Inbound M&A into China in 2020 and beyond: trends and recommendations in the light of the new Foreign Investment Law and the pandemic

Executive summary

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Foreign direct investment (**FDI**) has been, and continues to be, a subject of fundamental importance to the development of economies worldwide, including mainland China. This paper focuses on the inbound investment opportunity into mainland China, specifically through mergers and acquisitions (**M&A**), following the coming into force of the Foreign Investment Law (**FIL**) and associated laws, regulations and policies that aim to catalyse and encourage foreign investment into mainland China.

The paper is divided into three sections, whose findings are summarised below:

Section 1 is a review of the new FIL and associated laws and regulations such as the Implementing Rules for the FIL, the Ministry of Commerce of the People's Republic of China's (**MOFCOM**'s) overhaul of the foreign investment filing system, the ongoing reduction of the Negative List, the ongoing extension of the Encouraged Industries Catalogue, reform measures by the State Administration of Foreign Exchange (**SAFE**), changes to securities law, new measures from the State Administration for Market Regulation (**SAMR**), and other Covid-19 response policies from the State Council, MOFCOM and the

National Development and Reform Commission (**NDRC**).

These measures have significantly accelerated and encouraged foreign investment into mainland China via M&A by streamlining processes, offering reassurances in relation to equal treatment, widening the range of business activities that are available for foreign investment, and improving capital market access for foreign investments.

Section 2 is a review of how dealmaking by foreign investors has changed in the light not only of the FIL coming into force on 1 January 2020, but also the backdrop of the Covid-19 pandemic of 2020. Some of the major trends we identify include: a strong recovery in mainland Chinese inbound M&A in 2020 despite a fall in the first quarter of 2020; significant activity in sectors such as new energy, consumer and retail, healthcare, industrials, automotive and high technology, all of which reflects demographic shifts on the consumer side of mainland China's economy as well as the ongoing advancement of the production side of mainland China's economy up the global value chain; and increasing international diversification among acquirors of, and investors in, mainland Chinese businesses.

We suggest that China's rapid and robust handling of the Covid-19 pandemic has helped deal flow to recover to pre-Covid-19 levels and highlighted the strength and attractive prospects of mainland China's economy, including as an even more attractive destination for M&A and other forms of foreign investment. Nevertheless, the pandemic has led to a lengthening in deal duration, new areas for negotiation and due diligence between acquirors and sellers, and reappraisals

of business models across industries.

Section 3 of this report suggests areas of consideration for policymakers and dealmakers in light of these findings. These areas include a recognition of the importance of on-the-ground expertise (particularly operational expertise) in order to successfully source and close deals; a recognition of the increasing importance of transparency in obtaining regulatory clearance; the increasing role that the capital markets will have to play in connecting mainland Chinese businesses and international investors; and ongoing questions about the role of variable interest entities.

Dealmakers and policymakers therefore have a significant opportunity to accelerate investment into mainland China by engaging in dialogue, education and networking around these and other issues. Such dialogue is particularly important given ongoing global tensions in relation to trade and foreign investment scrutiny, which are a potential threat to deal flow. We also suggest that there is an exciting opportunity for mainland Chinese businesses and policymakers to continue to share their experience and insights of managing the Covid-19 pandemic, with corresponding benefits not only to China but also the world.

Section 1: Legal context

The liberalisation of inbound investment into mainland China has accelerated over the last few years, starting before the coming into force on 1 January 2020 of the FIL (which was enacted on 15 March 2019). In October 2016, mainland China fundamentally reformed its decades-old foreign investment approval system. Newly-established foreign invested enterprises and foreign-related M&A of companies incorporated in mainland China would no longer require the approval of 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".

Shortly afterwards, in January 2017, rules on the ratio of committed total investment levels to equity levels for foreign invested enterprises (**FIEs**) into mainland China were made more flexible and accommodating. In addition, restrictions were also relaxed on offshore lenders of acquisition financing from taking outbound guarantees or security from onshore entities (where the majority of the target group's assets was located in mainland China and the loan proceeds were to be injected onshore). These changes have enabled foreign investors to provide enhanced credit support to their financiers and thus attract better overall financing terms: and these improved financing terms in turn contribute to higher deal flow.

The continuing liberalisation of inbound investment into mainland China can be seen in two major recent legal developments: firstly, the ongoing shortening of the Negative List (and the parallel expansion of the Encouraged Industries

Catalogue); and secondly the FIL which takes measures to offer equal treatment and intellectual property (**IP**) protection for foreign-invested businesses, while also reserving the right to take action against economies that discriminate against mainland Chinese investment.

The FIL was passed after going through many rounds of revision and multiple readings, changing many applicable laws, rules and regulations (with some of them being revised substantially). The remainder of this section provides an assessment of the FIL, including its associated policies and regulations that have impacted the conduct of inbound M&A into mainland China in 2020.[①]

1. The Foreign Investment Law 2019

The FIL came into force on 1 January 2020. It is a landmark piece of legislation meant to serve two aims: improving the business environment for foreign investors in mainland China and ensuring that FIEs participate in the market on an equal basis as domestic enterprises.

