because the market is consolidating so quickly across virtually every industry.

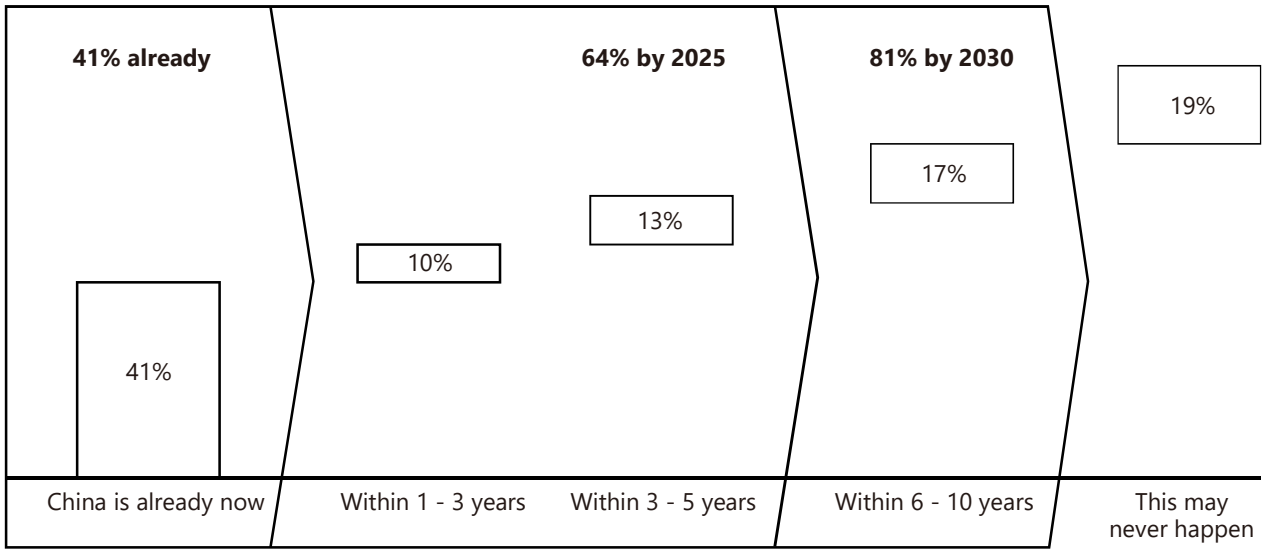
As such every multinational is in the process of rethinking their China identity, strategy, equity and growth models as part of their fight for relevance. Moreover, to become relevant they need to become full-scale, localised, and need to be generating huge sales to justify the huge costs of their Chinese operations.

Chart #1

The Importance Of China

Survey Question: How long will it take until China is your company's global no.1 or no.2 market?

No. of respondents, as % of total respondents surveyed



N = 229 respondents, InterChina analysis.

Acquiring listed companies

Faced with these huge pressures, how should multinationals respond? The answer will undoubtedly be through M&A, and I believe the acquisition route will now become the most common response to the need to be full-scale. Indeed, our recent surveys have shown that more than half of companies are currently considering acquisitions, while 40% regard M&A as their key corporate priority.

But where should multinationals stake their claims? This is where, in my opinion, we are now seeing a major shift in the M&A market towards the specific targeting of listed companies. In the fight for relevance and scale, where M&A is the key strategy, such acquisitions will become one of the few routes to making a transformational deal.

Notable deals

In recent years we have already begun to see some notable deals involving multinationals and Chinese listed companies. For instance, in 2019 global healthcare company Grifols, a leader in plasma medicines, acquired a $1.9bn stake in Shanghai RAAS, thereby becoming the second-largest shareholder in the company which specializes in the research, manufacture, and sale of plasma-derived products.

In 2018 the world's second largest brewer Heineken acquired a 20% stake in China Resources Beer (CRB), a key listed Chinese player in the alcoholic beverages industry. By doing so Heineken had direct access to CRB's best-in-class route to market network, and CRB was able to expand into the premium beer market. The combination of Heineken's brand portfolio along with CRB's presence and understanding of Chinese markets have been key success factors for both companies to grow in China.

