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Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West

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Key Points

- Buyers are fine-tuning their strategies to focus on sectors perceived to be favored by Chinese government policy, such as industrials, technology and health care.
- Chinese buyers have begun to turn their attention away from Western companies toward those in Asia and the Middle East, partly due to an increasingly unfriendly regulatory environment in the West.
- Chinese competition law and new data privacy protections are complicating deals and might deter some.
- As in Europe and North America, financial buyers are sitting on large sums of dry powder, which may find its way into transactions.

China's cross-border M&A market continued to face strong headwinds in 2022, with a slowing economy and new COVID-19 restrictions weighing on the market. There have been fewer outbound and inbound transactions, with total deal value at a multiyear low, and financial buyers accounting for a sizable portion of that value. And volatile public equity prices and increasing regulatory scrutiny of sectors such as technology, internet, critical resources, gaming and education have led to fewer megadeals.

Buyers have also become more selective, gravitating toward acquisitions in the energy, technology, health care, industrial and consumer sectors. Notable mega-deals, such as the $15.5 billion acquisition of Aramco Gas Pipelines Company by an investor group that included China Merchants Capital and the Silk Road Fund, demonstrate the state-owned enterprises' emphasis on strategically important sectors.

Furthermore, while the U.S. and other Western countries generally remain attractive destinations for certain outbound investments, Chinese buyers have been pivoting more resources and attention toward Asia and the Middle East, especially ASEAN (Association of Southeast Asian Nations) countries, partly due to an increasingly unfriendly regulatory environment in the West. For example, Canadian and British governments recently ordered several Chinese firms to exit their investments in lithium mining and microchip companies, citing national security concerns.

Investing in Favored Sectors

A prominent theme for market participants is investment decisions informed by the Chinese government's policy initiatives. With an economic downcycle looming, buyers are fine-tuning their acquisition strategies toward sectors such as industrials, technology and health care. Financial buyers under pressure to deploy capital may capture buying opportunities within these favored sectors and take advantage of beneficial government policies as well as softening valuation.

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U.S.-listed SPACs have been active in acquiring China-based targets in the technology, clean energy vehicle and digital health care sectors. The large number of SPACs still searching for acquisition targets suggests that this source of M&A deal activity could continue, at least until existing SPACs reach the end of their life cycles.

Regulatory Trends Affecting China M&A

Myriad merger-related regulations, including those on data privacy, competition and national security, bring both challenges and opportunities to M&A in China.

Data privacy. Critical legal frameworks on cross-border data protection, such as the recently implemented Cybersecurity Law, Data Security Law and Personal Information Protection Law, regulate how companies collect and transfer data across borders. As a result, data compliance by target enterprises is becoming a prominent factor affecting a transaction's valuation, deal structure and certainty.

Competition. China's Anti-Monopoly Law, meanwhile, has forestalled large companies from pursuing acquisition opportunities and dampened strategic M&A in the technology sector. This has opened the door for private equity firms and venture capital funds to approach technology targets. Strategic buyers are also seeking alternative ways to enter sectors heavily scrutinized by the anti-monopoly regime, such as through early stage investments in targets. (See "Demystifying China's Merger Review Process.")

National security reviews. In addition, opaque and unpredictable national security review processes under both Chinese and U.S. law have made cross-border M&A transactions in strategically critical sectors difficult.

In light of pre-closing regulatory filings and reviews, parties in inbound and outbound M&A transactions need to plan for longer deal timelines.

External Factors and Outlook

China's forceful measures to combat the COVID-19 pandemic and the country's economic slowdown due in part to those measures will continue to affect market sentiment for cross-border M&A. As future COVID-19 quarantine policies and travel restrictions have not been clearly declared, market uncertainty will remain high, hindering M&A deal activity. Nonetheless, pressure to deploy the record level of dry powder held by financial sponsors will likely support M&A dealmaking, especially if asset valuations continue to soften.

New opportunities may also arise as the Chinese government continues to institute market-stimulating policies in certain sectors. In addition, some multinational companies reassessing their existing presence in China may pursue divestment, spin-off or joint venture opportunities.

A contentious global geopolitical landscape characterized by competition between the U.S. and China will continue to influence M&A deal flow. For example, the latest U.S. export controls on semiconductors to China cast further doubt on the political and economic viability of private sector collaboration between the two countries. This does not, however, necessarily imply depressed cross-border M&A activity overall.

Buyers and targets from China shunning U.S.-connected deals will prioritize M&A opportunities in Asia, and alternatives to change-of-control transactions — such as minority investments and joint ventures that attract less regulatory scrutiny — may provide strategic alternatives.

(For perspective on the U.S. and U.K. markets, see "US M&A Levels Remain Healthy, but Due Diligence and Deal Protections Will Become Even More Critical" and "The Widely Forecast Recession in the UK Will Likely Reshape M&A," respectively.)