The FIL is relatively high level in 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 IP protection;

(3) offering reassurances over the ease of doing business in mainland China;

(4) ensuring that China retains the ability to take protective and reciprocal

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① This is only a very high-level review of applicable recent laws and regulations on foreign investment in mainland China. A more extensive review can be found in the Guide to foreign investment in mainland China 2020, available on request from Linklaters Zhao Sheng.

action where appropriate.

A selection of some of the measures in the FIL is given below.[1]

- Equal treatment
  - Foreign investors enjoy equal treatment with domestic counterparts, excluding sectors specified on the Negative List (Article 4)
  - FIEs have equal rights when participating in government procurement and standards setting processes (Articles 15 and 16)
  - FIEs have the ability to raise funds via public share offerings, corporate bonds, and other means in mainland China (Article 17)
  - A consistent standard for foreign-invested businesses and mainland Chinese businesses for reviewing business permits and licenses (Article 30)
- IP protection
  - Administrative departments and their staff members are prohibited from using administrative means to require technology transfers from foreign businesses (Article 22)
  - Technology co-operation is encouraged based on "free will and business rules" (Article 22)
- Ease of doing business in mainland China
  - The establishment of a "service system for foreign investment, and [the provision to] foreign investors and foreign-funded enterprises [of] consultation and services in respect of laws and regulations, policies and measures, investment project information and other aspects" (Article 11)
  - Government "at all levels" must "streamline procedures for handling affairs, raise their efficiency and optimise government services, so as to further improve the services offered for foreign investment" (Article 19)
  - Establishing a "complaint mechanism for foreign-funded enterprises" to be used where "any administrative act of an

[1] Source: http://www.fdi.gov.cn/1800000121_39_4872_0_7.html

administrative department or its staff member infringes [an FIE's] legitimate rights and interests" (Article 26)

- Reciprocity
  - Provision for China to take "corresponding" measures against countries that discriminate against Chinese investment (Article 40)
  - A foreign investment security review system that would cover foreign investments "affecting or having the possibility to affect" national security, any decisions under this system being "final" (Article 35)

The FIL is a brief document, focusing on general principles. Further laws and regulations will determine how it works in practice. Some of the ancillary laws and regulations that have impacted foreign investment transactions in mainland China in 2020 are given below.

2. Implementing Rules for the Foreign Investment Law 2019

The implementing rules (**Rules**) make important clarifications to the concepts given in the FIL. In particular, the Rules help enforce the FIL principle that foreign investments will not be expropriated without reasonable compensation: no discrimination, market value must be compensated, and rights of administrative appeal for the expropriated party.

The Rules provide a defined basis for investors to hold government authorities to their FIL obligations to comply with commitments and contracts, by (i) specifying that "commitments" include all forms of written policy support or preferential/ accommodative treatment for local investments, and (ii) expressly disallowing changes to governmental divisions, officers or functions as basis for reneging on their contractual obligations.

On the FIL's commitment to protect foreign investors' IP, the Rules promise to step up sanctions and law enforcement against infringers.

To underpin the FIL's commitments to a fair and competitive government procurement process including equal treatment of FIEs, the Rules provide that supplier selection may not be restricted on the basis of ownership, corporate form, nationality or brand.

3. Overhaul of foreign investment filing system

Around the same time as the Rules were released, MOFCOM updated its foreign investment filing system.

In accordance with the provision for a foreign investment information reporting system in the FIL, MOFCOM has introduced new reporting requirements for all FIEs, replacing the previous filing-based system for establishment of, and changes to, FIEs which had been in place since 2016. The new reports, which comprise an information report, an amendment report, a deregistration report and an annual report, are to be submitted through the enterprise creditworthiness publicity system which is also used to register the establishment of new FIEs and domestic enterprises. It is also clarified that the new reports must be completed for all direct and indirect investments by FIEs in mainland China.

The new system has resulted in time and efficiency savings for foreign investors, enabling them to submit all FIE-related information on a single platform without needing to make multiple filings with MOFCOM and SAMR. It should also be noted that procedures for the filing of the new MOFCOM reports

and the application to SAMR for the establishment of FIEs are not sequential and can largely be completed in a single submission.

All investment filings made by foreign investors, including FIEs, in sectors not on the Negative List (see below) are to be treated the same as domestic investor filings. Importantly, the new judicial interpretation of the Supreme People's Court on the FIL expressly prohibits mainland Chinese courts from declaring that an investment agreement in any of these sectors is void, or has not come into effect, on the basis that relevant industry regulatory approvals have not been obtained, thus drawing a clear line between the effectiveness of an investment agreement and compliance with industry regulatory approval, consent and filing requirements in these sectors.

For FIEs in sectors restricted to foreign investment under the Negative List, the previous requirement of MOFCOM approval, involving the issuance of a MOFCOM approval certificate, has been abolished. SAMR is required to register the establishment of these FIEs provided they comply with the restrictions as to foreign ownership percentage, legal representative and key persons in charge (if applicable) under the Negative List, and to the extent that necessary industry-specific regulatory approvals have been obtained.

