Reversing the flow – the inbound investment opportunity in China

Linklaters

Executive Summary

The growth and importance of the Chinese economy is widely recognised: for example, its position as the second largest economy in the world by GDP, the world's largest exporter, and the world's largest manufacturer are all widely known.

As the Chinese economy continues to evolve, it is not a given that today's and tomorrow's investment opportunities will be identical to previous opportunities. Economic and demographic changes are a significant driver of opportunity for international and Chinese businesses seeking to take advantage of the ongoing liberalisation of inbound investment into China. Two particularly important drivers of economic opportunity are (1) the evolving nature of China's consumer economy (driven by the emergence of a significant middle class, as well as wider demographic shifts in Chinese society), and (2) the desire for Chinese industry to continue to progress up the value chain.

The liberalisation of inbound foreign investment into the Chinese economy is a way of supporting the development of an increasing high-value-add industrial base in China. It will also support the continuing path of the Chinese economy into higher-value products and services which will be particularly important to service the demands of China's growing middle class and its export economy more generally.

The continuing liberalisation of inbound investment into China can be seen in two major recent legal developments: (1) the publication of a new negative list in 2018 which significantly reduced the amount of industries where foreign investment is restricted and prohibited; and (2) the draft (as at time of writing this report) Foreign Investment Law which takes measures to offer equal treatment and IP protection for foreign-invested businesses, while also allowing China scope to take reciprocal action against economies that discriminate against Chinese investment.

2018's negative list proposes relaxations of investment caps for investors across many sectors over the next few years. These include automotive and financial services: sectors which are particularly attractive opportunities for foreign investors given the growth in demand for these services that will be expected from the growth of China's middle class and other demographic changes. We have already seen significant deal activity announced or proposed in these and other sectors as a consequence of these changes (and across all sectors, inbound M&A into China hit a record level of US$56 billion in 2018).

These economic, demographic and regulatory changes in China imply a wide set of suggestions and possibilities for investors, businesses and policymakers in China and across the world. This report describes several such suggestions, including:

- **The scope for foreign investors to take a very wide variety of merger, acquisition and investment approaches** due to factors such as (1) the increasingly wide range of participants and potential partners (from incumbents to start-ups) in sectors such as automotive and financial services; (2) the potential for capital market participation through international schemes such as Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong

Stock Connect and the impending Shanghai-London Connect; and (3) the potential for a significant amount of restructuring at variable interest entities if and when they are covered by the new Foreign Investment Law.

- **The importance of transparency in order to complete deals**: transparency of regulation, of stakeholder structure, of information provided during due diligence, of organisational structure, of intent by both sides, and so on. Professional advisers (such as lawyers and accountants) and representative bodies (such as ASIFMA) could add significant value in helping to drive an appropriate level of transparency between market participants. Programmes of executive education for senior managers in Chinese and global companies will also help to bridge gaps and drive market practice.

- **Understanding how the wider global situation may impact the completion of a deal.** Inbound deals into China do not take place in a vacuum. Factors such as the US-China trade talks, and Western governments' continuing moves to increase regulatory screening of foreign investments into sensitive sectors, may in turn impact the ability of inbound investment deals to complete.

This report is divided into three sections.

The first section is a summary of the opportunity in the Chinese economy, and how China's economy of 2019 and the future has a different set of characteristics and opportunities to even a few years ago: in particular in relation to the rise of a large middle class, the changing demographics of Chinese society, and the continuing focus on supporting China's industrial base to rise up the value chain.

The second section is a summary of the changing legal environment that will support future changes for inbound investment into the Chinese economy. This section also includes a summary of recent inbound investment activity, including significant deals that have been triggered by recent and imminent changes in law.

The third section contains guidance to both Chinese and international stakeholders (businesses, investors and policymakers) about how to navigate this new opportunity, and includes commentary on Chinese M&A and capital market activity as well as particular suggestions for deal-making in the automotive and financial services sectors.

This report was prepared for the China Development Forum taking place in Beijing in March 2019. The report was written on 1 March 2019, and is therefore based on the draft Foreign Investment Law. An updated report will be available from the Linklaters website once the Foreign Investment Law is finalised.

I. The evolution of the Chinese economy

The growth and importance of the Chinese economy is widely recognised: for example, its position as the second largest economy in the world by GDP[1], the world's largest exporter[2], and the world's largest manufacturer[3] are all widely known.

