S&P Global Market Intelligence

Perspectives from China

Turning Inward: Chinese M&A in 2022

Regulation Asia

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Perspectives from China

Part 3

Executive Summary

The story of China over the past few years has been one of slowing growth and an increasingly tightening regulatory environment. The onset of Covid-19 was an obvious driver of the slowdown, but a string of unexpected regulatory moves from policymakers has also contributed to the more challenging business environment and impacted overall market optimism. Industries as disparate as technology, finance, education and transport have had to adapt to a new regulatory climate. These obstacles have bled into M&A, which has seen a slump in outbound deals and a flurry of reactive dealmaking in the domestic market. But perhaps one of the most important policy drivers of the past few years has been around ESG. The financial industry and corporations it services are under increasing pressure to incorporate ESG principles into their business practices and help pursue the lofty goal of carbon neutrality. But a lack of maturity in the ESG space means the strategy is often underdeveloped and reliable information tends to be hard to come by.

By Bradley Maclean, Co-Founder, Regulation Asia

Methodology

S&P Global and *Regulation Asia* surveyed three distinct themes of awareness and optimism towards (1) the changing regulatory environment, (2) attitudes towards ESG amongst investors and bankers in China, and (3) the outlook for M&A. The survey also included expectations of ESG disclosure requirements. The respondents constituted: retail bankers; corporate bankers; investment bankers; private bankers; wealth managers; asset managers; credit union employees; brokers; fintech employees and insurance employees. The majority of respondents' firms (92%) had domestic operations only. There were 6% of respondents headquartered in China but with overseas operations and 3% had multinational operations. Almost half of respondents' firms (46%) had assets of between USD 50-99 billion, with 31% having USD 10-49 billion, 16% having USD 1-9 billion and 5% having less than USD 1 billion in assets.

Part 3
Turning Inward: Chinese M&A in 2022

By Bradley Maclean, Co-Founder, *Regulation Asia*

Chinese M&A has undergone a flip in focus over the past few years. The big-ticket outbound deals that showcased China's financial muscle on the global stage have dropped off, to be replaced with an increasingly active domestic market. Shifts in the political mood, sweeping regulatory changes and other difficulties presented by Covid-19 mean activity within China's borders continues to gain prominence.

The global expansion of China Inc. was in full flow back in 2017 when the number of outbound M&A deals from the Mainland hit 806 with a total value of just over USD 127 billion, according to figures from S&P Global. In 2021, this figure dropped to just 502 deals worth USD 50 billion, marking a dramatic decline from the heady days just a few years earlier.

Financial buyers such as private equity and venture capital funds accounted for over half of the outbound

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deals last year, pushing out investment strategies from both the private and public sectors. The technology and consumer sectors were the two most targeted by value.

Although part of the slump in outbound dealmaking can be attributed to the complications of planning and completing deals during the prolonged pandemic measures, a cooling attitude toward Chinese investment has also played a major part in the drop-off. Politicians across the world, but particularly in the United States, have grown increasingly cautious and, in some cases, hostile towards acquisitions by Chinese companies, most notably in strategically important sectors.

The dampening of enthusiasm for Chinese buyers doing business in the United States has been accompanied by legislation complicating their ability to maintain listings in key destinations like New York, as well as prohibitions against US persons investing in securities issued by dozens of companies said to be linked to China’s military development.

The standout trend in the domestic Chinese M&A market has been the rise of financial buyers. The pandemic reduced opportunities for many financial buyers and left firms with money to spend but difficulty in spending it. This resulted in a large amount of financial firepower being built up in these firms, which is now coming to the market.

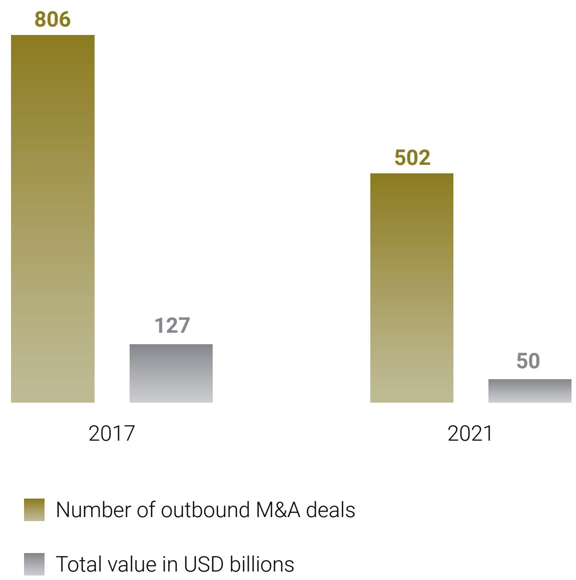
The volume of deals executed by private equity and venture capital buyers jumped 32% between 2020 and 2021 to 7,189 in total. But the value of deals over the same period sunk by 6% to USD 336 billion, showing that while more deals are being made, they are on average smaller in size.

