Paul Hastings

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Are LBOs Coming to China?

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As foreign investors vie for the growing number of promising companies in China, there is mounting interest in access to a broader range of financing options to implement commercial and strategic objectives.

Awareness of the potential of leveraged finance in China was heightened last November when The Carlyle Group announced it would acquire an 85% Stake in Xugong Group Construction Machinery Co Ltd for US$375 million (Rmb3 billion). The transaction is one of many high profile investments being made by international private equity funds in PRC companies, and one of a handful of deals vying for the much-coveted title of "China's first LBO."

Regulatory Hurdles

To date, however, there have been no true US-style LBOs completed in mainland China. This is primarily due to the current PRC legal regime, which impedes the ability of banks and private equity funds to structure highly-leveraged finance transactions in the jurisdiction.

A US-style LBO is premised on high amounts of debt, which is secured by all the assets of the acquired business group. In China, existing secured lending laws do not yet allow lenders to be granted a lien in all the assets of an acquired company, and even for those assets in which a lien may be granted – such as land and buildings – the enforcement process is often uncertain or subject to counterparty consents by government or local officials. Further, certain types of assets are not specifically covered by the PRC's secured lending laws, making it unclear if they can be pledged to banks. It is also not possible for PRC companies to guarantee the debt of offshore entities. The banks therefore lack the required confidence to fund a potential acquirer at a level that would qualify in other markets as a leveraged buyout.

By comparison, in the US, where LBOs are commonplace, the developed legal framework and history of secured lending means banks can apply tried-and-tested models to determine – industry by industry – how much of their loan they will recover as senior creditors.

Another hurdle for such transactions in China is the regulatory process required to obtain leveraged finance. For example, approvals from the State Administration of Foreign Exchange are needed if the loan is denominated in foreign currency.

Meanwhile, high levels of liquidity also account for a scarcity in leveraged finance acquisitions. Historically, Chinese banks have been willing to lend in large sums to borrowers, and at relatively low interest rates. Good financial terms along with a straightforward credit agreement between borrowers and local lenders have made it difficult for foreign banks to compete.

Early Precedents

In addition to Carlyle Group's pending purchase of 85% of Xugong, JP Morgan Partners' acquisition in 2004 of Sanda

What is a leveraged buyout?

A leveraged buyout involves the takeover of a company, or the acquisition of a controlling interest in a company, using a significant amount of borrowed money where the target company's assets often serve as collateral for the borrowed money. It is also non-recourse debt, so the lender assumes most of the risk.

Kan, one of the world's leading hobby train manufacturers, is also commonly cited as a landmark leveraged finance deal and referred to as "China's first LBO".

However, while almost all of Sanda Kan's assets were in China, it was incorporated in Hong Kong and all the debt was raised in Hong Kong under local law. Critics thus dismissed the Sanda Kan transaction as an LBO of a Hong Kong company that had substantial PRC assets and business activities. On the Carlyle-Xugong deal, rival private equity funds have pointed out that the financiers lent money to a Cayman Islands company, which then made shareholder loans to the PRC operating entity.

Plus, in neither the Sanda Kan nor Xugong transactions did the lenders take security over the hard assets of the group that were located in the PRC. That reduced the amount of leverage the sponsors could achieve. Purists thus insist that the title of "China's first LBO" is still up for grabs.

Other transactions competing to be the first LBO in China include the purchase by a Warburg Pincus-led consortium of 55% of Harbin Pharmaceutical, and Pacific Alliance's acquisition of the Goodbaby Group, one of China's leading baby-goods suppliers. Both of these transactions had some – but not all – of the attributes of a US-style LBO, and neither were highly leveraged by international standards.

Beyond the bragging rights, these deals demonstrate an important development in the PRC market: for the first time transactions are starting to be completed in China with more sophisticated financing techniques, which in turn will provide more opportunities to financial sponsors in the future.

Gradual Progress

For investors looking at the possibility of structuring leveraged finance deals in China, there are a number of advantages. For example, PRC tax laws are relatively straightforward, marginal rates are comparatively low and foreign investors are often entitled to tax holidays. In addition, the number of banks competing for mandates has grown considerably, giving extra leverage to borrowers to attract the best financing terms and structures.

At the same time, forthcoming changes to China's banking laws – in particular at the end of 2006 – as part of its World Trade Organization commitments are encouraging for leveraged finance opportunities. As foreign banks are given increasing flexibility and capacity to lend, assuming certain regulatory reforms are made, the prospect for LBOs is likely to increase.

Paul, Hastings, Janofsky & Walker LLP is a global law firm with 1,000 lawyers in 17 offices in Asia, Europe and the US. Paul Hastings has one of the largest, full service, multi-jurisdictional legal practices in China with over 85 lawyers in Beijing, Shanghai and Hong Kong, and 40 lawyers in Tokyo. For further information about leveraged finance in China, please contact:

Our Leveraged Finance Practice in Asia

Paul Hastings' Asia leveraged finance group is headed by partner Brett King who has led the field in advising on acquisition and leveraged finance transactions in Asia. He has represented major financial institutions and strategic and financial sponsors in a variety of acquisition and structured M&A-related finance transactions, including some of the first LBOs to be successfully completed in Hong Kong, Singapore, Japan and Korea. He has advised on a number of landmark transactions including:

- the Sanda Kan LBO, representing the consortium of private equity funds;
- the Mando Corporation LBO, representing the arrangers of financing in connection with the LBO and subsequent recapitalization of Mando Corporation, Korea's largest auto parts manufacturer;
- the Jinro LBO, representing the joint lead arrangers of a multicurrency facility to support a bid for 100% of the shares of Jinro Korea Ltd;
- the Fila LBO, representing the joint coordinating arrangers and a syndicate of Korean and international lenders in connection with a structured credit facility provided to Fila Korea Limited, a distributor of athletic and casual apparel, footwear and accessories under the "FILA" and "FILA Sport" brand names; and
- the Tower Records LBO, representing the lead arrangers in connection with a credit facility extended to finance the LBO of Tower Records KK, the Japanese retail operations of the Tower Records chain of music retail stores.

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