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1 Source: Financial Times, 14 January 2019
2 Source: The Economic Times, 13 January 2018
3 Source: The Economist, 10 September 2015

As the Chinese economy continues to evolve, it is not a given that today's and tomorrow's investment opportunities will be identical to previous opportunities. Economic and demographic changes are a significant driver of opportunity for international and Chinese businesses seeking to take advantage of the ongoing liberalisation of inbound investment into China. Two particularly important drivers of economic opportunity are (1) the evolving nature of China's consumer economy (driven by the emergence of a significant middle class, as well as wider demographic shifts in Chinese society), and (2) the desire for Chinese industry to continue to progress up the value chain.

i. The evolving nature of China's consumer economy: the rise of China's middle class, and China's evolving demographics

Over the last 20 years, the economic livelihood of many hundreds of millions of Chinese citizens has improved enormously, which has ushered in a new consumer economy. According to The Economist, the number of middle-income households in China rose from 5 million in 2000 to 225 million in 2016[4]: and in parallel, the size of Chinese household consumption has risen from 13% of US levels in 2007 to 34% of US levels in 2017.[5]

Analyst data suggests that this dramatic growth in prosperity will continue: mainland China's "upper-middle income" and "high income" citizens are projected to account for 35% of its population by 2030 (versus about 10% in 2015), taking consumer spending to the level now seen in the European Union.[6]

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4 Source: The Economist, 9 July 2016

5 Source: Financial Times, 29 May 2018

6 Source: South China Morning Post, 20 July 2018

Other data has suggested that China's middle class will include 65% of all households by 2028.[7]

This growth has changed, and will continue to change, China's consumer economy. The Chinese retail sector[8] is now the largest in the world, and new consumers are demanding higher quality goods for which they are willing to pay a premium. This in turn incentivises producers to improve the quality of their processes and output, which is reflected in the desire to move China up the value chain (see the next section).

In parallel, significant demographic shifts will also drive consumption patterns. Over the next 10 years, the number of people in China over the age of 60 is projected to grow by 100 million so that this cohort represents 22% of the population. This is expected to bring significant demand for products targeted at this demographic such as healthcare, pensions and life insurance. Over the same period, about 200 million people born in the 1990s are expected to start families. It is expected that this generation, with more expensive consumption preferences than previous generations, will "prefer premium and personalised products and services, and consume more than their predecessors." [9] The generation that is coming of age and/or starting families are also prime drivers of demand in the real estate, automotive, personal services and education sectors.

This vast shift in demographics and tastes brings a wealth of possibilities for the Chinese economy and investors. Government policies and initiatives are

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7 Source: World Economic Forum, Future of Consumption in Fast-Growth Consumer Markets: China, January 2018

8 Source: Forbes, 5 February 2019

9 Source: World Economic Forum, ibid

supporting the demands arising from these shifts. “Made in China 2025”, for example, has put emphasis on improving greenness and quality within manufacturing. This has meant that there has been more investment in technology, specialised labour and a shift in the type and quality of products being manufactured within China. In addition, legal changes to foreign investment limits will help China up the value chain in terms of innovation in design and delivery, and manufacturing know-how, as discussed below.

ii. Going up the value chain

China’s desire to move up the value chain, and to transition into a manufacturer of highly value-added products, has been widely seen in measures such as the “Made In China 2025” strategy.

This focus on going up the value chain has resulted in significant investment into new technology, and research and development (R&D) more widely, in China. For example, “China now places in the top ranks of global venture capital investment in virtual reality, autonomous vehicles, 3D printing, robotics, drones and artificial intelligence.”[10] China is also the fastest growing region for corporate R&D in the world, which grew 20% in 2018 (versus 9% for the US, 5.8% for Japan and 5.5% for the EU).[11] Indeed, the same source also suggests that “over the last decade… the main change [in global patterns of industrial R&D] has been an increasing share for China with a decreasing share for Japan”.[12]

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10 Source: McKinsey Quarterly, May 2018
11 Source: 2018 EU Industrial R&D Investment Scoreboard
12 ibid

At the more academic end of the spectrum, China recently became the world's leading producer of scientific papers[13], showcasing its investment in science and technology research and development and providing a pipeline of insights that may one day be translated into new products and services.

Over the last few years, one route through which Chinese businesses have sought to rise up the value chain has been to conduct programmes of outbound investment in order to acquire suitable assets, technologies, expertise and partners. However, increasing regulatory and political barriers in Western economies to foreign investment into sensitive sectors have made this a less viable route for going up the value chain. In parallel, the "Made In China 2025" strategy has also been cited as a source of discomfort by governments such as that of the United States[14] when considering foreign investment into their economies.

