



China's Capital Controls – Implications for China Focused Companies

In late November 2016, following speculative reports of increased restrictions on capital outflows, four Chinese government agencies, including National Development and Reform Commission (NDRC), Ministry of Commerce (MOFCOM), State Administration of Foreign Exchange (SAFE) and People's Bank of China (PBOC) issued a joint statement which stated that outbound investment deals will be subject to strict reviews. The statement was followed by further communication from SAFE, and other developments to slow renminbi (RMB) outflows.

At this time no official regulations have been enacted; however, parsing through the news reports and official communications the new policy developments can be summarized as follows:

Prohibited Transactions: Certain transactions will be prohibited in principle unless approved by the regulators, such as NDRC, MOFCOM, SAFE and/or PBOC, including:

- Outbound investments of US\$10 billion or more;
- Outbound investments of US\$1 billion or more by State Owned Enterprises (SOEs) on a single real estate transaction;
- Outbound investments of US\$1 billion or more if they fall outside a Chinese investor's core business;
- Outbound investments by limited partnerships;
- Outbound investments in equity stakes of 10% or less of publicly listed overseas companies;

- Outbound investments by small parent companies in large subsidiaries. Of late an increasing number of Chinese companies have acquired larger overseas targets by leveraging onshore and offshore financing tools and the regulators want to cut down on the associated financial risks;
- Outbound investments in order to participate in delisting of Chinese companies from overseas exchanges, commonly known as going-private transactions; and
- Outbound investments by companies with short corporate histories (typically, the company has been incorporated only for a few months and does not have any substantial business operations), locally known as "quick-establish-and-out" transactions.

Some Transactions Subject to Increased Scrutiny: Certain transactions will be subject to enhanced reviews and pre-approval from relevant authorities, such as NDRC, MOFCOM, SAFE and/or PBOC, including:

- Outbound investments by China domiciled companies with high asset to liability ratio and low return on equity;
- Outbound money transfers in foreign currency or RMB equivalent of US\$5 million or more;
- Capital outflows under any outbound investment project worth US\$50 million or more; and

- Outbound investments and profit remittances by foreign investors, generally.

RMB Outflows Restricted: The following transactions involving foreign exchange and RMB conversions will be restricted, and will require pre-approval from authorities, including PBOC:

- Outbound RMB transfers by China domiciled companies to their overseas shareholders and subsidiaries will be restricted to 30% of the shareholders' equity in the transferor;
- Foreign banks operating in China will now have to seek pre-approval from authorities to buy foreign exchange for their clients. Chinese domestic banks may have more quotas than foreign banks, however in practice it may not be easy to buy foreign exchange from domestic banks either as they will also seek to avoid prohibited capital outflows;
- The Shanghai Free Trade Zone (FTZ) will enhance monitoring of capital flows with the goal of ensuring a balance between the inflow and outflow of capital through the FTZ accounts; and
- In December 2016, PBOC also released new rules on cash transactions and overseas cash transfers. Effective July 2017, financial institutions in China are required to report to PBOC any cash transactions of more than 50,000 RB (US\$7,196) and any overseas cash transfers of more than 200,000 RB yuan (US\$28,783).

Beijing Seeks to Stem Capital Flight

Beijing's goal is to stop capital flight disguised as investment. After reaching almost US\$4 trillion in early 2014, foreign-exchange reserves have dropped significantly and are close to US\$3 trillion. The concern is that a number of outbound investments are not business-oriented transactions, but creative covers for moving capital out of China.

The Chinese government is also concerned with the loss in RMB's value, in November the RMB fell to its lowest level against the US Dollar in nearly eight years. During recent years, in a bid to encourage internationalization of RMB, the Chinese authorities allowed easier cross-border flow of capital. However, of late, RMB has depreciated due to concerns over China's stagnating growth and investors have been offloading RMB assets to move funds out of China.

Chinese authorities have also been unimpressed by the results of outbound M&A activity, particularly large acquisitions by SOEs. For instance, CNOOC, an SOE, paid a record US\$15 billion in 2013 for Nexen, one of Canada's largest oil firms but the investment has suffered due to the sharp decline in global oil prices. There have also been deals with doubtful synergies, such as Shandong Hongda's (an iron ore producer) purchase of a Jagex Games (a video game developer).

Another animating factor may be that even countries traditionally receptive to Chinese investments, such as Australia and Germany, have expressed concerns about the level of state interference in

outbound M&A deals. So, restricting some investments in the first place may help placate the concerns, for now.

A Necessary Measure

Given the circumstances, and the rate of capital outflow, Chinese authorities have limited tools at their disposal. In the short term, these restrictions make sense and buys the authorities time to develop long term solutions. Moreover, given the raw volume of outbound transactions (the value of outbound Chinese investments in 2016 alone is more than US\$150 billion according to Jefferies),¹ it is not surprising that Chinese authorities have taken some steps to cool the outbound M&A machine.