Finally, a key change of note is that compliance with these procedures is not, as a matter of law, a condition precedent to deal closing. The reformed regime is thus expected to further speed up the process of foreign investment via inbound M&A into mainland China.

4. The ongoing shortening of the Negative List

China unveiled its updated Negative List (a list of industries where foreign investment is either restricted or prohibited) in June 2020, which continued the trend of reducing the number of such industries and sectors. Areas on the national Negative List fell from 40 to 33 (and from 37 to 30 in free trade zones (**FTZs**)). Notably, there was significant liberalisation of the financial services and automotive sectors: foreign ownership caps on securities, fund management, futures, life insurance companies, as well as commercial vehicle enterprises, were removed. Other changes include allowing foreign investors to take majority shares in water supply and drainage joint ventures in cities with a population of more than 500,000, as well as allowing wholly foreign-owned institutions to set up vocational education.

5. The ongoing extension of the Encouraged Industries Catalogue

In July 2020, NDRC and MOFCOM published a draft of the 2020 Catalogue of Encouraged Industries, which lists industries where FDI will be encouraged at a national level and for central, western and north eastern regions. The draft national Catalogue contains 471 encouraged industries (a rise of 56 versus 2019).

The main trends of the draft Catalogue include a continuing encouragement for FIEs to invest in high-tech manufacturing (e.g. radars for autonomous driving and charging piles in the automotive industry; smart wearables, intelligent aerial drones and smart homes in technology manufacturing; etc.) and producer services

such as R&D, maintenance and repair of high end equipment, etc.[1]

Historically, investments made by FIEs investing in encouraged industries could enjoy preferential treatment, including favourable tax treatment, if the invested entities were considered as FIEs. However, as "national treatment" has become a fundamental principle of foreign investment, it remains to be tested in practice if local tax and other authorities would continue offering preferential treatment to FIEs, even though these preferential policies have not been officially repealed by the FIL.

6. SAFE Reform measures of October 2019

SAFE introduced 12 reform measures to boost foreign investment in October 2019. These include in particular (i) allowing non-investment businesses to make equity investments with their registered capital (before this change, such FIEs were required to have “investment” in their business scopes in order to make equity investments – a change that was difficult to make in practice); and (ii) making it easier for sellers of PRC assets to deal with buyers paying in foreign currency.

7. Changes to securities law

The FIL states that “foreign-funded enterprises may conduct financing through public offering of shares, corporate bonds and other securities or by other

[1] Source: https://www.china-briefing.com/news/china-foreign-investment-access-increased-draft-2020-encouraged-catalogue/

means".[1] In 2020, the mainland Chinese securities law was amended so as to transition towards a registration-based IPO system, increase disclosure requirements, and impose larger penalties for violations. These measures will not only liberalise mainland China's capital markets but also improve their attractiveness to domestic and foreign investors: in turn, increasing the propensity of inbound investors and acquirors to use them in order to fund M&A.

8. New measures from SAMR

In April 2020, SAMR, via its arm that supervises and regulates market competition and monopolies, published antitrust measures to manage the Covid-19 pandemic and the resumption of work and industrial production. SAMR has established a "green channel" for expediting its review of merger filings in some industrial sectors, including the pharmaceutical manufacture, medical equipment and apparatus manufacture, food production, transportation, wholesale and retail, and other sectors closely related to people's daily lives and the prevention and control of the pandemic.

Against this background, the review of no-issue cases has been increasingly expedited. Reportedly SAMR took an average of 12.8 days to approve deals placed under its simplified merger review procedure in the first quarter of 2020 compared to 13.4 days in the preceding quarter. This slight shortening of duration came about despite the suspension of onsite receipt of filings from early February following the Covid-19 outbreak.

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[1] Source: http://www.fdi.gov.cn/1800000121_39_4872_0_7.html

SAMR confirmed in a press release in mid-March that it has received 37 merger filings since 3 February, formally initiated 45 cases and closed 45 cases, at average closing two cases per business day, which "greatly supported company M&A activity."

Not only is the simplified merger review procedure expedited by taking advantage of the "green channel", some no-issue cases filed under the normal procedure have also been observed as having been cleared speedily: for example, SAMR's clearance of the merger filing for a joint venture between Coca-Cola and China Mengniu Dairy in April 2020.

By contrast, complex cases continue to face lengthy review processes. Based on the information set out in SAMR's conditional approval decisions published so far in 2020, it took filing parties an average of 291 days to obtain the approvals from the date of submission, and two out of the four remedy cases were pulled and refiled. This indicates that for high profile deals with substantive issues, SAMR is still tending to take time for a thorough review.[①]

9. Other Covid-19 response policies

China has published a plethora of policies to help businesses deal with the Covid-19 pandemic. Several are of particular interest to FIEs, including:

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① Source: Linklaters research and analysis

- The set of notices published by MOFCOM[1], which called for Chinese government at all levels to support FIEs to resume normal operations; streamlining and accelerating administrative and licensing procedures; and confirming mainland China's direction of travel in opening up further to foreign investors.