The liberalisation of inbound foreign investment into the Chinese economy is a way of supporting the development of an increasing high-value-add industrial base in China and will be increasingly important if outbound investment activity continues to be hindered or blocked. It will also support the continuing path of the Chinese economy into higher-value products and services which will be particularly important to service the domestic demands of China's growing middle class as well as support China's export economy (supported by such cross-border developments as the Belt and Road initiative) more generally.

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13 Source: Nature, 18 January 2018

14 Source: Hudson Institute, 4 October 2018

II. Recent developments of law for inbound investment into China

In October 2016, China fundamentally reformed its decades-old foreign investment approval system. Newly-established foreign invested enterprises and foreign-related mergers and acquisitions of Chinese-incorporated companies would no longer require the approval of China's MOFCOM. MOFCOM's approval jurisdiction was retained for those investment sectors that continued to operate restrictions and prohibitions on foreign investment - a group of sectors known as the "negative list". China has progressively reduced the scope of the negative list on an annual basis.

Shortly after, in January 2017, the rigid quota of committed total investment to paid up equity capital for cross-border financing of inbound investment into China was replaced by a more flexible formula defined in accordance with the borrower's net assets, with the quota being doubled from May 2016 when the new formula was first introduced. Restrictions on offshore lenders in acquisition financings from taking outbound guarantees or security from onshore entities (where the majority of the target group's assets were located in China and the loan proceeds were to be injected onshore) were also removed. These changes have enabled foreign investors to provide enhanced credit support to their financiers and thus attract better overall financing terms.

The continuing liberalisation of inbound investment into China can be seen in two major recent legal developments: firstly, the publication of a new negative list in 2018 which significantly reduced the amount of industries where foreign investment are restricted and prohibited; and secondly the draft (as at time of writing this report) Foreign Investment Law which takes measures to offer equal treatment and IP protection for foreign-invested businesses, while also allowing China scope to take reciprocal action against economies that discriminate against Chinese investment.

2018's negative list proposes relaxations of investment caps for investors across many sectors over the next few years. These include automotive and financial services: sectors which are particularly attractive opportunities for foreign investors given the growth in demand for these services that will be expected from the growth of China's middle class and other demographic changes. We have already seen significant deal activity announced or proposed in these and other sectors as a consequence of these changes.

i. Some context: the rise of inbound investment into China

The loosening of inbound investment restrictions into China comes in a context of increasing inbound activity. Analyst commentary suggests that inbound mergers and acquisitions into China hit a record high in 2018 of US$56 billion (23% higher than 2017), with more than half of this relating to the financial and real estate sectors. US investors were, despite the continuing US-China trade tensions, estimated to be responsible for 34% of this investment.[15]

Deals that took place in 2018 include the acquisition by an international investor consortium (including Canada Pension Plan Investment Board, GIC, Temasek, Warburg Pincus, Khazanah Nasional, Silver Lake and General Atlantic) of a minority stake in e-commerce business Alibaba's financial arm Ant Financial for $14 billion. Not only was this the largest inbound investment into a Chinese

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[15] Source: China Daily, 9 January 2019

company yet recorded[16], it was also “the biggest ever single fundraising globally by a private company”[17].

Other large deals announced in 2018 included:

- BMW’s $4 billion deal to increase its stake in its partnership with Brilliance China Automotive Holdings from 50% to 75% (under which deal the JV agreement will also be extended from 2028 to 2040)[18], so becoming the first foreign firm to take advantage of the relaxation of ownership caps in the automotive sector announced in 2018’s negative list;
- The $2 billion offer by Hunter Maritime (a special purpose acquisition company) for NCF Wealth Holdings, a fintech company[19];
- The $1.9 billion investment by TPG, Carlyle Group and other financial investors into Baidu’s spun-off financial services division[20];
- The reported “nearly $1 billion” raised by Ping An Insurance Group for investment in its medical data collection and analysis business Ping An Healthcare Management, from SoftBank Group’s Vision Fund and Japanese financial firm SBI.[21]

It can be seen from the list above that many of the largest inbound deals into China in 2018 related to the financial and automotive sectors: two of the sectors that (1) were given a clear path to liberalisation in the negative list published in 2018, (2) are projected to grow significantly given the ongoing rise of China’s

