Regional Focus: Asia

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A number of economic and political factors, both domestic and international, influenced M&A and capital markets activity worldwide in 2016. Skadden attorneys Christopher W. Betts, Will H. Cai, Z. Julie Gao, Bradley A. Klein, Steve Kwok and Haiping Li in Hong Kong; Nobuhisa Ishizuka and Kenji Taneda in Tokyo; and Jonathan B. Stone in Hong Kong and Rajeev P. Duggal and Parveet Singh Gandoak in Singapore provide insights on the developments impacting activity in China, Japan and India, respectively.

CHINA

Strong Momentum in Outbound M&A Activity

China's outbound M&A activity continued its strong showing in 2016, reaching approximately US$247.5 billion and surpassing the record set in 2015. Underlying the trend are a number of factors, including a desire to expand into new territories following domestic consolidations in a broad range of industries and to acquire strategic technologies amid the slowdown in China's domestic economic growth. Turbulence in the Chinese stock markets, coupled with the market expectation of renminbi (RMB) depreciation, have driven Chinese enterprises to accelerate their investments abroad in order to diversify risks and hedge against devaluation of domestic assets. The favorable financing environment for acquisitions in the U.S. and European markets has aided this overseas drive. Also, private equity firms were an important player in activity in 2016.

Chinese government policies also assume a key role in M&A activity. On the one hand, policymakers in China are encouraging Chinese enterprises to be more prominent on the world stage; to do so, companies need to look globally for quality investment opportunities to better position themselves for international and domestic competition and achieve long-term growth. On the other hand, in an attempt to curb capital outflows that are putting downward pressure on the RMB and draining foreign exchange reserves, China also imposed various new restrictions on outbound foreign investments in late 2016. This effort resulted in a cap on RMB-denominated loans issued outside China and a requirement that the loans be registered in China. In November 2016, China also imposed new limits on the amount of yuan that Chinese companies can remit overseas.

As the depreciation of the RMB accelerated in the last few months of 2016, Chinese foreign exchange regulators began vetting transfers abroad worth US$5 million or more to curb capital outflows. Additionally, regulators have privately proposed certain rules that directly restrict outbound M&A transactions valued over US$10 billion (or over US$1 billion if without strategic purposes or unrelated to acquirers' core businesses). Lastly, as debts continue to soar, the government is reining in shadow-banking loans and debt-fueled financial investments, raising the cost of borrowing. These regulatory changes have already created difficulties for certain deals; if they are fully implemented, the effects will ripple through the entire region.

Challenges in Deal Execution and Negotiation

Chinese buyers are still in the process of establishing a track record for executing large M&A transactions overseas. Thus, management teams of Western targets often have concerns regarding financing uncertainties. Some Chinese buyers have opaque corporate and ownership structures, which can raise doubts about the source of funds and present difficulties in securing regulatory approvals, particularly from the Committee on Foreign Investment in the United States (CFIUS). Chinese buyer consortiums often consist of a wide array of parties, such as government-backed investment vehicles, trusts, offshore holding companies or newly formed funds for the sole purpose of carrying out the transaction. Therefore, it is often impossible for a vendor or target to properly assess the consortium's creditworthiness.

In addition, Chinese buyers increasingly are using leveraged financing structures for acquisitions. When a Chinese bank funds a transaction with leveraged loans, Chinese buyers often present debt commitment letters that are intended to offer a degree of funding certainty comparable to that provided by their Western counterparts. However, these letters are typically in a short-form format without the customary terms used in the U.S. or Europe. As such, the enforceability of these letters has been a cause for concern.

In the past, Chinese buyers addressed a vendor's or target's worries about funding by offering a significantly higher valuation, thereby outbidding competitors. In more recent transactions, Chinese buyers have been more willing to cater to sellers' requirements and address their concerns over risks of regulatory approvals by depositing reverse-termination fees in an escrow account or by securing such fees with a letter of credit. As a result, reverse-termination fees are heavily negotiated and are often higher than those for U.S. domestic transactions. It remains to be seen whether such an approach is sustainable.