- NDRC's Notice on Further Deepening the Reform regarding Foreign Investment Projects to Respond to Epidemic Situations designates any foreign-funded investment projects in the manufacturing or high-tech service industries where total investment is more than US$1 billion in value as a major foreign investment project to be assigned a special team at the NDRC to help coordinate matters. (It should be noted that for projects relating to advanced technology, medical treatment and epidemic prevention, or in the central and western regions and the northeast region, the size requirement for this designation may be relaxed.)

- In August 2020, the State Council announced additional support for foreign investment projects of more than US$100 million in to-be-designated priority sectors, pledging additional efforts to provide essential services such as use of sea and land, energy consumption and environmental protection to both foreign and domestic investments.

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[1] These include the Circular on Actively Responding to Covid-19 and Strengthening the Services and Investment Attraction of Foreign Invested Enterprises; the Circular on Responding to Covid-19, Stabilizing Foreign Trade and Foreign Investment, and Promoting Consumption; the Circular on Promoting the Orderly Resumption of Work and Production of Enterprises in the Commercial Field on the Premise of Epidemic Prevention; and the Circular on Making Good Use of Special Funds for Domestic and Foreign Trade to Stabilize Foreign Trade and Foreign Investment and to Promote Consumption.

Section 2: How has inbound dealmaking changed in 2020 following the new FIL?

Of course, the FIL coming into force was not the only macro-level change for inbound M&A into mainland China. We have also seen the Covid-19 pandemic having a significant impact on international dealmaking at every stage of the process. Acquisition screening and portfolio review processes for potential divestments have been upended by the need to factor in changes in business models necessitated by the pandemic. The gap between buyers' and sellers' valuation expectations has often widened due to differing views about the potential size and duration of the pandemic's effect on economies and businesses. Auction and due diligence processes have also lengthened as international travel and site visits have become more problematic.

On the other hand, mainland China's robust weathering of the pandemic has led to a rapid recovery in its economy, as attested by international commentators: "among members of the [G20]… only China rebounded from a Covid-19 contraction as early as the second quarter of 2020"[①]. Mainland China's GDP growth in the third quarter of 2020 was "4.9% year on year… as industrial growth powered the country's recovery from the coronavirus pandemic… China has benefited from its containment of the pandemic, with new recorded cases remaining low over recent months as other big economies continue to grapple with new waves of infections."[②]

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① Source: "China is Winning the Virus-Economy Recovery Race", 2 Oct 2020, Bloomberg

② Source: "Chinese economy expands 4.9% in third quarter", 19 Oct 2020, Financial Times

So how has inbound M&A into mainland China changed in 2020 following the FIL and the onset of the pandemic? We note the following trends from our experience and wider data on international M&A:

1. Inbound M&A has only fallen slightly in mainland China in 2020: a much stronger performance than in large Western economies

Inbound announced M&A into mainland China was US$34.7bn for the period 1 January 2020 to 17 October 2020[①], or US$43.7bn in annualised terms. This compares to US$44.4bn for 2019: a fall of only 1.6%. This is a much stronger performance for inbound M&A than Western economies such as the US (a fall of 22% in inbound M&A between 2019 and annualised 2020) and the UK (a fall of 4% for an equivalent period).

In Q1 2020, inbound M&A into mainland China was US$6.7bn (46% below Q1 2019). By contrast, inbound M&A in Q2 and Q3 2020 came to US$27.6bn (42% above Q2 and Q3 2019 combined).[②] The rebound and maintenance of deal activity is testament not only to mainland China's management of the pandemic, but also the attractiveness of its economy in terms of its continuing opening-up, as well as its robustness and growth prospects in both its industrial economy and its consumer economy: "the recovery in the world's second-largest economy, which has been stoked by a state-backed industrial boom, now shows signs of extending to consumption at a time when global growth remains under severe pressure."[③]

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① Source: Refinitiv database

② Source: Refinitiv database

③ Source: Financial Times, ibid

2. Significant activity in the automotive, consumer and retail, energy, financials, healthcare, high tech and industrials sector…

Two-thirds (US$23.3bn, 67% of the total) of inbound M&A into mainland China was in the automotive, consumer and retail, energy, financial services, healthcare, high technology, and industrial sectors.[1]

Large deals announced in these sectors in 2020 include:

- The US$2.1 billion acquisition of a further 12.5% stake in BeiGene, a manufacturer of biological products, by an investor group comprising Amgen Inc, Baker Bros Advisors LP and Hillhouse Capital Group (healthcare);
- The US$1.4 billion acquisition of Meeca Technology and Topo Technology, manufacturers of sheet metal works, by LENS Technology of Hong Kong SAR (industrials);
- The US$1.0 billion acquisition of 23% of Gotion High-Tech Co Ltd, a manufacturer of storage batteries and electronic equipment, by Volkswagen (automotive/new energy/high technology);
- The US$0.9 billion acquisition of an undisclosed minority stake in Guangzhou Xiaopeng Motors Technology Co Ltd, an automobile manufacturer, by an international investor group including Hillhouse Capital, Coatue Management LLC, Mubadala Investment Co PJSC, Qatar Investment Authority, Aspex Management (HK) Ltd and Sequoia Capital (automotive/industrials);
- The US$0.7 billion acquisition of Hangzhou Haomusi Food Co Ltd, an online retailer, by PepsiCo (retail);
- The US$0.7 billion acquisition of 25% of JAC Volkswagen Automotive Co Ltd, a manufacturer of automobiles, by Volkswagen from its joint venture partner, taking Volkswagen's stake from 50% to 75% (automotive/industrials); and

[1] Source: Refinitiv database

- The US$0.7 billion acquisition of a 12.33% stake in TCL China Star Optoelectronics Technology Co, a manufacturer of semiconductors and related devices, by Samsung (high technology).

