

Issues in doing M&A transactions in China

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The panel began its presentation by illustrating the importance of the Chinese market and noted that by 2025, China will exceed the United States in its consumption of goods. In order to meet this growing demand, business in China is moving with such velocity that the market is a bit chaotic. However, such chaos should not be viewed as a negative to conducting business in China; in reality, the chaos is an indication of China's prosperous future.

The unbridled entrepreneurial spirit that permeates the market has allowed research and development to progress at a rate that has far exceeded expectations. As the 'factory for the world', there is a tremendous need for resources. To meet this need, over 700,000 Chinese people have migrated to the city. Even if, as some pundits predict, China's demand were to slow after the Olympics, we should expect continued growth in mergers and acquisitions as fragmented industries continue to consolidate.

Notwithstanding China's excitement and progress, the market does present challenges.

As China's domestic capital markets develop, the financial sector is in flux. The regulations that are in place are not consistently enforced. Corporate governance is poor and improvement in this area has proven to be a slow process. Although private enterprises contribute the greatest amount of money to China's economy, they have to struggle for access to financing. The system continues to favour state-owned enterprises. This is evident when one considers that 90 per cent of new capital raised is made available for state owned enterprises.

In spite of the above, or, perhaps because of the above, the role of private equity in China is flourishing. Given buyouts are a rarity in China, private equity represents a means to fuel China's growth.

The rapidly developing real estate market in China is an example of private equity's influence. Ten years ago, it did not occur to people to own their own home. However, to the extent lenders believe that there is, or will be, a bubble in the housing market, they are not making the necessary monies available to property developers. Instead, it is often private equity that is the source of funding that makes it possible for property developers to fulfil customer orders.

Careful analysis of the regulatory scenario in China is necessary before considering any investment opportunity. By way of example, the panel provided the following guidance:

- Take the time necessary to learn the attributes of Chinese law with respect to any investment. For example, real property must be owned by the state. In turn, the state grants long term leases. As a result, one typically purchases interests in a real estate company rather than buying real estate directly.
- In order to form a Chinese entity, there must be a memo of understanding in place. It is recommended that one avoid investment in sensitive industries. You do not want to find yourself in a situation where the state refuses to grant permission for an investment.
- Chinese law will apply to the formation and operation of an investment; the opportunity to select a choice of law to govern an investment is not an option. Therefore, the panel advised that care should be taken when drafting arbitration provisions. In order to insure impartiality, parties should consider having their issues and disputes reviewed outside of China.
- When evaluating the expected returns of an investment, it is important to recognise that it not an easy process to get listed in Hong Kong. However, there should be little difference between Chinese and GAAP reporting standards.
- A 15 per cent dividend withholding tax is expected for 2008; treaties can reduce this tax to 10 per cent.
- Securitisation legislation is in the process of being written.

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- Chinese brands must go through a notification process in order to avoid antitrust violations. Pre-filing consultations with government officials are helpful. Whenever possible, a foreigner should consider the purchase of shares rather than the purchase of assets. It is easier for a foreigner to effect the former rather than the latter.
- Proper due diligence is crucial. You cannot always rely on the results of an audit given the quality of auditors varies. Consider using the services of companies that are available to conduct background checks.

Finally, the panel noted that all of the above must be considered in light of China's culture. The competition in the marketplace is fierce. At the same time, publicity and sensitive political issues are avoided. Relationships are key and they take months to develop. In addition to designing a process within which to develop the relationships, consideration must be given with respect to how the relationships that ultimately form are managed.