Domestic deals, including those involving foreign buyers, where the transaction was deemed ‘strategic’, saw a jump in volume of 12% to 5,285, but again total value dropped, by 28% to USD 281.6 billion.

Domestic acquisitions by strategic buyers were spread across several industries, but the highest volumes were seen in industrials and the technology and consumer sectors. When it came to value, industrials continue to be at the head of the pack, with the energy sector and financials following behind. Some key factors driving deals across sectors were related to a push for industrial upgrades and the transition to renewable energy.

Themes such as the push for renewable energy point to government policy being a key driver behind much of the recent dealmaking seen within China. State objectives can often spur businesses into shedding assets or adding to their portfolios, and a flurry of regulation in recent years in areas as diverse as financial services, education, technology and real estate has signalled to Chinese firms that changes are required. The

Outbound M&A deals: 2017 versus 2021



government's hand in driving domestic dealmaking could prove to be particularly critical to rescuing the embattled real estate sector.

Private equity continues to see an active year in 2022, with a focus on exiting less productive or profitable businesses. Year-on-year, exits nearly doubled to a record high, as firms increasingly focus on assets with good value. Listings involving private equity firms were also prominent, with venues such as the Shenzhen ChiNext and Shanghai STAR exchanges benefitting from the drive to float. Even so, the majority (67%) of survey respondents indicated expectations of an extended period of cooling due to an increasingly uncertain domestic and international economic outlook.

Chinese policymakers responded more strongly than most to the Covid-19 pandemic, presenting difficulties to those looking to enter the country and discouraging inbound deal activity in the past two years. However, as we look ahead, in the current climate, companies and investors indicated (71%) they will be looking to future-proof their assets and mitigate risks by investing in strategic and emerging industries.

Though China has been partially open for some time, many investors (53%) indicated that they would need to remain patient until the country fully opens up and once again allow buyers to survey possible investment targets.

The dip in cross-border M&A could potentially slow the country's economic development, but recent pilot programmes such as Wealth Connect and other opening-up policies are offsetting the gloom.

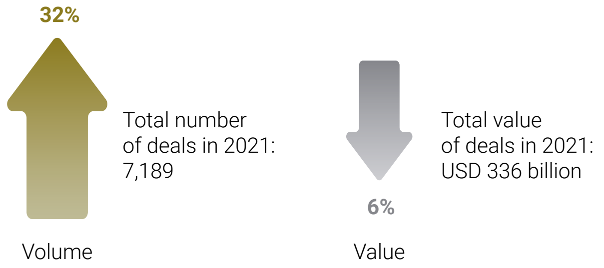
Wealth Connect was launched last year to facilitate greater cross-border investments in the Greater Bay Area, including the financial hub of Hong Kong and some key southern Chinese cities such as Guangzhou and Shenzhen. The mechanism means investment products can be offered between the cities, giving Mainland Chinese investors access to Hong Kong's international offerings and foreign investors the chance to increase their Mainland China exposure.

Policymakers have been traditionally coy about allowing cash to flow freely overseas and have been notoriously protective over the injection of too much foreign capital into domestic markets. In stark contrast to traditional policies, Wealth Connect represents the possibility of a more interconnected financial future.

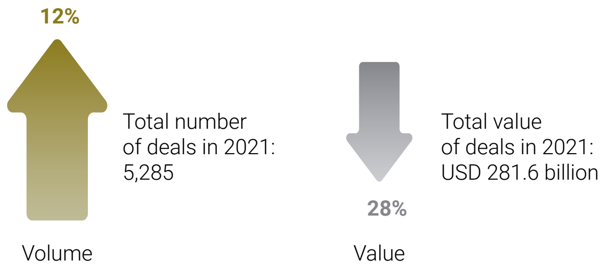
Meanwhile, a number of other initiatives designed to further open up domestic markets to foreign participation are also seen as encouraging. China has already removed a number of restrictions that prevented foreign financial institutions from entering the domestic banking, securities, futures, asset management and insurance sectors. Regulators have recently announced similar relaxations for insurance asset management companies and finance companies, as well as for other non-financial industries.

This year, Chinese authorities have also been working on expanding Stock Connect, which now provides cross-border connectivity to ETFs and will later this year be further enhanced to align Hong Kong and Mainland trading days. Bond market connectivity has also improved, with regulators allowing easier access to both the exchange and interbank bond markets, as well as increased flexibility for cross-border issuance and subscriptions.