3. …reflecting the transition and development of the consumer and production sides of the mainland Chinese economy

The importance of the sectors listed above reflects demographic trends that are driving the consumption side of mainland China's economy, namely:

- the rise of mainland China's middle class: according to the McKinsey Global Institute, the middle class population of mainland China has risen from 44 million to 374 million between 2000 and 2018: a rise from 8% of mainland China's urban population to 49%.[①] A rising middle class accompanies a rise in demand for consumer goods, technology, quality healthcare, financial services and automotive products.
- the projected growth over the next 10 years of the number of people aged 60 and above: a cohort projected to grow from 241 million in 2019 to 351 million in 2029 (a rise of more than 100 million people).[②] The rise of this cohort will result in increasing demand for healthcare, as well as financial services (for example relating to retirement and insurance).
- a new generation coming of age and starting families: by 2027, "about 200 million people born in the 1990s will start families, and about 150 million in Generation Z will transition from school or university to the mainland Chinese workforce. They will prefer premium and personalized products and services and consume more than their predecessors."[③]

The growth of these sectors also reflects industrial trends on the production side of mainland China's economy, especially the movement of mainland China's

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[①] Source: China consumer report 2020, McKinsey

[②] Source: Populationpyramid.net

[③] Source: Future of Consumption in Fast-Growth Consumer Markets: China, World Economic Forum, January 2018

economy up the value chain, for example:

- Mainland China's continuing desire to transition into a manufacturer of highly value-added products has been widely seen in measures such as the "Made In China 2025" strategy as well as the activities that have come off the Negative List or put onto the Catalogue of Encouraged Industries;
- Mainland China having the fastest growth in industrial R&D in the world (27% in 2018, versus 10% for the US, 5% for the EU, and 4% for Japan)[①]; and
- The share of the value of mainland China's exports added outside of mainland China has trended down, falling from 26% in 2005 to 17% in 2016, highlighting mainland China's reducing dependence on foreign manufacturers in its industrial value chain.[②]

Over the last few years, one route through which mainland Chinese businesses have sought to move 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 more recently made this a less viable route for going up the value chain (see Section 3 below).

The liberalisation of inbound foreign investment into the mainland Chinese economy is a way of supporting the development of an increasing high-value-add industrial base in mainland China and will be increasingly important if outbound

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① Source: 2019 EU Industrial R&D Investment Scoreboard, available at https://iri.jrc.ec.europa.eu/sites/default/files/2020-04/EU%20RD%20Scoreboard%202019%20FINAL%20online.pdf

② Source: China is the world's factory, more than ever, Economist, 23 Jun 2020 https://www.economist.com/finance-and-economics/2020/06/23/china-is-the-worlds-factory-more-than-ever

investment activity continues to be hindered or blocked. Supporting the continuing path of the mainland Chinese economy into higher-value products and services will also be particularly important to service the domestic demands of mainland China's growing middle class as well as promote mainland China's export economy (supported by such cross-border developments as the Belt and Road initiative) more generally.

4. Acquirors are becoming more international

Hong Kong SAR-based acquirors accounted for more than half of inbound deal flow in 2020 (US$18.5bn, 53% of total). This was followed by the United States (US$4.2bn, 12% of total), Singapore (US$4.1bn, 12%) and Germany (US$2.3bn, 7%).[①]

The concentration of Hong Kong SAR-based acquirors is unsurprising given political, legal, cultural and commercial linkages between this region and mainland China. However, the proportion of non-Hong Kong SAR-based acquirors for inbound M&A has been on a long-term upswing. In 2015, this figure was 37% of the total (US$19.9bn of inbound M&A versus a total of US$54.4bn). In 2020, this figure was 47% of the total (US$16.3bn versus a total of US$34.7bn).[②] Again, this reflects not only the ongoing liberalisation of the mainland Chinese economy but also its increasing attractiveness as a robust region with strong growth prospects.

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① Source: Refinitiv database

② Source: Refinitiv database

5. Deal times are lengthening as negotiations and due diligence become more protracted post-Covid-19

Everything else being equal, the FIL and associated changes in law and policy would have shortened the duration of deals. For example, before the FIL, MOFCOM was the usual approval authority for the acquisition of mainland Chinese companies or assets by a foreign purchaser. However, with the FIL coming into effect from 1 January 2020, MOFCOM's approval system has been replaced by the SAMR online information reporting system and, accordingly, a foreign investment information report should be first filed with the SAMR online system in relation to the acquisition by a foreign investor of a mainland Chinese company or assets. The repeal of the MOFCOM approval system is a potential accelerator for deals.[①]

In addition, while the FIL reserves the right for deals to be scrutinised and/or blocked for national security reasons, this has so far been little used in practice.

