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Chinese Outbound M&A: Execution Risks and Consequences

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Chinese outbound M&A activity reached an unprecedented level over the past twelve months. The total value of transactions announced in 2015 set a new record at over $110bn. By the start of June 2016, the 2015 record was already eclipsed. This growth has spanned the market, covering both long-term strategic outbound investments and take-private transactions which have the ultimate goal to re-list in China.

Notwithstanding the valuations being offered, sellers and their boards continue to take a very cautious approach when receiving interest from a Chinese acquirer. This can be attributed to a number of factors.

First, the regulators, both in China and abroad, are paying close attention to these transactions, ranging from the Committee on Foreign Investment in the U.S. (CFIUS) to SAFE and the China Securities Regulatory Commission who are focusing on capital outflows and back-door listing practices at home.

Second, the identity of the acquirers themselves is often the most challenging hurdle for the sellers to overcome – the ultimate ownership of the acquirer is sometimes opaque and the acquirer is often extremely highly leveraged (in some cases, with leverage multiples exceeding 20x).

Third but not last, the ever-increasing deal size, and the corresponding importance of the debt financing supporting these acquisitions, have made sellers nervous as such financing is often provided on non-customary terms and/or by banks that may have very little previous international presence. It is also not uncommon for a single bank to underwrite a commitment in excess of multi-billion U.S. dollars, focusing the risk of potential funding failure on one institution.

Given the current market context, it would be particularly useful to examine some of the different approaches being taken in the market in financing the outbound investments from China and the measures the sellers are taking to address the additional uncertainty.

Certainty of Financing

Following English or New York Law Practice

In a typical transaction in Europe or the U.S., if an acquirer presents an offer including a “certain funds” debt financing commitment consistent with the market, it goes a long way to convincing the seller of the certainty of financing. The only remaining hurdle for the acquirer is to then convince the seller that the banks providing the financing are reputable and will respect their contractual obligations to fund contained in the commitment documentation. The market practices are, namely:

- **English law approach:** A certain funds commitment with full-form facility agreement (or at least an interim facility agreement) would be negotiated prior to signing the binding acquisition agreement.
- **New York law approach:** A SunGard style “certain funds” commitment with a full-form term sheet with a specific facility agreement precedent to be used as a fall-back in case the parties are not able to reach an agreement based on the term sheet.

These two approaches developed as a result of the governing law and the regulatory environment in each market and provide participants with an acceptable degree of comfort around the enforceability of the debt commitments.[1]

Adopting a Less Certain Approach

A significant proportion of Chinese outbound M&A transactions (including private transactions) are financed on a basis consistent with customary English or New York law acquisition financing practice. However, in a series of recent Chinese outbound transactions, the certain funds standards seen in Europe and the U.S. have not been followed, raising questions as to the enforceability of the debt commitments and certainty of funding.

Even though the commitment letters for these transactions usually include the "certain funds" language drawn from the customary European and U.S. practices and, on their face, are intended to offer a commitment with a similar degree of certainty to their counterparts in more established markets, the varying documentation structures do not always ensure that the commitment is enforceable under the relevant governing law. The financing commitments for a number of transactions have been documented with only a short form term sheet governed by laws of jurisdictions that may not enforce the commitment without further specifics, such as English law, and certain transactions even omit the reference to a governing law. In some cases, the financing commitments were not available for review by the seller. Indeed, in many instances, the financing was arranged after the offer was accepted.

A shorter-form or non-customary approach to debt financing may avoid front-loading time and resources, which is important to the buyer if the offer ultimately does not succeed. However, the buyer needs to weigh the expediency against the overall certainty of the offer from the seller's perspective and the procedural or economic consequences that may result from the lack of certainty.

Consequences of Uncertainty

Until now, many successful Chinese acquirers have been able to outbid the competition through extremely high valuation. However, sellers, in facing the additional execution risk from the shifting regulatory environment and the lack of transparency and certainty as to the source of funding, are imposing a tougher threshold for Chinese bidders compared to the competition and resorting to other measures of comfort when evaluating offers from Chinese buyers. As a result, Chinese bidders often encounter extra burdens, in addition to the price, that they must bear at a higher economic cost.

For instance, sellers are placing more significance on reverse termination fees and deposits. Some sellers are taking an additional step and demanding measures are put in place to ensure recovery of the termination fee through escrows or letters of credit and often requiring the escrow accounts to be held outside China and in an offshore currency. In certain deals, non-refundable deposits are being required even to start the diligence process.

A seller requirement to deposit non-refundable fees to even enter into discussions and to escrow reverse termination fees on a strategic transaction is something unique to the Chinese outbound market and places Chinese acquirers on an unequal footing with acquirers from virtually any other jurisdiction. As the market continues to evolve and as Chinese outbound M&A continues to represent a growing proportion of all global M&A, Chinese investors may need to conform their approach to the process and certainty, and it will be interesting to see whether sellers will then begin to relax their requirements and begin to feel more comfortable when faced with an offer from a Chinese acquirer.

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1. It is important to note the target's jurisdiction of incorporation and the rules of any applicable stock exchange (on public deals) will also influence the structure of the debt commitments. By way of example, public transactions in most major European markets have the overlay of a mandatory "certain funds" regime. As a consequence this leads to a very high "certain funds" standard in these markets. This can be contrasted to the U.S. which does not have an equivalent regime mandated by law, even though as a practical matter, target boards are equally focused on certainty of financing.

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