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China's Private Players Help Fuel Record US Investment

By **Chelsea Naso**

Law360, New York (March 17, 2016, 4:19 PM ET) -- Chinese foreign direct investment in the U.S. is still on the rise after hitting record heights in 2015, as Chinese policies motivate private equity funds and privately held companies to get creative with the art of cross-border deal-making, experts say.

Cross-border investment by Chinese buyers hit a record $15.3 billion in transactions on assets in the U.S., with a particular focus on the real estate, automotive, financial and businesses services, and information technology sectors, according to a recent study of closed transactions by Baker & McKenzie LLP.

And, with nearly $20 billion in Chinese foreign direct investment already pending in North America, it appears that Chinese cross-border deal-making is poised for another record-setting year in 2016, the study found.

The steady build of foreign direct investment in the U.S. can be in part attributed to Chinese policies that encourage buying into cross-border assets, which has also helped fan the growing private sector in China, according to Michael DeFranco, a Baker & McKenzie partner and chair of the firm's global M&A practice.

"The Chinese government has stated as a policy that they want China to go global, and, as a result of that, I think you're seeing a tremendous increase in outbound investment. You're also seeing a lot of growth out of financial investors in China; it's not just state-owned enterprises," DeFranco said.

Financial investors — which the study defined as private equity players, insurers and privately owned conglomerates — accounted for $15 billion of the total $40 billion worth of investment in North America and Europe in 2015, up from "virtually zero" just three years prior, the study found.

That rang especially true in North America, where Chinese financial investors' deal-making surpassed that of state-owned enterprises, the study found.

The rise in financial investors showcases a growing sophistication within China's burgeoning private sector, evidenced in the rising number of small and midsized transactions as well as a greater willingness to take a minority stake, DeFranco noted.

"Historically, what we have seen is that Chinese investors have preferred to take a majority or full ownership stake," he said. "We are seeing more and more small to midsized deals. And in these smaller to midsized deals, you are seeing companies more willing to take a small stake or a minority stake."

Even though small to midsized deals are on the rise, the trend is still in its youth. Large-scale buyouts still account for the largest portion of deal activity, the study found. In 2015, out of the $22.9 billion in deals in North America and Europe that were individually worth $500 million or more, 90 percent of the transactions saw the Chinese buyer take a stake of 75 percent or higher.

That has remained the trend particularly among Chinese investors diving into U.S. real estate assets, so much so that they're often willing to give on some terms, noted Len Rosenberg, a leader of Mayer Brown LLP's cross-border real estate practice.

"Chinese real estate investors, I think, have historically been much more interested in control and therefore willing to give up some yield or potential tax advantages in order to maintain that in both economics and governance," he said.

But the desire for full control may continue to fade in industries like real estate, as Chinese buyers look to reassure affected parties, such as the target's workforce, that they are committed to the long-term by turning to options like convertible debt, which also serve to sweeten the deal later on, noted Mayer Brown corporate partner Paul de Bernier.

"There have been more instances where realistic Chinese acquirers realize they are out of their depths or not optimizing value if they come in and buy out a company without being sufficiently mindful of existing U.S. workforce sensitivities and capabilities, in large part because they increasingly appreciate that the human capital doesn't always trust non-U.S. buyers in the long term, particularly in sales of financially challenged targets," he said.

Another factor standing in favor of the smaller stakes largely being bought by financial investors is the fact that private players generally can more quickly and easily access capital, de Bernier said.

And more companies are looking to fund growth while also diversifying risk within their portfolios, according to Stroock & Stroock & Lavan LLP special counsel Anne Salladin.

"The Chinese are interested in diversifying their deal-making in general," she said. "They are interested in using different deal-making structures so as to diversify risk. We’ve seen more complicated and different types of deals in recent years."

Private players taking minority stakes may also have a greater chance at successfully clearing a national security review by the Committee on Foreign Investment in the U.S., a notion that may also motivate more minority plays in the future as the perception of increased scrutiny of Chinese deals is on the rise.

"Obviously you are not allowed to circumvent those requirements, but where a company isn't taking a triggering controlling interest ... the CFIUS risks are lower," de Bernier said.

Another budding area of creativity among Chinese players is in greenfield investments, which are direct foreign investments that see parent companies build new ventures from the ground up in foreign jurisdictions.

North America in 2015 saw 72 greenfield investments from China worth $1 million or more, totaling $2.1 billion, compared to the 58 greenfield deals worth a combined $750 million inked by Chinese buyers in Europe, the study found.

--Editing by Katherine Rautenberg and Catherine Sum.