Past barriers

Traditionally public markets have not been a source of targets for multinationals for several reasons. Firstly, many first-generation led companies have only been listed on public markets for a relatively short time, and are only partially floated. Especially for those on strong growth trajectories, they have had little incentive to delist.

There have also been specific regulatory issues and complex lock-up periods to consider, which means companies cannot delist anyway. But more than anything, valuations have also been historically very high, thus putting off potential suitors.

New landscape

However the landscape for listed companies in China is now no longer what it used to be. In particular, we are beginning to see this first generation of entrepreneurs retiring, while lock-up periods post-flotation are either ending or about to finish. Many owners have also pledged their equity to do other projects so need cash.

Moreover, given that partial floats are common and original owners still hold significant equity, this brings opportunities to acquire their stakes through private negotiation, which could facilitate negotiations with a potential buyer.

And just as high valuations have acted as a barrier in the past, so falling valuations today represent perhaps the most significant change in terms of the attractiveness of public markets. As you can see from the table on the next page, average PE ratios are currently at historically low levels on the Shanghai, Shenzhen, and Hong Kong exchanges.

Chart #2

Comparison Of China's Stock Markets

As of 7th Sep 2021	Third Board	STAR	HKEX (Hong Kong)	Shenzhen Stock Exchange	Shanghai Stock Exchange
Total Market Cap (Trillion CNY)	1.73	5.41	48.06 (Trillion HKD)	38.01	51.52
Trading Value (Billon CNY)	3.69	51.06	289.97 (Billion HKD)	745.28	661.4
Trading Volume (Billion shares)	0.44	0.96	227.00	47.03	54.88
Average PE Ratio	19.05	74.89	17.08	31.67	18.00
No. of Listed Company	7,407	120	2,561	2,485	2,020

All of these factors taken together mean that acquiring listed companies - or significant shareholdings in them - has become a far more viable option for multinationals. And looking further ahead there is likely to be a bigger pool to choose from in the years to come too as non-listed Chinese champions also look to go public.

InterChina's Experience

As one of the few firms with a consistent track record of advising on stock market transactions in China - in the last two years we have been involved in five deals – I believe our learnings on these types of deals have significant value for the industry as a whole.

Third Board

With more than 7,000 companies listed on the Third Board NEEQ, there is now a significant pool of acquisition targets. So what should be the strategy of multinationals targeting companies in this market?

1. Firstly, they could delist the target with a signed SPA, and then acquire it as a private company, in our view a proven and practical option. The target company is generally more comfortable about the delisting once the SPA is signed, and the main transaction risk is around the full alignment of majority and minority shareholders on the key deal terms. Should the transaction not take place due to condition precedents not being met, there are no obligations or responsibilities to the foreign buyer.

2. The second option is a public tender offer. This has been possible since regulatory changes in 2019, but no multinational has yet gone down this path. In our view, this option is not recommended as it is both risky and unpredictable, not least because the offer requires additional processes for the acquirer, which complicatest he process. These include opening an account on the Board and engaging an authorised security broker, while a deposit or guarantee is also required. A delisting procedure is also still required after acquisition and is not an automatic process.

3. The third option is to delist without an SPA. This is less complex since it does not involve formal communication of the acquisition offer. However the target company is normally not comfortable delisting prior to reaching a final agreement.

Key considerations

For a successful process, three key areas are worth paying close attention to.

1. Firstly, a Third Board company usually has fragmented shareholder ownership, so a single negotiation point is critical and effective for M&A negotiations.

2. Secondly, it is worth noting that the Board has less strict information disclosure requirements compared to other boards, although during the M&A process the target company still has to comply with relevant disclosure rulings when signing binding contracts.

3. Thirdly, there is a challenge of potential dissenting shareholders. If this is the case the shareholders of the target company should formulate reasonable protection measures, such as stock repurchases or cash compensation. Be warned that resolving the issue of dissenting shareholders can delay the entire M&A process.

Main Boards

Multinationals have two options when looking at acquisitions of companies on Main Boards.

1. The first is a private placement and the injection of new capital which dilutes the pre-existing shares of other shareholders. If treated as a strategic investor, the new shares can be issued at a larger discount to the market price compared to a financial investor. Any private placement by foreign investors must first be approved by the relevant Chinese financial authorities, and shares cannot be transferred within 36 months.

