WILL THE ROOSTER CROW? CHINESE OUTBOUND INVESTMENT IN 2017

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Legal Briefings – By **Tony Damian** and **Karen Ip**

The new Year of the Rooster is likely to see increases in approval timeframes for certain kinds of outbound Chinese investments following a number of recent Chinese regulatory changes. Greater regulatory scrutiny for outbound capital flows from the Chinese authorities may impact the size and nature of Chinese outbound investment.

IN BRIEF

- Under new Chinese regulatory changes, certain categories of overseas investment by Chinese companies are expected to no longer be permitted without approval, including transactions over US$1 billion outside the acquirer's core business and all acquisitions above US$10 billion.

- It is expected that Chinese companies investing overseas with high liabilities-to-assets ratios or low return-on-equity ratios will be subject to higher levels of scrutiny and checks under new Chinese rules.

- Reports have suggested that overseas money transfers of US$5 million or more will now require pre-approval by the State Administration of Foreign Exchange (**SAFE**) (formerly US$50 million) and transfers over US$50 million will be monitored.

- Target companies and vendors of assets to Chinese buyers can mitigate Chinese counterparty regulatory risk by requiring regulatory approvals to be received before transaction documents are entered into or by seeking reverse break fees.

BACKGROUND AND SUMMARY

Recently, Chinese capital outflow has put downward pressure on the Renminbi, which depreciated approximately 6% against the USD last year. This reportedly prompted the People's Bank of China (**PBOC**) to undertake a selling of foreign currency reserves to stabilise the yuan. In addition, new regulatory controls are being put in place to increase scrutiny for capital outflows and prevent capital flight which may result in extended approval periods for deal makers and lead to changes in the size and nature of Chinese outbound investment.

THE CHANGES

Restrictions targeting the size and nature of overseas acquisitions

In November 2016, the State Council issued an internal document listing categories of overseas investment that will attract extra scrutiny and, in the absence of specific approval by the relevant authorities, will not be permitted. These include:

- transactions over US$1 billion that are outside of the acquirer's core business;
- acquisitions above US$10 billion;
- outbound investments directly made by limited partnerships;
- acquisitions of 10% or less of the shares of an overseas listed company;
- overseas investments where the investing entity is a newly-established vehicle (without substantial business operation or established for a short period, usually less than one year);
- investments in assets with a value greater than that of the acquirer;
- transactions involving domestic capital participating in the delisting of overseas listed Chinese companies; and
- state-owned enterprises entering into real estate transactions over US$1 billion.

These restrictions are expected to expire in September 2017. The temporary rules appear to be in response to concerns in recent years that Chinese companies were taking advantage of declining exchange rates at the potential risk of thorough due diligence and prudent leverage ratios.

Additionally, it was reported that the State Administration of Foreign Exchange (**SAFE**) recently stated that it would continue to put a stop to 'fake' transactions (e.g. shifting money overseas through payments to dummy companies in Hong Kong for exports which are never subsequently delivered) while clearing outbound capital to fund genuine acquisitions.

Under the regulatory changes, it is also expected that Chinese companies with a high liabilities-to-assets ratio and low return on equity will be monitored. Furthermore, deals which have already received approval from the Chinese authorities may be rechecked for compliance and authenticity. It is thought that local authorities will, in the first instance, examine whether the ROE and debt ratios fall short of set thresholds and, if so, then require rechecking procedures.

Greater scrutiny of outbound capital flows

On 28 November 2016, it was widely reported that an internal meeting of the Shanghai Branch of SAFE resulted in the implementation of new measures to reduce the maximum amount that companies established in China (both foreign and domestic) may repatriate overseas without pre-approval by SAFE from US$50 million to US$5 million. In addition, it is understood that transactions of US$50 million or more will now be strictly controlled through a system of direct monitoring and review by SAFE.

It is also rumoured that SAFE has advised banks to control their FOREX deficit by not exceeding the SAFE-set quota limits for FOREX transactions each month. Once the quota is filled, it is expected that transactions will be required to be held over until the next month.

SOE outbound investment restrictions

The State-Owned Assets Supervision and Administration Commission (**SASAC**) announced on 18 January 2017 that it will use a negative list to regulate the overseas investment of state-owned enterprises. It has not yet been confirmed what the negative list will cover. However, it is expected that outbound investment will now be required to:

- be strategic and boost capacity for innovation, leadership and the international competitiveness of the relevant SOE's business;
- be lawful in China and abroad;
- be an appropriate investment considering the size of the investment, as well as the financial position, industry and management experience and ability to adapt to risk of the investor; and
- offer a reasonable return.

COMMENTARY

As a result of the changing regulatory landscape, we are likely to see longer approval times and more thorough scrutiny by the NDRC, MOFCOM, SAFE and SASAC (for SOE investors) with respect to Chinese outbound investment. The increased controls have the potential to impact both the size and nature of Chinese outbound investments.

Where certain consents are required from regulators, applications for outbound investment approvals will need to clearly address the stated concerns of Chinese authorities. Additionally, relationships with banks and regulators will be crucial to managing the lengthier timeline for purchases of foreign exchange and cross-border RMB remittances by Chinese companies.

Nonetheless, despite the changes, it is expected that genuine overseas acquisitions by Chinese companies with strong and strategic business cases are still likely to be approved.

Key takeaways: mitigating counterparty regulatory risk

In light of the changes and lack of transparency around new policy considerations, how can a company transacting with a Chinese counterparty protect itself?

- **Upfront approvals**: Target companies and vendors of assets to Chinese buyers may require that relevant Chinese regulatory approvals be sought and obtained prior to entry into transaction documentation.
- **Reverse break fees**: Requiring the payment of reverse break fees where a key Chinese regulatory approval is not obtained is another useful protection target companies and vendors of assets to Chinese buyers can seek against Chinese regulatory risk, even if the failure to obtain an approval has occurred despite the counterparty's best efforts.

To read more on break fees, read our article 'Recent developments with reverse break fees'.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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