

China's world of Mergers and Acquisitions

The Red Synergy

The following is based on our understanding of relevant PRC Law and practice and our experience in representing foreign companies in their business activities in the PRC. As a foreign company we are not authorised to practice law in the PRC and cannot express a formal legal opinion on PRC law. The application of PRC laws and policies regarding the activities of foreign enterprises in the PRC is constantly evolving.

Accordingly this advice is necessarily preliminary and subject to confirmation from the relevant Chinese authorities.

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- Market Trends
- Some data to understand the Chinese Market potentials
- Trends of the M&A Transactions in China

Market Trends

Some data to understand the Chinese Market potentials

- The Chinese economy achieved a 10.7% GDP growth in 2006 compared to a 10.2% growth in 2005. Whereas the GDP grew 11.1% in the first quarter of 2007
- Imports in 2006 went up by 22.7% to US\$ 90.3 billion
- In 2006 China reported a global trade surplus of US\$ 177.5 billion. For the first quarter of 2007 the global trade surplus amounts to US\$ 46.4 billion
- China's trade surplus with the EU rose to 31% in 2006, amounting to a total of US\$ 91.7 billion
- Exports with the EU reached EUR 191.5 billion in 2006, becoming the EU's largest source of imports
- The Chinese government has set a 8% GDP growth target for the year 2007, aiming to slow down the economy

Market Trends

Trends of the M&A Transactions in China

- The M&A deal activity rose 10.7% to 1,945 announced deals in China (excluding HK) in 2006 compared to 1,757 in the whole of 2005
- Total disclosed value of announced deals in China in 2006 amounted to US\$ 43.5 billion (US\$ 30.5 billion were disclosed in 2005)
- Deal activity in 2007 will continue to grow, driven by accelerating industry consolidation and the growth of China's middle class

- Investment options - how to “get into China”
- Green Field Operations
- Main Characteristics of REP Offices
- Preference for establishment of WFOE
- The fundamental differences between the FIEs compared to Western style corporations
- Restrictions to Green Fields Operation
- The factors created new opportunities for outside investments

Investment options - how to “get into China”

Green Field Operations

- Foreign Direct Investment (“FDI”) in the PRC is generally carried out through the establishment of a:
 - Sino-foreign Joint Venture (“JV”) or;
 - Wholly Foreign-Owned Enterprise (“WFOE”),

collectively also referred to as “Foreign Investment Enterprises” (“FIEs”)

- For more passive indirect business activities (e.g. liaison and marketing activities), foreign companies may establish a Representative Office (“REP Office”) in China

Investment options - how to “get into China”

Main characteristics of REP Offices

- **Purpose:** explore the market and search for business opportunities
- **Legal:** NO legal personality. Not a separate legal entity, merely an extension of the parent company
- **Establishment costs:** relatively low, no capitalization required
- **Allowed Activities:** can only engage in non-profit making activities
- **Restrictions:** cannot invoice directly or collect money, receive fees for services, sign contracts on behalf of parent company, represent other companies, buy property or import production equipment
- **Taxes:** subject to Business Tax and Foreign Enterprise Income tax which amount to approx. 10% of the REP Office’s expenses

Preference for establishment of WFOE

- Unlike the REP Offices, the WFOE will permit the foreign investor to invoice and receive money locally. Downside: the requirement for a high initial registered capital commitment
- Due to changes in the company regulations, the registered capital requirements have been considerably reduced.
- As a result, considering the tax burdens of a the REP Office, the establishment of a WFOE may actually be less expensive

Investment options - how to “get into China”

The fundamental differences between the FIEs compared to Western style corporations

- FIEs must operate within an approved “scope of business”. China has an ‘ultra vires’ doctrine: Any contract made on behalf of the company beyond the business scope of the company is invalid and has no legal or binding effect on the company
- Various corporate matters (incorporation, transfer of equity interest, increase of capital, change of business scope, dissolution) are subject to governmental approval

Investment options - how to “get into China”

Restrictions to Green Fields Operation

- FDI used to be restricted to particular industries categorized as follows:
 - ‘Permitted’
 - ‘Encouraged’
 - ‘Restricted’
 - ‘Prohibited’
- After joining the WTO, China has slowly started opening up some of “the restricted industries” (banking, insurance etc.). However...
- **U-Turn.** The Chinese government has recently begun to protect its “key industries”, “limiting” foreign participation in industries previously categorized as “permitted”