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16 ibid
17 Source: Reuters, 8 June 2018
18 Source: Wall Street Journal, 11 October 2018
19 Source: Lloyds List, 8 October 2018
20 Source: Bloomberg, 28 April 2018
21 Source: Reuters, 18 January 2018

middle class population, and (3) are projected to offer significant future value. For example, the Chinese financial sector is estimated to be sized at $40 trillion, and analysts suggest that "barring a major economic slowdown or change" that foreign banks and securities companies could be making profits of "more than $32 billion a year in China by 2030".[22]

Other potential deals in the financial services sector that have been announced following the changes to the negative list include:

- UBS becoming the first foreign bank to gain approval for holding the majority stake in its securities joint venture, under which plans it will raise its stake from 24.99% to 51%[23];
- Applications by JP Morgan and Nomura to set up majority-controlled joint ventures[24]; and
- Allianz winning the first ever approval for the "preparatory establishment" of a 100% owned insurance holding company.[25]

ii. The negative list

China published a new "negative list" of sectors that are prohibited or restricted to foreign investment in June 2018, which became effective in July 2018. The 2018 list sets out 48 prohibitions and restrictions on foreign investors across 34 industries (or, for Free Trade Zones, 45 prohibitions and restrictions across 32 industries). This represents a significant ongoing reduction in the amount of

22 Source: Bloomberg, 8 January 2019
23 Source: Reuters, 30 November 2018
24 ibid
25 Source: Allianz, 25 November 2018

prohibitions and restrictions that foreign investors operate under, which numbered 63 in 2017's list and (before the negative list was introduced) 120 in 2011.[26]

Many sectors were opened up, including "finance, infrastructure, transportation, culture, automobile, shipping, aircraft, agriculture, energy and resources."[27]

It is worth noting the particular timetable that has been mapped out for the financial sector and the automotive sector under 2018's negative list. For foreign investors into the automotive sector:

- The present ownership cap of 50% is to be removed for special purpose vehicles and electric vehicles;
- The foreign ownership cap on commercial vehicle manufacturers is to be abolished in 2020;
- The foreign ownership cap on passenger vehicle manufacturers is to be abolished in 2022; and
- The restriction on setting up a maximum of 2 joint ventures manufacturing the same kind of complete vehicles is to be abolished in 2022.

For foreign investors into the financial sector:

- There are now no restrictions on foreign ownership of domestically funded commercial banks; and
- For businesses in the securities, fund management, futures and life insurance sectors, the foreign ownership cap was increased to 51%, and this cap is set to be abolished in 2021.

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26 Source: Bloomberg, 2 July 2018

27 Source: MOFCOM, 6 July 2018

These sectors are of particular importance to the emerging Chinese (and global) middle class described in Section 1 of this report: as populations become more prosperous, the demand for products of affluence such as cars and financial services grow significantly. The growth of cohorts of population in the over-60 and the family-forming phases of life described in Section 1 of this report will also be a significant driver of demand in automotive and financial services.

As well as the particular sectors that are being opened up, the continuing effort to liberalise can be seen in some of the commentary emanating from MOFCOM in relation to the negative list: “As for areas beyond the negative lists, the localities and authorities should not impose restrictions on the access of foreign investment and should create a level-playing field for domestic and foreign investment.”[28]

This focus on a level playing field informs the other major legal development discussed in this report: the proposed draft (as at the time of writing this report) Foreign Investment Law.

iii. Draft Foreign Investment Law

At the time of writing of this report, a new Foreign Investment Law in China is being considered. The text of the draft law is relatively high level in its nature, and many of the measures suggested therein can be grouped under the aims of (1) offering equal treatment to foreign investors; (2) offering reassurances over intellectual property (IP) protection; and (3) ensuring that China retains the ability to take reciprocal protective action where appropriate.

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28 ibid

A selection of some of the suggested measures in the draft Foreign Investment Law are given below. It should be noted that the Law is still in draft form – stakeholders have been invited to offer comments on it and market participants including Linklaters have offered such comment.[29]

- Equal treatment
    - That foreign investors can enjoy equal treatment and market access with domestic counterparts (excluding sectors specified on the negative list)
    - Equal rights when participating in government procurement and standards setting processes
    - The ability to raise funds via public share offerings, corporate bonds, and other means in China
    - A consistent standard for foreign-invested businesses and Chinese businesses for reviewing business permits and licenses
- IP protection
    - That mandatory technology transfer from foreign businesses by government departments and officials using administrative means is to be banned
    - That technology co-operation should be based on voluntary principles and commercial rules
- Reciprocity for China
    - Provision for China to take retaliatory measures against countries that discriminate against Chinese investment

29 Linklaters helped to prepare the response to the draft Law submitted by the Asia Securities Industry & Financial Markets Association (ASIFMA), based on feedback from the wider ASIFMA membership.