China Further Opens Access to Capital Markets, Increases Enforcement

The most recent development in the Chinese capital markets is the launch of the new Shenzhen-Hong Kong Stock Connect (SZ-HK Connect) on December 5, 2016, which follows the November 2014 launch of the Shanghai-Hong Kong Stock Connect (SH-HK Connect) (see *2015 Insights* article "Shanghai-HK Connect Opens Possibilities for Companies Looking to Tap Chinese Investor Demand"). These schemes allow investors located in Shanghai and Shenzhen to trade in Hong Kong-listed securities and Hong Kong investors to trade in Shanghai- and Shenzhen-listed securities, in each case through their own brokers and in their own currency.

SZ-HK Connect further increases Hong Kong's appeal as a listing venue for companies seeking to tap Chinese investors and as a base for foreign investment into China. In particular, by virtue of SZ-HK Connect, mainland Chinese investors will now be able to trade in stocks on the Hang Seng SmallCap Index, which offers about 180 shares more than the SH-HK Connect. The Shenzhen Stock Exchange allows foreign investors to buy into the growth stories of the technology, media and health care companies that are primarily listed on the Shenzhen Stock Exchange instead of in Shanghai. The Stock Connect schemes allow mainland Chinese capital to be invested in Hong Kong-listed entities without drawing the ire of capital control hawks in China, because proceeds from sales are returned to the owners in RMB and do not become part of the foreign currency market.

In addition, there have been increasing regulatory enforcement and disciplinary actions by Hong Kong securities regulators. In May 2016, the Securities and Futures Appeals Tribunal affirmed the Securities and Futures Commission's (SFC) decision to reprimand and fine Moody's Investors Service Hong Kong Limited HK$11 million (US$1.4 million) for various failures relating to its preparation and publication of a special comment report. Similarly, in August 2016, the Market Misconduct Tribunal (MMT) found that Andrew Left of Citron Research disclosed false or misleading information in a report he published and ultimately banned him from trading securities in Hong Kong for up to five years, disgorged him of profits worth HK$1.6 million, and ordered him to pay investigation and legal costs of HK$4 million.

Both rulings were firsts for Hong Kong. Moody's fine was the first disciplinary action of its kind the SFC has taken against a credit rating firm since it started regulating rating activities more than five years ago. Similarly, the MMT's finding against Left was the first time it had found a short seller guilty of market misconduct arising from the publication of otherwise unregulated market commentary.

FCPA Scrutiny of Chinese Companies and Executives

The Foreign Corrupt Practices Act (FCPA) enables U.S. authorities to assert "territorial jurisdiction" over foreign entities and nationals. Under this theory, as the FCPA Resource Guide warns, "a foreign national who attends a meeting in the United States that furthers a foreign bribery scheme may be subject to prosecution, as may any co-conspirators, even if they did not themselves attend the meeting."

In the past, FCPA enforcement actions against foreign entities and nationals were relatively rare because of the difficulty for U.S. prosecutors and regulators in identifying a U.S. nexus from the alleged corrupt payments to foreign officials. The enforcement challenge was heightened by the need to gather evidence abroad. With increasing numbers of Chinese companies and employees entering the U.S. to do business, however, many of these evidentiary obstacles no longer stand in the way.

There is already some indication that prosecutors have been paying closer attention to the territorial theory of jurisdiction. In the February 2016 enforcement action against Massachusetts software company PTC, Inc., the U.S. Department of Justice (DOJ) named not only PTC but also PTC's China entities as defendants. To do so, prosecutors alleged that the jurisdiction requirement was satisfied because PTC China employees accompanied Chinese "foreign officials" on their travels to tourist destinations in the U.S. such as New York, Las Vegas and Honolulu.