Nevertheless, our recent experience of advising on international M&A suggests to us that deal times have lengthened. This is due to new focuses for negotiation arising from the Covid-19 pandemic, and deal processes also being impacted by the pandemic.

From a deal negotiation perspective, buyers are seeking additional protections and conditionality in order to cover themselves against Covid-19

[①] We should note that an advance filing with the central MOFCOM is required if an acquisition which results in control passing to a foreign entity involves a key industry, has an impact on the economic security of mainland China or results in a transfer of the controlling interest of an enterprise that owns any famous or traditional brands.

related risks. We have seen especial focus on material adverse change (MAC) clauses, allowing potential buyers to walk away from deals if there is a significant worsening in the target's business, as well as break fees and reverse break fees (where targets and buyers pay a fee to the other side in the event of a transaction not completing for one or more specified reasons).

These negotiation points come on top of widening valuation expectations between buyers and sellers, as the two sides take different perspectives on the duration and impact of the Covid-19 crisis. This difference in perspective can be particularly pronounced between the seller of a domestically-focused mainland Chinese business versus an international purchaser, given the speed with which the pandemic has been contained in mainland China versus the rest of the world.

From a deal process perspective, the durations of due diligence and between deal signing and closing are lengthening. This is largely due to travel restrictions arising from the pandemic (for example, 14-day quarantine requirements, and stringent visa requirements for travel into mainland China). While a lot of due diligence can take place remotely, key items often still need to be checked in person. In addition, handing over key business matters will also often still need to take place in person.

Section 3: Recommendations for dealmakers and policymakers

We list below a set of recommendations for dealmakers seeking to participate in, and policymakers seeking to manage, inbound M&A into mainland China following the observations and trends listed in Sections 1 and 2 above.

1. The increasing importance of on-the-ground operational expertise

While the pandemic runs its course, international buyers will continue to have a greater need to conduct due diligence remotely. Large international firms of lawyers and accountants will have offices or "best friend arrangements" in mainland China to support legal and accounting due diligence, as well as commenting on legal process issues.

However, it is often harder to outsource operational due diligence, given that a large part of it is often conducted in-house by acquiring companies in order to ascertain how a business might be integrated with its new owner. There is a greater need for local expertise to assist with such due diligence, particularly given (1) the increasing range of business activities that are newly open to inbound investment following the launch of the FIL and changes to the Negative List; (2) the number of business models that are undergoing significant evolution as a result of the pandemic; and (3) the need to understand stakeholders that are influential or vital to commercial success (for example, particular customer relationships, supplier relationships, or regulatory relationships), and to understand the extent to which these relationships will continue or how they might evolve, especially after a change in ownership.

Local operational experts are also potentially of great use in sourcing new investment or acquisition candidates. The most attractive candidates for investment or acquisition might be relatively new start-ups or otherwise relatively unknown businesses, especially in emerging subsectors or where emerging technologies are concerned.

Dealmakers would therefore be well served to develop relationships with local experts to assist such diligence. Policymakers are well placed to catalyse such relationships through (for example) networking platforms, online seminars and conferences, and so on.

2. The increasing importance of experienced and innovative advisers

As described in Section 2, the pandemic is changing every aspect of how deals are sourced, valued, negotiated, diligenced and closed. New solutions and norms are evolving in dealmaking in response to these challenges, whether it is in relation to structuring, conducting due diligence, or the project management of an M&A process.

It is therefore increasingly important for acquirors, investors and sellers to work with experienced and innovative advisers who are plugged into "live" dealmaking in the Covid-19 era, and who can bring contemporaneous insights from the wider dealmaking universe to any particular situation. In particular, being able to bridge the gap of understanding between a buyer and seller with very different expectations of the impact of Covid-19 will be very important to negotiating deals successfully.

3. The increasing importance of transparency

Significant regulatory reporting requirements remain in relation to dealmaking, despite the streamlining arising from the FIL and Rules. In our experience, there is still a relative lack of uniformity of practice amongst authorities tasked with administering the revamped foreign investment filing regime at local level: for example, differences in whether filings should be physical or electronic, what accompanying documentation needs to be submitted as part of transaction filings, and so on. In addition, authorities require increasing amounts of information in order to process deals.

Dealmakers therefore need to be prepared to offer increasing levels of transparency about their businesses and bids. Such transparency will also be important against the ongoing global backdrop of scrutiny of foreign investments in sectors vital to the national interest or national security, as well as the risk of retaliatory action arising from economic measures taken by particular countries. Policymakers can assist the speed and certainty of deals by continuing efforts to make reporting requirements more consistent and increasingly streamlined.

4. The opportunity to share expertise in pandemic management

China's handling of the Covid-19 pandemic, and economic performance, in 2020 has been instructive to the rest of the world. There is a significant continuing opportunity for mainland Chinese businesses and policymakers to share their expertise in handling the pandemic with the rest of the world. Such expertise sharing would continue to showcase the strength of the mainland Chinese

economy, with corresponding benefits for inbound M&A (both in terms of volume and value). It would speed up the recovery of the rest of the world, again putting potential overseas buyers and investors in a better position to engage in targeted M&A in mainland China to offset the problems caused by the pandemic in their home markets. Finally, it would increase global levels of business and societal resilience in the long run (for example in the face of potential future pandemics): such a global de-risking would not only encourage further growth in business internationally, but would also reduce the negative impact of future global shocks, not limited to pandemics.