- A foreign investment security review system without a right of appeal that would cover investments that affect (or may affect) national security

The proposed law recognises that encouraging inbound investment will be vital for developing China's consumer economy, and for bringing China up the value chain. In parallel, it recognises that the rising Chinese middle class will demand certain products (for example, cars and financial services) which are associated with complex regulation and whose value is increasingly based on intellectual property. Therefore, not only are these sectors being liberalised, but foreign investors are being given assurance on being regulated in an equal manner, having greater flexibility with how IP is contributed and shared with Chinese partners, and having the ability to tap the increasingly affluent Chinese financial markets for financing for these activities too. This last point allows Chinese middle-class consumers – the very people whose demands will benefit from this liberalisation – to also benefit from this opportunity as investors, too.

These developments are complemented by an emergent trend of changes in the Chinese regulatory environment aimed at facilitating foreign investment, in particular, the increasing maturity and efficiency of the framework for merger control. In 2018, the merger control authority, SAMR, handled a record caseload of 494 filings and cleared 448 cases, out of which 362 cases (around 81%) were cleared under the simplified procedure. Despite the increasing workload and the China-US trade tensions reportedly slowing down the review of US-related deals, SAMR nonetheless managed to further expedite the review of simple cases. On average, simple cases were approved within 16.5 days after formal case acceptance, compared to 24 days in 2017[30]. Purely offshore cases with no nexus to China were cleared within an even shorter timeframe, some being waved through immediately after expiry of the 10-day publication period with the whole process typically taking three to five weeks from initial filing to clearance.

III. Advice for businesses and investors seeking to offer or benefit from inbound investment into China

Global businesses have a mixed record of success when it comes to foreign investment. Approaches that work in one country may not work in another. By the same token, approaches that worked in the past in a particular country may not be optimal as that same country's economic and regulatory environment evolves.

This third part of the report offers some tips to businesses, investors and policymakers in China and globally for how to successfully navigate the new opportunity in China.

i. There may be significant corporate activity around Variable Interest Entities

A significant amount of foreign involvement in the Chinese economy has taken place through the use of Variable Interest Entities (VIEs): it has been estimated that "investors outside China have about $1 trillion invested in firms that use them".[31] These structures allow a foreign investor to take effective control over (and to receive economic benefits from) a Chinese company via contractual arrangements: thus they have been adopted as a structure to enable foreign

30 Source: Linklaters publication
31 Source: The Economist, 16 September 2017

partnership with China businesses in sectors that are subject to restrictions on foreign investment.

Many analysts regard these structures as having an ambiguous status due their perceived use as a manner of skirting foreign investment restrictions. The draft Foreign Investment Law covers investment activities being conducted "directly or indirectly", and covers not only investors acquiring equity "or other similar rights" but also "where foreign investors invest in mainland China through other means prescribed by laws, administrative regulations, or the State Council".[32]

If VIEs covered by the new law, or its implementing rules, are not found to be compliant (for example because they fall foul of effective ownership or control restrictions in industries on the "negative list"), they may be required to restructure their operations. This will lead to a significant amount of renegotiation and restructuring, with any legislated deadline potentially offering significant negotiating leverage to one or more of the parties involved. Companies, investors, advisors and regulators should engage in dialogue in order to ensure that any renegotiating and restructuring that takes place in these circumstances is a "win-win" rather than a value-destroying exercise that detracts from the wider goal of market development.

ii. For the automotive and financial sectors, alliances should be pursued along with M&A

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[32] The English language quotations come from an unofficial translation of the draft Foreign Investment Law provided in December 2018

One of the biggest trends of the global economy that has taken place in parallel with the loosening of investment restrictions in China's automotive sector is the paradigm shift that is taking place in the automotive industry. This paradigm shift includes:

- the rise of electric vehicles: China is the largest electric vehicle market in the world, and this is expected to grow even more dramatically as new legislation aims to penalise manufacturers unless they meet quotas for zero-/low-emission cars (or they buy credits from other companies that are meeting these quotas)[33]
- the rise of ride hailing: the Chinese ride hailing market was estimated to be worth US$23bn ("more than the rest of the world combined") in 2018 and projected to grow to US$72bn by 2020[34]
- the push towards driverless vehicles: with China laying out national guidelines for testing self-driving cars in 2018[35]

From these trends we expect that an ever-more complex ecosystem of businesses across the globe, ranging across parts suppliers, OEMs, energy companies, distributors, infrastructure companies, ride-hailing companies and technology companies, are competing and cooperating in the race to define the future of transport.