In the debate over what the FCPA enforcement landscape will look like under President Donald Trump, comparatively little attention has been paid to FCPA risks that foreign companies and executives doing business in the U.S. face. Some expect the next attorney general will issue new guidance requiring prosecutors to consider the impact on American business competitiveness in FCPA cases; however, enforcement actions against foreign entities level the playing field by forcing all companies subject to the FCPA's jurisdiction, foreign and domestic, to play by the same rules.

China's Anti-Corruption Campaign Continues

These U.S. trends may be of particular relevance to Chinese companies, as China's anti-corruption campaign, now in its fifth year, continues in full force. Faced with rising public anger about mounting social problems amid a slowing economy, Chinese authorities are expected to continue their scrutiny of industries that have a direct bearing on the quality of life of Chinese citizens in the forms of, for example, drug prices, food safety, environmental quality and building hazards.

Moreover, unlike investigations of corrupt party or government officials that are almost invariably conducted out of public view in their initial stages, investigations of these industries are, with increasing frequency, preceded by highly public exposés that identify the accused and showcase the Chinese government's ability to bring them to heel.

Once the information is in the public domain, it is readily accessible to regulators in other jurisdictions, including the U.S. This has significant implications for companies operating in China that also are subject to the FCPA. In responding to Chinese government inquiries, companies should take into account the very real possibility that the alleged conduct also may pique the interests of American prosecutors and regulators. As a result, an array of U.S. law issues must be considered at the outset of a Chinese government inquiry. Such issues include safeguarding the attorney-client privilege to enable privilege arguments to be asserted later in a U.S. court if necessary, and conducting an internal review in a manner that will pass the scrutiny of U.S. regulators.

External Political Factors and Predictions for M&A Activity in 2017

Brexit and the U.S. presidential election did not have an immediate impact on China-originated deals. However, as the change in U.S. administration unfolds, we anticipate major shifts on a variety of policy fronts. It is widely perceived that Chinese buyers will have more difficulties obtaining CFIUS approvals under the Trump administration, especially given that technology and intellectual property assets are prized targets for many outbound transactions. (See "CFIUS and Foreign Investment Reviews in 2017 and Beyond.") This trend would follow an already challenging CFIUS environment for Chinese investors. In 2016, for example, CFIUS blocked Fujian Grand Chip Investment Fund's purchase of German semiconductor maker Axitrom and prompted the Blackstone Group to withdraw the sale of Hotel del Coronado to Anbang Insurance Group.

More importantly, in a country where government policies heavily influence private dealmaking, the general political and economic tensions between the U.S. and China may impact cross-border M&A activity. International trade, cybersecurity and currency manipulation were all prominent issues during the U.S. election cycle. More recently, there is renewed concern that Taiwan may again become a critical feature of U.S.-China relations. These all increase the unpredictability of future policy directives and contribute to the volatility of the M&A market.

That said, the strongest headwind to outbound Chinese M&A is China's move to combat capital flight. If these temporary control measures are lifted, and absent any major changes in the regulatory environment, we expect to see continued momentum in Chinese outbound M&A dealmaking.

JAPAN

Cross-Border Activity Slows Amid Rising Domestic Consolidations

Cross-border Japanese M&A activity significantly decreased in 2016 compared to 2015. This can be attributed in part to a pause in activity stemming from a number of companies continuing to integrate large acquisitions from prior years; increasing competition for attractive assets, particularly from Chinese acquirers; a lack of larger targets at appealing valuations; and a significant increase in domestic consolidations that likely diverted attention from outbound activity in some sectors.

In addition, uncertainties created by Brexit, the U.S. election and financial market volatility at the beginning of the year made Japanese buyers more cautious when considering foreign acquisitions. Notably, only two transactions accounted for over 50 percent of Japanese outbound deal volume during the first three quarters of 2016 — Softbank/ARM and Sompo Japan/Endurance Specialty Holdings — underscoring the relative lack of activity.