Investment options - how to “get into China”

Factors created new opportunities for outside investment

- The opening of previously closed industries under China’s accession to the WTO
- The increasing sales of State Owned Enterprises and restructuring of FIEs in China
- M&A activities represented an attractive alternative to green fields operations.
- Acquiring an existing entity may reduce the risks of failure, by taking advantage of an existing business (operating facilities, distribution networks, production knowledge, intellectual property and existing financial and legal structures)

- M & A Transactions according to Chinese Law
- M & A related activities
- Inbound M & A transactions
- Targets Company of an inbound transaction
- Asset Acquisition and Share Acquisition
- Threshold Requirements for FIE's Preferential Treatments
- The crucial difference between a JV and a WFOE lies in the decision Making process
- PROS and CONS of Asset Acquisition
- PROS and CONS of Share Acquisition

M & A Translations according to Chinese Law

M & A related activities

M&A related activities can be divided in the following categories:

- **inbound investment** (foreign companies investing in China)
- **outbound investment** (Chinese companies investing overseas)
- **domestic consolidation** (M&A among existing Chinese companies)

M & A Translations according to Chinese Law

Inbound M & A transactions

An Inbound M&A transaction can be effected either by an:

- Equity Acquisition; or
- Asset Acquisition

Merger, according to the “Western model”, does not exist for FIEs in China. The law only contains provisions for mergers of domestic companies.

M & A Translations according to Chinese Law

Targets Company of an inbound transaction

Targets Companies of an Inbound transaction may be:

- State Owned Enterprises (limited liability companies wholly funded by the State)
- Foreign Invested Enterprises (WFOE or JV)
- Listed Companies
- Privately owned domestic companies

M & A Transactions according to Chinese Law

Asset Acquisition

An Asset Acquisition is defined as:

- a foreign investor's establishment of a FIE, which purchases and operates assets of a domestic enterprise (the domestic enterprise is then normally liquidated)
- a foreign investor's purchase of assets from a domestic enterprise, which are used as a contribution for the incorporation of a new FIE, used to operate such assets

Share Acquisition

A Share Acquisition is defined as:

- a foreign investor's purchase of equity in an enterprise other than a FIE (a "Domestic Company"); or
- a subscription by a foreign investor to new shares in Domestic Company

M & A Translations according to Chinese Law

Threshold Requirements for FIE's Preferential Treatments

- if the foreign investor's participation accounts for less than 25% of the domestic enterprise's registered capital, the business license is marked as "Foreign Investment less than 25%". In that case the domestic company does not qualify as an FIE for tax purposes (domestic companies' tax will apply)
- if the foreign investment in the domestic company accounts for 25 % or more of the registered capital the relevant company is 'converted' into an FIE (Joint Venture)
- if the foreign investment in the domestic company accounts for 100% of the registered capital, the company will become a WFOE

M & A Transactions according to Chinese Law

The crucial difference between a JV and a WFOE lies in the decision Making process

The crucial difference between a JV and a WFOE lies in the decision Making process. In a JV, regardless the different share capital participations, unanimous decision making is required in the following situations:

- Reduction of the registered capital
- Amendment to the articles of association
- Share transfer
- Company's liquidation

M & A Transactions according to Chinese Law

PROS of Asset Acquisition

- Purchaser avoids debts and liabilities
- Purchaser can pick the most viable assets
- Allows a “fresh start” from tax point of view (relevant for tax holidays until the end of 2007)

CONS of Asset Acquisition

- Potential negative tax implications (business tax or VAT depending on type of assets)
- Different procedural requirements (approvals, registrations) for transfer of different types of assets
- Purchasing entity must be approved and obtain required operational licenses

M & A Transactions according to Chinese Law

PROS of Share Acquisition

- Quick solution: immediate use of business, assets and “skilled staff”
- The target company has already a reputation (trade name, sales network, client base, market share)
- All contracts and licenses are automatically inherited and continued
- Subject to governmental approval and registration but no further transfer procedures required
- Less tax implications than asset deal

CONS of Share Acquisition

- More intensive due diligence and pre-deal structuring
- Exposes purchaser to existing liabilities
- Where the target is a domestic company, conversion of FIE status required (more than 25% reg.cap), time consuming

- The New M&A Regulations
- National Economic Security Examination
- Share Swaps
- Round Trip Investment
- Antitrust review
- Do the new regulation really make a change?