An ever-widening range of methods of co-operating should be considered by global companies seeking to enter the liberalising Chinese automotive market: everything from full acquisition, investment, joint ventures, commercial contracts, consortiums, incubation and so on. Finding appropriate partners is not a straightforward process because there are so many new areas of activity to be

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33 Source: Bloomberg, 14 November 2018
34 Source: Bain & Company, 16 May 2018
35 Source: Reuters, 12 April 2018

considered. Additionally, in many of these subsectors, the most attractive participants might be relatively new start-ups or otherwise relatively unknown businesses. In addition, negotiating an appropriate relationship (whether an acquisition, investment, joint venture, etc) will be made all the more difficult given the plethora of alternative structures and partners available.

As a result, foreign businesses seeking to do corporate development in the Chinese automotive industry will need extensive local knowledge – for example provided by local advisers, or via insights gained from working with pre-existing partners or operations – in order to find the best set of partners and structures for success.

These predictions for the automotive industry are also applicable to the financial services industry too: the rise of fintech means that market participants will need to be able to work with a wide variety of players in a range of new areas of activity – from established incumbents, smaller financial services companies (who may have greater need for capital), all the way to startup fintech companies. Some of these areas will be developing at a faster pace in China than in foreign players' home markets.

In any case: despite the difficulties, the upside of engaging in this complex set of partnerships, investment and acquisitions in these industries is significant: not only in relation to risk-sharing between partners, but also in attaining a critical mass that would help place a business in an ever-stronger position to make further alliances and partnerships.

iii. M&A processes will be very different depending on the nature of the target company – and may affect the ultimate exit strategy for an investment as well as the initial investment

Broadly, other than setting up a new operation, there are two types of target company that foreign players may seek to acquire or invest in: private companies, and state-owned enterprises. We would expect the sale or investment process for a Chinese private company to be somewhat analogous to that of a standard "Western" process, though the guidance in this section will still apply.

On the other hand, we would expect the sale or investment process into a state-owned enterprise to be comparatively more complicated. For example, all such sales need to go through a public bidding process handled via one of China's equity exchange centres, whose specific rules are often not familiar to foreign bidders. Foreign bidders may find themselves facing having to place mandatory deposits, participate in a mandatory (and potentially lengthy) competitive process, use standardised terms and conditions, and so on.

In addition, these processes will continue to be in place if the acquirer or investor eventually decides to sell their stake in the target state-owned enterprise, and may significantly affect the exit price, identity of the ultimate acquirer and the time it takes to exit the investment. Contingency planning for such a situation will be a vital part of transaction planning – advice from lawyers as to ongoing regulatory developments in this area will be vital.

iv. Capital markets will be just as important a route for foreign investment into China as M&A

The Shanghai-London Connect scheme will allow Shanghai-listed companies to raise funds in the UK stock market. It will allow international investors to access China A-Shares via Global Depository Receipts (GDRs) traded on the London Stock Exchange, and in parallel it will allow London-traded firms to list Chinese Depositary Receipts (CDRs) in Shanghai.

This will open China's locally listed companies to a much broader pool of international investors, for the first time. While large asset managers, hedge funds and pension funds may already invest in Chinese mainland-listed A-Shares, a much wider pool of investors – such as investors with limited local presence in China but attracted by the increased convenience of investing via Shanghai-London Connect, as well as investors that are restricted to investing in London-listed stocks – will become available to Chinese businesses.

In addition to investors seeking out specific Chinese companies to invest in, the increasing trend for passive investing should also be borne in mind. Given the sheer size of the Chinese economy, it may well be the case that there may be significant latent demand for Chinese equities by investors seeking to ensure that their portfolios reflect the global economy. According to one analyst, "China represents 15-20% of the world's GDP, yet its weighting in key indices is in the low single digits."[36]

As an example of the potential size of the effect of index inclusion: at the time of writing this report, equity index provider MSCI announced that it would increase China's weighting in its flagship emerging markets index from 0.71% to 3.3% by

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36 Source: BNP Paribas, 29 November 2018

November: a move that "could see an estimated US$125 billion flowing into the country's equities this year."[37]

Such demand may take a while to come in as Shanghai-London Connect has not been launched as at the time of writing this report, and even once it is launched it will take a while for investors to get acquainted with this channel, and for Chinese businesses to list via this channel. Nevertheless, data points such as the record US$9 billion that foreign investors invested in Chinese equities in January 2019 alone[38] indicate the interest that international investors have in participating in China's capital markets.