Practical Challenges for Businesses

Notwithstanding the reasons and strategic benefits, the broad sweep of the new policy presents several practical issues for Chinese companies and overseas enterprises that have dealings with China.

First, given the complexity of modern day transactions, it is likely that a range of deals will be affected, including genuine transactions with legitimate business purposes. Second, ongoing M&A transactions involving Chinese firms are likely to suffer from delays and uncertainty. Although, nominally the focus is on larger transactions, SAFE has indicated that it will review outbound money transfers of US\$5 million or more as compared to the previous threshold of US\$50 million. Third, overseas shareholders will now face additional restrictions in the use of the profits of their Chinese operations. This will be an issue for investors, including Canadian enterprises, who will want to use the profits from their Chinese operations for dividends or loan payments. Fourth, as the details of the new pre-approval and review process are still unclear, banks and financial institutions have in practice suspended capital outflows for investments, even for those transactions that had obtained pre-approvals from NDRC and MOFCOM.

Responding to the Changes

There has been near unanimous commentary that Beijing is concerned about the quality of Chinese overseas investments. The government fears some transactions are rushed through without proper vetting. Prudent outbound investors should look to establish proper due diligence procedures and demonstrate in their applications to NDRC, MOFCOM and other authorities, that targets are high quality and genuine. A meticulous diligence review can not only identify and allocate risk proportionately but also highlight synergies between the acquirer and the target. Having said this it is unclear of the how the Chinese authorities will manage decisions around what investments to permit.

The new policy environment is complicated and in a state of flux, there is still no official publicly available copy of the relevant rules, and authorities may require several weeks or months to provide

¹ "Chinese Outbound M&A Surging Across Industries and Deal Size", *Jefferies* (18 December 2016) online: [Jefferies LLC <https://www.jefferies.com/OurFirm/2/1098>](https://www.jefferies.com/OurFirm/2/1098).

approval. So, investors should engage with their legal and financial advisors as soon as practicable so that their transactions utilize efficient corporate structures that require less regulatory intervention. Investors should also provide their advisors with detailed information, so that applications for outbound investments are presented in full compliance with the new directives.

Investors should consider the sectors in which they are seeking to make investments. For instance, China will continue to encourage outbound investment in high technology areas (e.g., robotics) that support its move up the value chain but acquisitions in sectors such as real estate are likely to face more scrutiny.

For prospective foreign investors, who were (or, still are) looking to tap into capital from China, the new policy brings a different set of considerations. If the seller selects a Chinese acquirer then it may be able to command a higher premium given the uncertainty. Sellers may also ask for higher break fees as protection against deal failure due to regulatory concerns and require payment funds to be put in escrow in offshore banks. Investors should also understand the acquirer's structure and business operations before entering into a transaction to avoid falling into the categories of transactions that are generally prohibited or closely reviewed.

In the long term, China-focused investors should start developing offshore structures for overseas investments as these investment vehicles are less affected by regulatory changes. Offshore entities also offer advantages in regards to taxes, listing prospects, and potentially simplified corporate governance requirements if the entity is not listed. Many Chinese companies already have offshore investment vehicles, with some domiciled in Hong Kong. Given the new policy prospective foreign investors may prefer to transact with offshore investment vehicles and Chinese investors may wish to use offshore investment vehicles to raise funds. For example, Ping An Insurance Group, China's second-largest insurer, plans to sell US Dollar denominated bonds and borrow from banks offshore to finance its overseas investments. At this stage, it is unclear how the relevant rules will affect this type of investment, if at all.

Take Away

At first glance the new policy developments seem daunting, and may portend the dawn of a new era, however, investors should note that this move has not come in a vacuum. A policy shift has been under way for a while, particularly since early 2016 when Chinese stock markets suffered from significant turbulence. For instance, Chinese authorities have already instituted caps on the amount of money Chinese holders can withdraw outside the country.

The new policy changes will impact M&A activity in the short term as investors pause to understand its intention and consequences. However, it is unlikely that Chinese authorities will alter their generally pro-investment sentiment and insulate the economy entirely from global integration, especially given its World Trade Organization (WTO) membership. The point was underscored by PBOC Governor Zhou Xiaochuan. Last month, he described the capital control measures as temporary means for preventing capital flight and restoring calm to the currency markets. Hong Kong Monetary Authority's Chief Executive Norman Chan has also stated that the measures may be subject to adjustments once the currency markets are stabilized.²

The new policy is likely to remain in effect until the end of September, 2017. It would not be surprising to see the regulatory landscape evolve in a more permissive manner after that.

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² Phoenix Kwong & Cathy Zhang, "China's currency curbs merely 'temporary' to stem yuan's outflow, central bank chief says", *South China Morning Post* (19 December 2016) online: South China Morning Post <<http://www.scmp.com/business/money/article/2055798/chinas-currency-curbs-merely-temporary-stem-yuans-outflow-central>>.

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