By contrast, domestic Japanese M&A activity in 2016 increased significantly over the prior year, due to consolidation transactions. The continuing global slowdown in the industrials and chemicals sectors, persistent low oil prices in the energy, mining and utilities sector, and conglomerate reorganizations drove companies in these sectors to seek greater competitive advantages through combinations with industry peers.

Decrease in Capital Markets Activity

There also was a general decrease in capital markets activity by Japanese issuers in 2016, due to factors such as volatile markets and a negative interest rate environment. In terms of equity capital markets, the number of initial public offerings (IPOs) in 2016 fell to a seven-year low, and despite the successful listings of some prominent companies such as LINE Corporation and JR Kyushu, there were fewer large-scale IPOs than in previous years. In addition, the number of follow-on public capital raises by listed companies fell by more than 50 percent as compared to 2015. This decrease is attributable in part to sluggish share prices that persisted prior to the U.S. presidential election and were due to factors such as a stronger yen and Brexit. However, the decrease in equity offerings also was the result of an enhanced focus that many Japanese corporations have placed on the efficient use of capital, as well as the availability of favorable bank financing caused by negative interest rates.

Activity was somewhat stronger in the debt capital markets, reflecting the availability of low interest rates for domestic bonds. In terms of cross-border activity, overseas issuances were again dominated by Japanese financial institutions, such as banks and insurance companies, offering hybrid and other subordinated debt products to overseas investors to raise regulatory capital.

Impact of External Political Factors

The implementation by the Bank of Japan of its negative interest rate policy in January 2016 and the resulting tightening of credit spreads put pressure on banks to seek more diversified sources of revenue. At the same time, the policy has provided an incentive for Japanese corporate borrowers, which tend to save cash rather than spend capital, to deploy excess savings. Further supplementing this trend is a continued focus on new corporate governance reforms, in their second year of implementation, which impose increased accountability on Japanese companies to productively use their surplus cash with a particular focus on shareholder returns. As a result, while corporate boards are taking a more holistic view of their balance sheets and are increasingly considering M&A transactions in the larger context of overall financial performance, we expect these incentives to productively deploy cash will continue.

For Japanese companies — members of an export-driven economy — currency fluctuation is a double-edged sword that can create uncertainties impacting Japanese outbound M&A transactions. A weaker yen such as that triggered by the recent U.S. election (as a result of strong dollar-buying) boosts corporate earnings but makes foreign acquisitions more expensive. Conversely, a stronger yen such as that resulting from the Brexit vote (as a result of strong safe haven purchases of the yen) makes such acquisitions cheaper but hurts corporate earnings. On balance, and as Japanese companies have shown in recent years, cross-border M&A activity generally should be immune to both environments because the sustained need to address stagnant growth in the domestic market will continue to drive outbound M&A activity. However, volatility in the strength of the yen complicates valuation and adds to the uncertainties for such transactions. It is too early to tell whether Japanese companies should anticipate continued volatility as the new U.S. administration transitions to governance and implementation of policy and as the U.K.'s exit from the European Union unfolds.

Outlook for 2017

Notwithstanding these potential headwinds, we expect that strategic considerations around the use of large cash reserves and slow domestic growth driven by an aging population and deflation will continue to drive Japanese outbound acquisition activity in 2017.

A heavily import-dependent country for natural resources, Japan is particularly vulnerable to fluctuations in oil prices. As crude oil prices have stabilized and strengthened as a result of the recent Organization of the Petroleum Exporting Countries (OPEC) agreement and ongoing ancillary negotiations to limit production among non-OPEC countries, it remains to be seen what the potential impact will be on Japanese M&A activity in the energy, oil and gas, and industrial and chemicals industries.

The ongoing impact of the Bank of Japan's negative interest rate policy will continue to generate margin pressure on Japanese lenders, which will drive the larger banks to seek more diversified sources of revenue, including potentially through acquisitions, and will increase pressure on smaller regional banks to consolidate.