Further evidence of the demand for foreign investors in investment opportunities in mainland China comes from the experience of Bond Connect, a mutual market access scheme that allows overseas investors to buy Chinese bonds through Hong Kong (along with future plans to allow trade in the other direction), launched in 2017. Prior to the launch of Bond Connect, foreign investors formed 2% of investment in the onshore debt market. This is expected to reach over 10% over the course of the next decade[39]: an extremely high growth rate.

In further news on the bond side of the capital markets, the recent approval of S&P Global to start scoring Chinese bonds (the first foreign credit-ratings agency to win such approval) will also help to open China's bond market to international investors and "may in the longer term… potentially [open] up onshore Chinese corporates to index inclusion".[40]

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37 Source: Financial Times, 1 March 2019

38 Source: Financial Times, 11 February 2019

39 Source: Linklaters analysis

40 Source: Financial Times, 28 January 2019

v. Ongoing increased transparency will help deals to complete successfully

Transparency (of ownership and of stakeholder interests in relation to Chinese businesses, and of policy direction for Chinese regulators) remains a perennial concern for global businesses seeking to invest or acquire in China (and indeed a general concern for overseas investments or acquisitions all over the world, not just in China). Continuing moves by the Chinese government to improve disclosure, to improve governance, and to discuss policy goals and direction will all increase the comfort that foreign businesses have with inbound investment into China. Education and networking (see below) will be useful here.

In parallel, signing up to international business standards, agreements and treaties; complying with international standards and rules; and transparently disclosing the continual efforts to do so will improve the perception of Chinese businesses globally and make international investors more receptive to investing in China.

vi. Education and networking of both Chinese and global managers will help deals to complete successfully

The standard "Western" model for an investment or acquisition process – an auction where bids are based on the analysis of thorough information provided during due diligence, the process itself is underlined by predictable and well-understood regulation, and acquisition risks are priced into an offer or divided up between seller and acquirer in a negotiated fashion – sets expectations for global investors and acquirers which may not always be fulfilled in markets still opening up to such investment.

Inability to fulfil these expectations may reduce the ability of domestic businesses – particularly if they are unused to bridging these different perspectives – to attract foreign investment. Consequently, education programmes targeted at senior management at both Chinese businesses and foreign investors – to help the former understand how to navigate these processes, and to help the latter manage their expectations and consider different ways of assessing and managing acquisition and investment risks -- would be very beneficial.

Convening networks to help businesses, regulators and governmental bodies in China and across the world to understand the expectations and requirements on both sides of the table can also help both sides to navigate these tensions and get deals successfully over the line. Global advisory firms, membership associations, and political organisations (including China's programme of diplomatic and economic engagement) all have their part to play here by contributing to dialogue and offering focus for discussion. These networks may also help and accelerate the formation of relationships and partnerships between Chinese businesses and foreign businesses by helping them find each other and engage in initial dialogue in relation to cooperating and investment.

vii. Using professional advisers will help to bridge the due diligence gap

Due diligence – the analysis of a company's most important information and documents by an acquirer or investor – is a fundamental part of any acquisition or significant investment decision. The quality of information offered by a target business will significantly affect whether the decision to acquire is a "yes" or a “no” – and where it is a “yes”, will significantly impact the price and the conditionality of an acquirer or investor’s offer.

However, the quality of information available for buyers provided by companies seeking an acquirer can vary extremely widely in markets which are opening up to foreign investors. In these situations, the use of professional advisers by target companies can be a game changer. Professional advisers including lawyers and accountants can ensure that information is presented in an organised and transparent way. On the one hand, this will increase bidder interest and raise competitive tension. On the other, it will also offer assurances to bidders as to the quality of the underlying business. Professional advisers can also draw on their experience of other deals in order to determine what might be an acceptable or reasonable level of disclosure during due diligence.

Education and networking for senior management in companies considering finding a foreign investor can also help here (see above).

viii. Identifying and managing important stakeholders will be important to foreign investors and acquirers

Another important aspect to due diligence is understanding the extent to which a business’s operations are dependent on a particularly important stakeholder – for example, a particular customer relationship, supplier relationship, or regulatory relationship. This is particularly important in industries such as automotive (with a complex web of suppliers and customers across the industry) and financial services (which often rely on networks of customer-facing intermediaries as well as strong regulatory relationships).

