This article sponsored by Baker McKenzie originally appeared in The China Special 2018 published by PEI in May 2018

OUTBOUND DEALS

Breaking out

Baker McKenzie partners Bee Chun Boo and William Holder describe a Chinese private equity industry looking overseas for deals

Private equity in China is powering forward. At the heart of the Asia-Pacific region, the Greater China area of China, Hong Kong and Taiwan saw $73 billion of private equity transactions take place last year, up 15 percent on 2016. The same three markets saw a hearty $48 billion of combined exits.

Beijing-based Baker McKenzie partner Bee Chun Boo and London-based partner William Holder explain how Chinese managers are contending with stiff competition for assets from multiple sources of abundant capital.

Q As the Chinese economy continues to reform, where are China-based managers focusing their attention?

Bee Chun Boo: In the past Chinese funds have been very focused on the domestic market but competition is fierce and good assets are scarce. Chinese private equity has been forced to look outside. That has led to an increase in outbound activity, which is going from strength to strength.

A lot of local managers that in the past were very focused on renminbi funds are raising offshore vehicles to participate in offshore transactions. Investee companies are looking overseas so it's very natural for managers to team up with them and other strategic partners and LPs to look at outbound deals.

Q What markets are GPs targeting?

William Holder: A lot of Chinese GPs are looking to deploy capital particularly into Western Europe or the US. We are working on a number of processes now where multiple Chinese funds have participated in the auction. When you look at European and US sellers there has been a significant shift over the past decade from seeing Chinese acquirers as being useful for pricing tension to credible contenders and now to buyers. In Europe, Germany and the UK still see the largest volume and value of deals and then certain countries have spikes, like Portugal. Italy and Hungary have also been active markets for Chinese investors.

BCB: If you want brands, consumer goods and technology, Europe is a great destination for Chinese investment. But if you look at other sectors, such as EMI [energy, mining and infrastructure] and maybe even agriculture, you see Chinese investors go everywhere. Latin America was very quiet for a while but has become very popular within the last one to two years.

Q What impact has the hostile rhetoric from the Trump administration and increased Committee on Foreign Investment in the United States (CFIUS) scrutiny had on Chinese acquirers?

BCB: We are currently involved in a few deals that are going through the CFIUS approval process. It has been quite painful. Based on what has happened over the last few months and the number of Chinese deals that have been rejected or forced to withdraw, the sentiment in China is that it is going to be very difficult to do a deal in the US, particularly in the high-tech space. In other sectors, people are willing to look at the US but for anything to do with technology, for instance handling large amounts

> ***The sentiment in China is that it is going to be very difficult to do a deal in the US, particularly in the high-tech space***
>
> **Bee Chun Boo**

of data, investors are consciously trying to avoid the US and are looking at Europe.

WH: It has become a very fluid situation particularly in the past few months. The US focus has shifted from national security concerns to "technology transfer". But there are still deals to be done outside of technology transfer. From a European perspective, there is noise from Brussels about strengthening foreign investment reviews. That process is at the early stages. The sense in the UK is that it's very much open for business. Not withstanding some of the regulatory issues, Chinese private equity and pools of capital will continue to be part of the European and US M&A landscape.

Q What effect do domestic restrictions have on outbound deal activity?

BCB: Transactions in sectors such as real estate, entertainment, football clubs and hotels are subject to a more rigorous approval process. For these kinds of deals it's still going to be difficult to get the necessary government approvals unless acquirers can demonstrate that there is a strong strategic value. If you're not doing a deal within those sectors then it's pretty much still business as usual.

There was a slight dip in activity at the end of last year when there was talk about the government restricting capital outflows because of currency concerns but that phase has passed. It doesn't seem as if capital controls pose a major issue right now.

Q Are Chinese regulators shining a spotlight on any other areas?

BCB: The government is keeping a close eye on bogus private equity funds set up offshore to provide onshore LPs with a route to transfer money overseas. There will be more scrutiny on these structures. Managers need to demonstrate that theirs is a real private equity fund that will make real investments. My LP clients have obtained the necessary approvals to invest into well-established private equity funds.

Q Are you seeing a more diverse set of LPs looking at China?

BCB: A lot of Chinese state-owned enterprises are now investing in private equity funds. In the past they would typically make the direct investment themselves. Now they are more willing to participate as an LP. The other trend is many securities firms in China are setting up private equity funds. Many of them already have funds but they are generally quite small and not as active as traditional private equity vehicles. They are ramping up efforts to set up larger funds to partner with their clients to do offshore deals.

Q What are the advantages of partnering up?

WH: Many outbound deals tend to be consortium deals where there is more than one party on the buy-side. One classic example is a private equity fund teaming up with a listed strategic in China. Often the fund originates deals and finds a financing partner in the List-Co. From the List-Co point of view it gives them an access to international markets that they might not have otherwise had. Sometimes the fund has its exit pre-baked into the deal, maybe in two to five years when the List-Co will become the majority or 100 percent owner of the asset. Co-investment is a wider interpretation of the consortium deal.

> ***There are few Chinese infrastructure funds but you can assume that will develop***
>
> **William Holder**

The other characteristic of outbound transactions is that many have a China angle, for instance acquiring a company with a product or technology or knowhow that enables the buyer to leverage some assets or situation back in China. Hony Capital did it with Pizza Express. They acquired the brand and the knowhow and rolled out the UK restaurant chain across China and Hong Kong.

Q Funds like Hony and CITIC PE (currently targeting $2 billion for its latest China vehicle) are significant in size. How easy is it for mega funds to deploy capital?

WH: Dependent on the strategy and the diversification of the fund and where it is trying to deploy its money, then they are at least equal to any of the other large US or European funds being raised at the moment. One added advantage for them might be the extent that they have interests in infrastructure related to China's Belt and Road Initiative to develop projects across Asia. Currently there are few Chinese infrastructure funds but you can assume that will develop. ■