2. The second option is to purchase shares from a third party. The offering price and quantities of shares are determined by the investor and the listed company. The contractual transfer for foreign investors must first be approved by the board of directors, then, submitted for MOFCOM's approval. If a transfer gives de facto control of a listed company to a foreign investor, an acquisition report and related documents must be submitted to the CSRC for approval.

Chart #3

Share Purchase Options

Transaction With Holding Company

- Many shareholders of listed companies invest indirectly via a holding company.
- It is then possible to negotiate at a holding company level (rather than listed company level).
- Listing rules still apply (e.g. communication, tender offer), thus preferable to stay below 30%.
- And the new investor would be subject to the same lock-up conditions as the holding company.

Hybrid Approach

- **Private placement,** directly with the top shareholders of the listed company.

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- Acquisition of **newly issued shares** equivalent to the targeted shareholding %, or
- **Indirect transaction** with the holding company.

New Share Issuance

- Listed company issues new shares to be acquired by the new investor.
- % of outstanding shares determined so a to give new investor their targeted shareholding %.
- The new issuance price is normally the average of the past 20 trading days.
- This is negotiable if the new investor is designated "strategic" by the regulatory authorities.

Key considerations

Deal structure

A key question is whether the investor will be considered by authorities as a strategic or financial investor. In our experience, to be labelled strategic there is a need to prove that there is a contribution of assets or synergies valuable to the listed company.

Being labelled strategic has advantages, especially in terms of valuation and possibly a longer time frame to complete the transaction, although the strategic investor is subject to a three-year lock-up period. Fully acquiring the company is also possible, but the issue then is around anti-trust laws.

Governance

Control issues are critical and one of the key areas for dispute and risk. In China there are very few companies that are so liquid that there is no real controlling shareholder. Instead, in most cases, there are one or several controlling or lead shareholders.

A foreign investor can take a minority stake without a public tender, as long as they do not become the highest controlling shareholder or own more than 30% of shares. If there is a real change of control, there will be a need to trigger a tender offer requirement.

One of the best strategies is for the multinational to achieve a minority role with a high level of influence but not trigger a tender offer. This is usually done by being the second-largest shareholder, either by real equity or proxy rights which need to be made public.

Disclosure and compliance

A key issue is when to make the offer public as once it is the authorities will push to have the deal closed in three months to avoid insider trading and uncertainty to minority shareholders. However, it is possible to negotiate an extension of up to six months under special circumstances, such as a strategic investor needing more time to work out synergies and integration plans with the Chinese company.

Therefore it is critical to have the key terms discussed and negotiated in private before formal disclosure of the deal is required. Usually due diligence can begin only when terms have been discussed and negotiated, although this has to be checked case by case.

Finally, insider trading is a key issue and a critical risk factor. It can be a deal killer, and all meetings must require all attendees to sign NDAs.

Summary

At this early stage it is hard to conclude whether multinational acquisitions of Chinese listed companies will become mainstream or not. Indeed at the moment there are very limited examples from the past, so we are facing unchartered territory.

However we have been involved in several projects involving Chinese listed companies and continue to be invited to support our clients in new initiatives.

It is possible that many of these will not fly either due to valuation challenges or complex regulatory or shareholding issues.

But we are sure some of these transactions will be successful and when they do they will become truly transformational deals for investors. Indeed, in the new China, acquiring listed players might be one of the limited options for some international companies to retain sector leadership, become more local and achieve true relevance.

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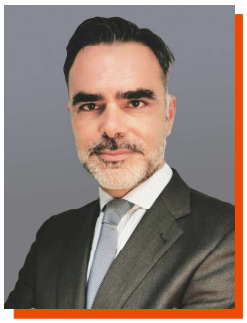

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Eduardo Morcillo is InterChina's Managing Partner and the chair of its management committee. He has been in China for the past 20 years, focusing on M&A and corporate restructuring transactions as lead negotiator. He also serves on a number of boards for companies and organizations in China and APAC.

About InterChina

InterChina is the leading advisory firm specialized in China. Our multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done. We are a partner led firm, and distinguish ourselves by the deep level of engagement partners have in client projects.

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