In particular, it is vital to understand the extent to which these relationships will necessarily survive the passage of time, especially after a change in ownership structure. For example, if significant value arises from a strong personal relationship between an individual salesperson at the supplier and individual employee at the client and is unsupported by a long-term contract, this is clearly a riskier situation than value arising from a long-term contract with clear and objective obligations set on both sides. Or, in a situation where a business deals with related parties, it is vital to understand the extent to which the commercial relationship between related parties that prevailed historically would prevail once a new ownership structure exists at one of the related parties.

Buyers need to be able to understand and price these exposures. Professional advisers can be helpful here – especially where those advisers not only have deal experience, but their own personal networks of contacts that can offer insight into the realities of a commercial (or other stakeholder) relationship. Long-term relationship-building on the ground in China by investors and businesses to establish their own such networks is likely to be useful, too.

ix. Investment decisions should go hand in hand with decisions on management, governance and organisational structure

Typically, the greater the investment, the higher the level of control desired by the investor. Businesses seeking foreign investment need to be ready to offer clarity as to how decisions are made, contracts are negotiated, information is shared, and moneys are disbursed to allow investors and acquirers to understand how the business's organisation might have to evolve under a new ownership structure.

This might involve complex and nuanced considerations of personnel, governance and organisational structure. For example, private equity acquirers will typically spend a significant amount of time considering what the appropriate management team might be after the acquisition, how the members of this team should be incentivised, and so on.

Therefore, both the buyer and the target need to be on the same page in relation to how decision-making will take place after the acquisition. This should mean a focus during due diligence of understanding in great detail how decisions are made in the target business – not just big strategic decisions made by the senior personnel, but also how individual operational decisions are made (e.g. hiring, taking on new customers and suppliers, etc).

Target companies will need to be ready to consider changes in boards, changes in key management, and control over company decisions, processes, spending and information. Acquirers and investors will need to put in the time to ensure that the ownership and management models that they are seeking to install will actually work harmoniously with the target business.

x. Trade tensions, and continuing restrictions on outbound investment, will also determine the nature of inbound investment

Our two previous reports for the China Development Forum concentrated on outbound investment from China and the increasing political and regulatory barriers to foreign investment (often Chinese investment) in the US and Europe into sectors deemed to have national importance (particularly from a national security perspective).

This trend shows no sign of abating: in the US, the Foreign Investment Risk Review Modernization Act (FIRRMA) broadened the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS), meaning that a wider range of foreign transactions in areas seen as a threat to national security may be blocked in the US.

In Europe, such concerns also remain very present. For example, in August 2018, German Chancellor Angela Merkel for the first time vetoed a potential takeover of German machine tool manufacturer Leifeld Metal Spinning by Yantai Taihai Group, "marking the first time [the German government] has used a tough investment law passed [in 2017] to veto an M&A deal."[41]

In November 2018, the European Parliament, the European Council and the European Commission reached a political agreement on an EU framework for screening foreign direct investment. This framework:

- creates a cooperation mechanism where Member States and the Commission will be able to exchange information and raise specific concerns
- allows the Commission to issue opinions in cases concerning several Member States, or when an investment could affect a project or programme of interest to the whole EU
- encourages international cooperation on investment screening policies, including sharing experience, best practices and information regarding investment trends
- reaffirms that national security interests are the responsibility of Member States: it will not affect the Member States' ability to maintain their existing

[41] Source: Financial Times, 26 July 2018

review mechanisms, to adopt new ones or to remain without such national mechanisms (currently 14 Member States have such mechanisms in place).[42]

While EU member states "keep the last word whether a specific operation should be allowed or not in their territory[43]," the nation in which the foreign investment was planned to be introduced would have to give "due consideration" to any comments and opinion as well as take "utmost account" of any Commission view regarding a foreign investment deemed to affect a European project or program.[44]

The evolution of trade negotiations between the US and China runs in parallel with tensions over foreign investment into sensitive sectors. At the time of writing this report, President Trump of the US announced that he would delay an increase in tariffs on US$200bn of Chinese imports into the US that was set for 1 March 2019[45], though a full trade deal has not yet been agreed.

All of this context is important given the draft Foreign Investment Law's proposal that China may take retaliatory measures against countries that discriminate against Chinese investment. Inbound investors will need to monitor the situation, and work with advisers with deep knowledge of the regulatory outlook in China as well as the wider global picture, in order to ascertain the risks of their deals being affected by such measures.

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42 Source: European Commission, 20 November 2018
43 Source, European Commission, ibid
44 Source: Bloomberg, 20 November 2018
45 Source: Financial Times, 25 February 2019