New M & A Regulations

On September 8, 2006, the '*Regulations on mergers and acquisitions of Domestic Enterprises by Foreign Investors*', became effective, replacing the interim provisions issued in 2003

The key changes introduced by the new regulations are:

- National Economic Security Examination
- Share Swaps
- Round Trip Investment
- Antitrust review

New M & A Regulations

National Economic Security Examination

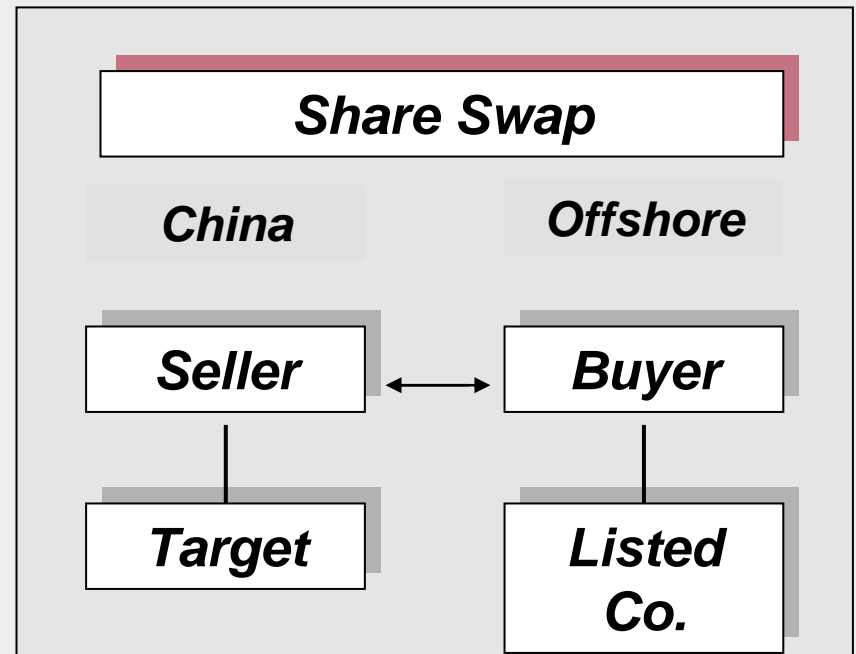
- MOFCOM must be informed if an M&A transaction results in the transfer of 'actual control' of a domestic company in a 'key industry', that has or may have an impact on 'state economic security', or that owns a 'famous Chinese trademark or traditional brand', the thereof MOFCOM will need to issue an approval
- In case of failure to report to MOFCOM (when this authority believes that the transaction may significantly impact state economic security), it may block or reform the transaction
- Above mentioned terms are not defined in the M&A Regulations, their interpretation is thus left to the discretion of the MOFCOM or other governmental authorities. Furthermore, the regulations do not specify the approval procedures or timeline applicable in this context

New M & A Regulations

Share Swap

- New or existing shares in an overseas company can be used as consideration to acquire a domestic company, instead of a cash payment
- The overseas company must be publicly listed
- The domestic company or its shareholders must engage an agency or intermediary organization registered in China an acquisition consultant
- The acquisition consultant is responsible for due diligence, accuracy of the application documents, the financial status of the overseas company and the compliance with the M&A Regulations
- MOFCOM approval is required
- Domestic company turns into an FIE (registration change)

Picture



New M & A Regulations

Round Trip Investment

A Chinese shareholder in a domestic target company sets-up an offshore vehicle:

- to which it transfers the control of the PRC operating company; and
- sells part or all of the shares in the offshore vehicle to a foreign investor

Advantages of this structure (compared to the joint venture model):

- Offshore vehicle may be incorporated under sophisticated corporate law system allowing for the creation of share classes
- Shareholders' agreement may be more efficient and private equity type mechanisms may be contemplated
- Tax perspective, investors are able to shop around

The new M&A Regulations require that:

- The establishment, by Chinese Investors, of an offshore entity or special purpose vehicle (SPV) and the issuance of its shares

Must obtain the prior approval of MOFCOM

New M & A Regulations

Antitrust Review

A draft Chinese Anti-Monopoly law is still under consideration, the new regulations have gone ahead and provided guidelines on antitrust review of M&A transactions, containing antitrust review requirements for certain “large” transaction or transactions involving “large” companies.

New M & A Regulations

Do the new regulation really make a change?