As the Japanese venture capital market continues to grow after a long, slow development period, smaller independent companies in the technology sector, such as developers of software applications and social media, are becoming increasingly attractive targets for foreign acquirers. While overall inbound acquisition activity has been low relative to outbound activity for a number of years, a majority of the inbound deals in 2016 by value were in this sector, a trend we expect will continue.

In addition, there may be an increase in activity in the equity capital markets due to the recent recovery in share prices that has continued in the aftermath of the U.S. presidential election. In particular, higher share prices may attract more exit transactions by major shareholders, including not only private equity funds but Japanese corporates seeking to unwind cross-shareholdings by selling large blocks in the capital markets. In addition, there may be an increase in issuances of debt or equity securities by Japanese companies seeking to finance both domestic and cross-border acquisitions.

INDIA

Positive Conditions in Market and Government Spur M&A

India's strong M&A environment in 2016 was driven by favorable economic conditions and an encouraging regulatory regime. Its economy overtook China as the fastest-growing major economy, with a growth rate of almost 7.6 percent last year. The U.S., U.K. and Japan continue to lead in inbound investments, with China's interest in India expected to grow in 2017. Meanwhile, political stability, including one party having an absolute majority, has helped India initiate economic reforms that have had a positive impact on activity.

Technology, media, telecommunications, financial institutions and pharmaceutical companies remain key targets for foreign buyers and private equity investors. Private equity funds, after waiting many years for a capital markets recovery, are finally achieving public market exits for their investments and raising new funds. We expect a lot more private equity deal activity in the coming year, as India-focused funds are sitting on close to $7 billion ready to be invested. However, valuations and control deals still seem to be a challenge, as Indian promoters (as company founders are known) typically demand comparable market valuations and are reluctant to cede control.

Active Capital Markets Should Continue

The Indian equity markets were very active in 2016, with more than 25 companies raising almost $3.6 billion in aggregate through November 30, 2016, and several companies lined up to go public in the coming months. Some very large IPOs are in the pipeline, such as Vodafone, and 2016 was the best year for capital markets fundraising in India in the last five years. We expect this trend to continue in 2017 on the back of stable foreign direct investment inflows. The industrial and financial services sectors have been the busiest in terms of both value and volume.

Domestic dual listings on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) continue to dominate India's IPO scene, and very few Indian companies have listed internationally. That said, improved business confidence should drive more companies to pursue fundraising opportunities abroad. We expect some technology companies to explore international listings in the coming years to target sophisticated global technology investors, offer more attractive valuations and provide a means to access capital not available in India.

Currency Demonetization Should Positively Influence M&A, Debt Markets

Another factor impacting the deal landscape is India's decision to demonetize its 500 and 1,000 rupee notes (approximately US$7.50 and US$15, respectively) in an effort to fight tax evasion and corruption. The notes account for over 85 percent of currency that was in circulation and had to be exchanged with banks for new legal tender prior to December 30, 2016. Because the economy relies predominantly on cash, this change may negatively impact economic activity in the near term. In January 2017, for example, the International Monetary Fund cut India's projected growth rate for the current fiscal year to 6.6 percent. However, in the long run the move could boost government revenue by increasing tax compliance and improving the overall business environment.

One immediate impact of the currency demonetization has been a drop in bond yields, as banks have parked most of the canceled currency into debt securities. This drop should help companies refinance debt and fund capital expenditures, as well as make acquisitions less expensive.

With less developed local debt capital markets, Indian companies have historically borrowed at high interest rates and relied on bank loans to raise funds. The regulators recently eased the rules with respect to the issuance of rupee-denominated bonds to foreign portfolio investors (FPIs), known as "masala bonds." FPIs also have been allowed to invest in unlisted nonconvertible debentures and other debt securities. These developments should have a positive impact on the development of debt capital markets.