5. Ongoing questions about Variable Interest Entities

Variable Interest Entity (**VIE**) structures allow a foreign investor to take effective control over (and to receive economic benefits from) a mainland Chinese company via contractual arrangements. They have been adopted as a structure to enable foreign partnership with mainland Chinese businesses in sectors that are subject to restrictions on foreign investment. They have historically been perceived as having an ambiguous status due their perceived use as a manner of skirting foreign investment restrictions. The FIL covers investment activities being conducted "directly or indirectly" and covers not only investors acquiring equity "or other similar rights" but also "where a foreign investor invests in any other way stipulated under laws, administrative regulations or provisions of the State Council".

In our last report for the CDF[①] we described ongoing questions among

① See "Reversing the flow; the inbound investment opportunity in China", Linklaters, 2019.

market practitioners as to if and how VIEs might be regulated under the FIL, and the possible ramifications thereof. This is especially important given that "investors outside China have about US$1 trillion invested in firms that use them [VIEs]"[①].

The FIL does not expressly touch on VIE structures. Furthermore, the provision in the consultation draft of the Rules which would have exempted from foreign ownership restrictions all reverse investments into mainland China by wholly Chinese-owned entities subject to approval by the State Council (which was considered a step to lay down the foundation for future regulation of VIE structures) was withdrawn from the final text.

Changes to the regime in 2020 have not settled the issue of the status of VIEs, albeit that we would note that April 2020 saw SAMR accepting a merger filing[②] explicitly involving the VIE structure for review: a major breakthrough that brings more clarity on SAMR's attitudes towards VIE issues, especially given its past reluctance to accept transactions involving a VIE structure.

In the absence of further regulations, and in light of other recent legal and policy changes and developments beneficial to VIEs such as the China Depositary Receipt regime and the New Tech Board of the Shanghai Stock Exchange, the risk of VIE structures being generally unwound continues to be low in practice, though there remains a possibility that the government may test-regulate VIEs in specific sectors within the Negative List, and then extend this to other sectors. Thus, VIEs

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① Source: Economist, 16 September 2017

② The filing relates to a greenfield 60/40 JV jointly controlled by Mingcha Zhegang and a subsidiary of the Yum group to provide technology solutions for the catering sector.

continue to be a key area in which future developments should be monitored by dealmakers.

6. The role of international capital markets

International investment into mainland China via the capital markets continues apace. This has been encouraged by the continuing rise of Bond Connect through 2020; the successful launch of Shanghai-London Stock Connect in 2019 (and the approval by the China Securities Regulatory Commission for China Pacific Insurance to issue securities via this scheme in June 2020); the quadrupling of the weighing of China A-shares in Morgan Stanley Capital International's global benchmarks; and September's announcement that two major inbound investment programmes (QFII and RQFII) which provide foreign institutional investors with access to China's A-share markets will be combined into a single 'qualified foreign investor' regime to provide broader and deeper opportunities in these markets.

In parallel, the FIL allows for investments into be funded via the issuance of public securities. All of this means a greater level of investor interest in foreign businesses with direct investments in mainland China, alongside foreign direct investment in mainland Chinese businesses.

Policymakers, regulators and exchanges in the capital markets therefore have an opportunity to harmonise, or at least to clearly explain, disclosure and investment norms in order to further encourage international investment. Bankers and fund managers also have the opportunity to increase their use of technology in order to conduct roadshows and due diligence into new public market investment

opportunities.

7. The increasing scrutiny of foreign investment and ongoing impact of trade tensions

Our previous reports to the CDF on outbound and inbound investment to and from mainland China described the increasing political and regulatory barriers to foreign investment (often, but not always, mainland Chinese investment) in the US and Europe and other economies such as Australia into sectors deemed to have national importance (particularly from a national security perspective).

This trend continues to gather pace. In the US, the Foreign Investment Risk Review Modernization Act (**FIRRMA**), which broadened the jurisdiction of the Committee on Foreign Investment in the United States (**CFIUS**), completed its implementation in February 2020. CFIUS's 2019 annual report[①] confirms that companies filed 231 notices of transactions that CFIUS determined to be subject to CFIUS jurisdiction – in line with the levels of 2017 and 2018. 89% of these notices related to transactions in the manufacturing sector (especially computer and electronic product manufacturing, electrical equipment manufacturing, and transportation equipment manufacturing), the finance, information and services sector (especially professional, scientific and technical services), or the utilities sector.

Over the period 2017-2019, mainland China-based acquirors accounted for 20% of covered transactions: the highest share of any country (the next largest

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① Source: https://home.treasury.gov/system/files/206/CFIUS-Public-Annual-Report-CY-2019.pdf

being Japan, with 14%). Nevertheless, it should be noted that mainland China was not at the top of the CFIUS league tables in 2019 alone. For example, in 2019, mainland China-based acquirors only accounted for 25 out of 231 notified transactions: second place behind Japan (with 46), and nearly on par with Canada (23). Mainland China was also very low down the list of acquirors of US "critical technology" in 2019, with only 3 instances versus 20 for Japan, 11 for Germany, 7 for France and Canada, 6 for the UK and 4 for South Korea.