They seem to constitute a step forward in developing a reliable framework for M&A transactions

- Although they increase business' flexibility in how companies pay for their purchases (stock exchange), they also raise new regulatory hurdles to approval. In particular cross-border M&A deals will be subject to a higher level of scrutiny by the Chinese central government
- Are the new limitations and restrictions on M&A transactions perhaps a move which reflects a rise in economic nationalism ?
- It is clear that with these regulations China intends to ensure that foreign investments and M&A are carefully supervised and that such activities serve the needs of Chinese Economy and national interest

- China invests outside the "Great Wall"
- Chinese outbound investments
- Outbound investment-driving factors
- Reverse Merger

China invests outside the “Great Wall”

Chinese outbound investments

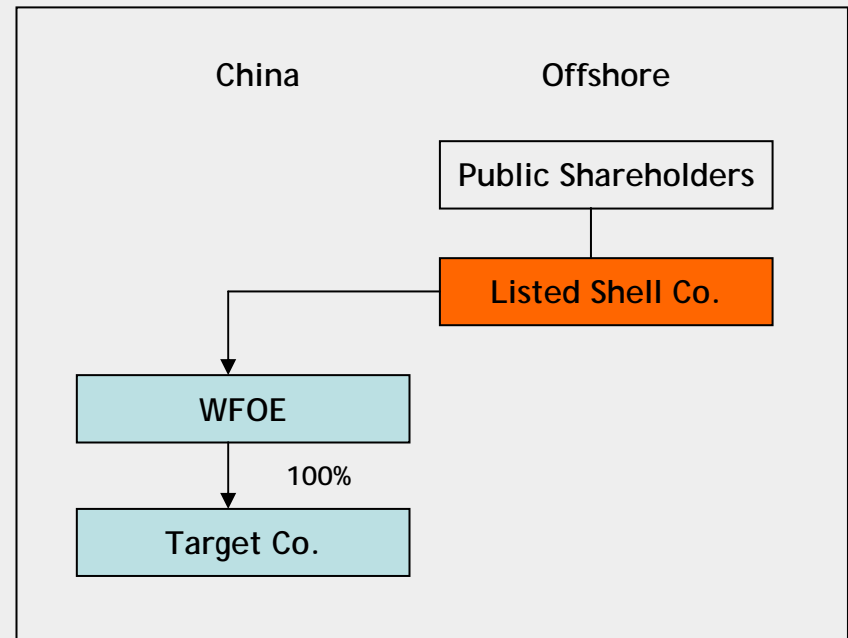
- Chinese Outbound Investments increased to US\$ 14.1 billion in 2006
- 61% of the deal value related to acquisitions of oil and gas companies in Russia, Kazakhstan, Nigeria and Singapore
- The Chinese Ministry of Commerce forecasts outward investment will grow by at least 22% annually
- Likely targets for future Outbound Investments are: oil and gas, mining, high-tech, telecommunications and manufacturing industries

China invests outside the “Great Wall”

Outbound investment-driving factors

- Increased demand for natural resources
- Excess domestic capacity (i.e. trade surpluses, accumulated cash)
- Growth potential in new consumer market
- Escape the intensely competitive domestic market where margins are shrinking
- Acquisition of strategic assets (Technology, recognised brand names, distribution networks)

Picture



China invests outside the “Great Wall”

Reverse Merger (continued)

The reverse merger is an attractive alternative for small Chinese companies compared to the traditional IPO, for the following reasons:

- less time consuming and expensive
- IPOing may be difficult when operating in an unpopular business
- Less interference from investors; hedge funds that buy the shares usually do not demand to be involved in decision making

■ Final Considerations

Final Considerations

Main issues when evaluating an M & A deal

- Though much more familiar than in the past with M&A, Chinese companies are still very much inexperienced with these kind of deals
- Language barriers, “creative accounting” (the two-sets-of-books trend is very common among Chinese SMEs) and government involvement, can easily turn your acquisition into a far more complicated deal
- Legal due diligence is an absolute must in any M&A Deal, but remains a very complicated task
- Due to the above, Chinese deal cost (both in terms of timing and money) can become nearly triple compared to those of an average M&A deal in the US or Europe. China is not a place where the “do-it-yourself” approach can really work

Final Considerations

Key issue when evaluating your target

Before committing to any deal, the following steps should be taken into consideration by any purchaser:

- legal due diligence
- interview with management
- interview with employees
- financial due diligence
- asset evaluation (compulsory)
- check with local banks