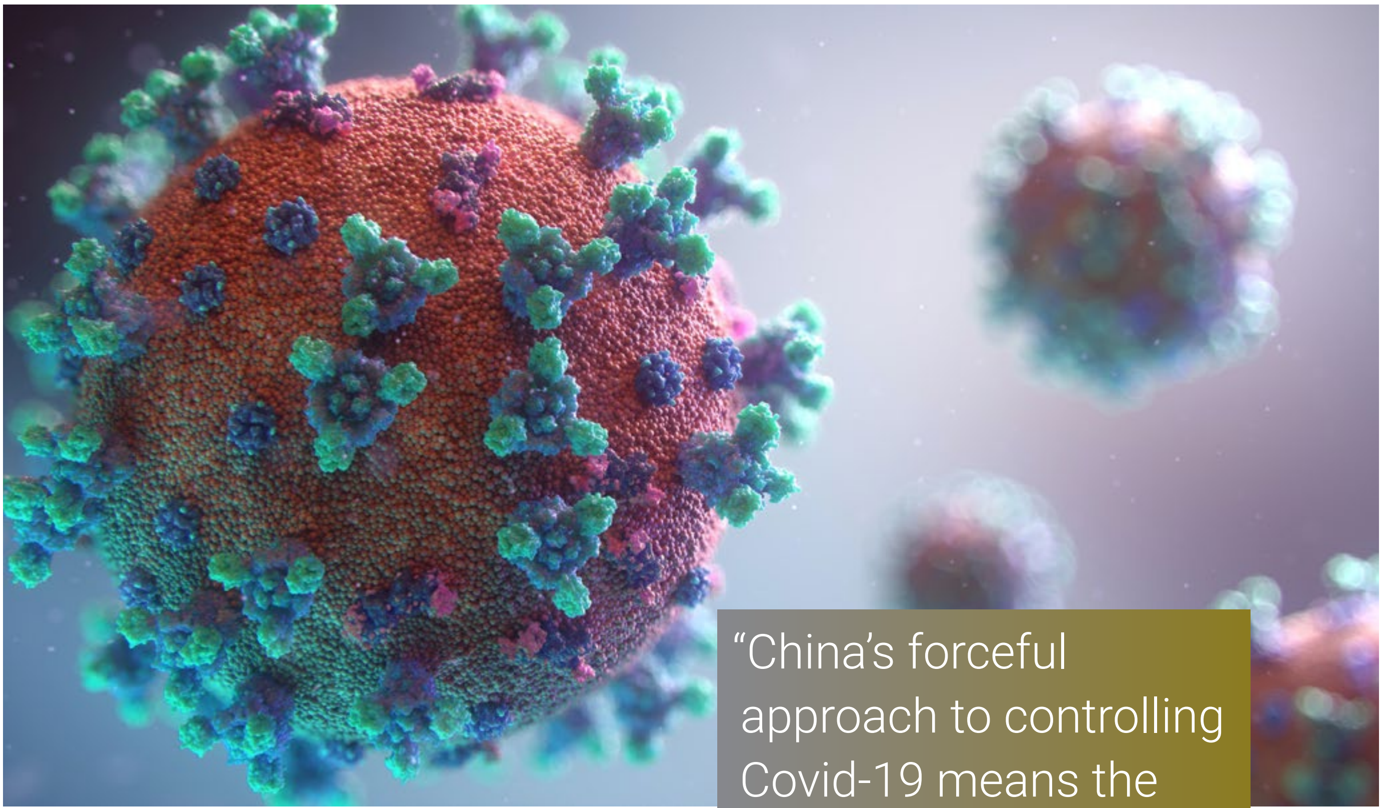
Deals executed by private equity and venture capital buyers: 2020 versus 2021



Domestic deals, including those involving foreign buyers, where the transaction was deemed 'strategic': 2020 versus 2021



On the derivatives front, a new mutual market access programme with Hong Kong known as Swap Connect is expected to be launched early next year, and a new Futures and Derivatives Law has taken effect that broadly aligns with international standards around netting enforceability, risk management and investor protection. Derivatives products listed on Chinese



“China’s forceful approach to controlling Covid-19 means the country is still stuck in the throes of dealing with the virus.”

exchanges are also increasingly being opened up to foreign participants.

The last few years have brought unusual times and have impacted the investment landscape and the market for deals globally, including in China. Border closures due to Covid-19 and the economic nationalism that has come to the fore in some influential countries have disrupted dealmaking and forced an adaption of M&A priorities. But as the world moves into a post-pandemic environment and political priorities evolve, dealmakers and investors could get the opportunity to unleash some of the potential that has so far been stifled.

What’s Next?

China’s forceful approach to controlling Covid-19 means the country is still stuck in the throes of dealing with the virus. In contrast, many other countries have started to learn to live with it. China’s economy is likely to continue facing challenges until it gets to grips with the virus domestically.

Increasingly, policymakers are using waves of regulatory changes to assist the broader economy and companies in their recovery efforts. Sympathetic voices from policymakers focusing on supporting and uplifting businesses rather than cracking down on excesses are increasingly becoming the norm in 2022, as we look towards a relaxation of quarantine requirements and possible border reopenings later this year.

Meanwhile, policymakers are continuing to shift focus from introducing waves of regulatory changes to a focus on ESG; a trend that doesn’t appear to be slowing down anytime soon. As we look to the future, domestic policymakers have made their goals very clear, and it is now up to corporates and the financial sector to help achieve them.

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