Indian Companies Eye Brexit Cautiously

Many Indian conglomerates and information technology (IT) companies have large U.K. operations that are a gateway to Europe. Brexit threatens the U.K.'s position as a major investment hub for Indian companies, which worry that they could be subject to higher tariffs for exports as well as unfriendly regulatory and immigration policies. British Prime Minister Theresa May's recent visit to India was disappointing to many in the business community given the U.K. government's refusal to ease visa restrictions for business travel. At the same time, the decline in the pound has been a cause for concern, and many companies are cautiously reviewing their operations in the U.K.

On a positive note, Brexit will likely compel Britain to seek a more robust trade relationship with India. The two countries have been unable to reach a free trade agreement so far, with negotiations becoming mired in the politics of the European Union bloc;

however, with Britain's commitment to attract new investment from further afield, this could change. A lot will depend on the shape and timing of the U.K.'s actual exit from the EU. If the process is drawn out, Germany and France may be able to nullify the U.K.'s diplomatic first-mover advantage and reach an EU-India free trade agreement first.

IT and Pharma Sectors See Downside to Potential Trump Policies

In general, the U.S.-India relationship is expected to continue on a positive trajectory under President Donald Trump. India is seen as a strategic and economic partner and thus has strong bipartisan support in the U.S. The two countries work together on a range of issues, from defense and security to space, health care, energy, technology and climate change. The U.S. is also India's largest trade partner.

However, some of President Trump's protectionist policies could adversely affect Indian industry and bilateral trade. For example, India's IT industry earns 60 percent of its $100 billion revenue from the U.S., much of which is attributable to outsourced U.S. jobs. If the Trump administration works to bring back these jobs, Indian IT companies could suffer. In addition, the possibility of extra duties being levied on imports could impact Indian exports to the U.S. and adversely affect the Indian pharmaceutical industry in particular, which accounts for about 40 percent of all generic medicines supplied to the U.S.

President Trump is likely to pressure India for more market access, especially as it relates to defense. We expect to see some major investments and joint ventures between Indian and American companies in this sector.

Impact of Regulatory Developments in 2017

India has seen quite a few developments on the tax front that could significantly impact companies in the year ahead. The general anti-avoidance rules (GAAR) will be applicable starting April 1, 2017, and provide sweeping powers to Indian tax authorities to declare any arrangement an "impermissible avoidance arrangement" if it has been entered into with the principal purpose of obtaining a tax benefit. Because the taxpayer has the burden to demonstrate that this is not the case, the tax authorities could question any transaction that results in tax savings. The rules also could deny tax treaty benefits to many investors who are unable to show "commercial substance" in the country through which they invest. Investments made before April 2017 will be grandfathered in, but GAAR will apply to arrangements where an entity continues to claim tax benefits on an ongoing basis.

In 2016, India and Mauritius announced an amendment to their tax treaty, as a result of which Mauritius tax residents will no longer be exempt from Indian capital gains tax on sales of shares of Indian companies that are acquired on or after April 1, 2017. Investments from April 1, 2017, that are sold prior to April 1, 2019, will be taxed at 50 percent of the prevailing rate, subject to satisfying certain requirements, including a minimum spend in Mauritius and that the Mauritius resident not be a shell or conduit company. Similar changes were made to the India-Singapore tax treaty on December 30, 2016. Thus, we expect that investors will have to think about alternative investment structures into India.

The recently passed Goods and Services Tax Bill, which takes effect on April 1, 2017, will completely overhaul India's current indirect tax system and unite it as a common tax market for the first time. Currently, goods are taxed multiple times at different rates and at different stages by the federal and state governments, which makes it challenging and costly to do business across state borders.

Additionally, the passing of the Insolvency and Bankruptcy Code 2016 and the Reserve Bank of India's initiative to require banks to clean up their books should make the next few years ripe for stressed-asset investors. However, the speed with which the attendant regulations and infrastructure will be rolled out remains unclear.

Coupled with these regulatory changes, the government's push to encourage investments through policies such as Make in India and Start-Up India and to improve the overall ease of doing business is expected to start showing results in 2017.

Skadden is not admitted to practice law in India. This article is for general informational purposes only, and Skadden would work with Indian counsel on specific transactions.