2020 has been an active year for the various authorities responsible for US foreign investment review, even without considering the widely publicised presidential order requiring the divestment of Musical.ly, the US predecessor of the popular video-sharing application TikTok. In particular, CFIUS issued a new rule in September revising one of the thresholds for non-US investments in "critical technology" businesses for which pre-closing filings will be required. For those investors that CFIUS would view as benign, certain transactions will no longer be subject to mandatory pre-closing filings just because the target was involved in a sensitive industry. On the other hand, investors from countries subject to heavier export licensing requirements will be subject to more required filings. The new threshold also increases the level of diligence required by parties to assess whether a pre-closing CFIUS filing is required. Not only do the parties have to know whether the US business develops or produces critical technologies, they also need to know whether export licenses would be required for the non-US investor or its owners. This analysis can be particularly challenging for early-stage US businesses with immature export compliance programs. It may also present

issues for non-US investors that are less accustomed to dealing with export controls or their application to the investors' owners.

In Europe, the new EU framework for screening FDI became operational in October 2020. This follows the EU framework for screening foreign direct investment approved in 2019. This framework:

- created a cooperation mechanism for Member States and the European Commission (**EC**) to exchange information and, if necessary, raise concerns related to specific investments;
- allows the EC to issue opinions when an investment poses a threat to the security or public order of more than one Member State, or when an investment could undermine a project or programme of interest to the whole EU;
- sets deadlines for cooperation between the EC and Member States, and among Member States, observing non-discrimination and strong confidentiality requirements;
- establishes certain core requirements for Member States who maintain or adopt a screening mechanism at national level on the grounds of security or public order;
- encourages international cooperation on investment screening, including sharing of experience, best practices and information on issues of common concern.[①]

It should be noted that the new regulation complements (rather than replaces) screening mechanisms of EU Member States, which are also being strengthened in several countries. It is designed to help Member States and the EC to collectively assess potential cross-border threats to security and public order arising from a foreign direct investment. Member States retain the final decision as to whether an investment is authorised in their territory and under which

① Source: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1867

conditions.[①]

It should also be noted that the EC also recently published a set of proposals intended to prevent foreign investors from using government subsidies to enable them to price out other bidders for European assets.[②] The proposals describe "a specific concern about foreign subsidies in the contexts of the acquisition of EU targets".[③] While mainland China is not mentioned by name, commentators have suggested that such measures may be directed towards mainland Chinese acquirors.[④]

These laws have contributed to a significant fall in mainland Chinese outbound investment into Europe and the US: for example, "Chinese investors' mergers and acquisitions in Germany last year [2019] amounted to just 1.3 billion euros, according to the German Economic Institute, a fraction of the 12 billion euros of deals seen in 2017."[⑤]

The increasing scrutiny of foreign investment, particularly in the US, runs parallel to ongoing trade tensions between the US and China. The US administration at the time of writing this report[⑥] has made efforts to restrict Chinese imports (e.g. via tariffs and export controls), control Chinese access to US-owned technologies perceived as "sensitive", and to reshore manufacturing

① Source: https://trade.ec.europa.eu/doclib/docs/2019/june/tradoc_157945.pdf

② Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1070

③ Source: https://ec.europa.eu/competition/international/overview/foreign_subsidies_white_paper.pdf

④ Source: https://www.nytimes.com/2020/06/17/business/european-union-china-deals.html

⑤ Source: Nikkei Asia, 3 April 2020

⑥ October 2020

from abroad. All of this will serve to inhibit investment, especially from the US into China.

This backdrop is important given the FIL's statement that China may take measures against countries that discriminate against Chinese investment (and there are anecdotal examples of investors seeking to manage such risks in negotiating their inbound investments in mainland China). Inbound investors will need to continue to monitor the situation, and work with advisers with deep knowledge of the regulatory outlook in mainland China as well as the wider global picture, in order to ascertain the risks of their deals being affected by such measures.

Conclusion

In conclusion, the new FIL and associated legal measures have done a significant amount to accelerate and encourage foreign investment into mainland China via M&A by streamlining processes, offering reassurances in relation to equal treatment, widening the range of business activities that are available for foreign investment, and improving capital market access for foreign investments.

China's rapid and robust handling of the Covid-19 pandemic has meant not only that deal flow has recovered, but has also highlighted the strength and attractive prospects of the mainland Chinese economy, making it an even more attractive destination for foreign investment including M&A.

Nevertheless, the pandemic has led to a lengthening in deal duration, new areas for negotiation and due diligence between acquirors and sellers, and reappraisals of business models across industries. In addition, ongoing tensions in relation to trade and foreign investment scrutiny are also a headwind to deal flow. Dealmakers and policymakers therefore have a significant opportunity to accelerate investment into mainland China by engaging in dialogue, education and networking.