At The M&A Advisor’s 2014 International Financial Forum, Selig Sacks, Partner and Co-Chair of the International Practice at Foley & Lardner LLP moderated a panel of thought leaders in law, finance and entrepreneurship who bring informed opinions on the state of foreign direct investment (FDI) into China as well as outbound direct investment.

The fast-paced session addressed:

- Impact of China’s worst economic slowdown since the 1990s
- Sectors of investor interest and how they have changed
- Early results of the Shanghai Free Trade Zone
- Narrowing of cultural differences between China and the West
- Outlook for Chinese companies seeking to list on U.S. stock exchanges

China is changing and change creates opportunities for both inbound and outbound investing. Facing its worst economic slowdown since the 1990s, China is retooling its economy for more consistent growth. To accomplish these goals, China is actively courting foreign investors, particularly those willing to make greenfield investments. Outbound investing continues to mature with private-companies leading the charge towards diversification.
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EXECUTIVE SUMMARY

Five years ago, discussion about FDI and ODI in China centered on state-owned enterprises investing in energy reserves. Private companies were a small part of the equation and focused almost entirely on real estate investments. Facing its worst economic slowdown since the 1990s, China is retooling its economy for more consistent growth. Programs such as affordable housing, expanded railways and an increased commitment to healthcare are designed to improve quality of life for its citizens and to create consumption. To accomplish these goals, China is actively courting foreign investors, particularly those willing to make greenfield investments. Outbound investing continues to mature. Privately-owned Chinese companies are leading ODI efforts into a range of new industries such as biotech, automotive parts and agriculture and despite several well-publicized corporate scandals, Chinese companies are eager to get listed on U.S. exchanges and win back investor confidence.
Selig Sacks Partner and Co-Chair of the International Practice at Foley & Lardner LLP opened the session with statistics outlining the tremendous modernization in China in recent years while also illustrating how much further the nation can go. “The bad news is China is facing its worst economic slowdown since the 1990s. The good news is that even with that slowdown, JP Morgan thinks that the GDP growth will be 7.2% this year. Bank of Communication and Chinese International Capital Corporation (CICC) see growth at 7.3%. This is still a very robust number. In a recent article, Jim O’Neill of Goldman Sachs noted that even at a 7% growth, [China] provides $1 trillion in global GDP per year.”

“So China clearly is a powerful engine. But things have changed within China itself. In a recent report, JP Morgan noted that: the external demand recovery will not be significant; the pace of growth will be very slow; and the developed countries will overtake the emerging markets as major contributors in the next phase of global growth.”

Sacks went back to statistics commenting, “Income growth for China from 2005 to date is from $2,500 per person to $6,500 per person. Internet users have gone from 100 million to 600 million users over that eight-year period including 450 million mobile devices. English proficiency has risen from 10% to 30%. There’s a whole network of high-speed rail that didn’t exist eight years ago. Consumer spending is estimated to go up 10% annually.”

Transitioning into the first question, Sacks asked the panelists, “Which sectors seem to be of interest to investors and how have those sectors changed? And how have some of the factors in China changed?”

Yuan “Lawrence” Tian, Chairman of CIFCO, brought his entrepreneurial view to the topic. “The health industry is attracting significant interest.” He pointed to the Chinese government’s ambitious plan to increase healthcare spending from $2 trillion to $8 trillion by 2020. In addition, the government has established a policy to encourage development of privately-owned hospitals. “We see opportunity for the whole healthcare chain – hospitals, senior living, healthcare management.”

Sacks pointed to recent transactions where private companies are investing in healthcare. TPG and Fosun acquired Chindex’s United Family Healthcare, a network of private hospitals and clinics, with plans to accelerate their expansion throughout China. Taikang Insurance is building 3,000 bed senior living facilities in Shanghai and in Beijing.

Melanie Chen, Managing Director at UHY LLP, sees China as transitioning from a low-labor cost manufacturing economy to one of self-sustaining consumption. “I agree with Lawrence [Tian] that everything related to quality of life will present great opportunities.”
opportunities: quality of air, environment, health, food and education. When I travel to China I bring two suitcases. One is filled with vitamin supplements from GNC, Vitamin Shoppe and Costco. Those are presents I give to friends. My husband always wonders if my friends are sick. I say no, my friends are all healthy, but they have greater trust in the quality of U.S. products – especially when they are health related. They don’t have confidence in similar products made in China – even if it appears to be same brand.” Ms. Chen went on to describe a client that manufactures vitamins in the U.S., “They were acquired by a group of Chinese investors in 2010. In three years, their sales went from $90 million to $300 million. Their plan is to sell U.S.-made products back to China.” Another client, a helicopter manufacturer acquired in 2012 by a Chinese company, has seen its production double in a year due largely to strong demand from Chinese customers. “High-end consumption will be another significant opportunity for investors,” added Chen.

Sacks commented that China has raised the ceiling for private and commuter aircraft to 10,000 feet, creating more demand for private aircraft. He noted that 12 of the 15 potential buyers who sought to be prequalified in the Hawker-Beechcraft sale were Chinese entities.

Alex Hao is a Partner with Jun He, a leading full-service law firm. He started by discussing the Chinese government’s recently announced mini-stimulus plan which has three prongs: construction of more affordable housing; construction of railways particularly in the western part of China and reduction of taxes on small and medium-sized businesses. Hao noted that this plan is really designed to increase investment in areas that will improve the lives and incomes of the Chinese population. These investment projects have drawn comparisons to the China’s large projects in 2008-2009, which left the country with high debt and related problems. “These are investment projects, but the similarities end there. The affordable housing, improved transportation, these projects will directly benefit people’s lives and will create consumption.”

Hao agreed with previous panelists that investors should look at healthcare and quality of life as potential opportunities and he emphasized any opportunity that leverages the impact of China’s aging population. “Senior housing is both a real estate play and an aging population/healthcare play.” To these opportunities he added themes of urbanization and new energy.

“By 2023, China is expected to overtake the U.S. in GDP,” commented Sacks, “But there is also that question of quality of GDP itself. We should keep in mind in terms of the expanding middle class that on a per capita basis, China is 81st in the world—on par with Namibia and the Dominican Republic at $6,091. Contrast that with the per capita of the U.S. at $51,000.”
Sacks next asked Qing Hong, Deputy General Manager, Industrial and Commercial Bank of China (ICBC), NY Branch about the opportunities in financial services, noting, “There is a disproportionate amount of assets that are concentrated in real estate. Part of that is because there isn’t other financial product or services where people can comfortably and credibly invest. Where do you see the financial services industry headed in China and what is the timeframe for seeing it implemented?”

Mr. Hong commented that, “Greenfield investment is particularly welcomed into China as it creates more jobs.” He believes that areas like education and healthcare are ripe for investment. “I know people are worried about the real estate market in China, but it’s not that bad,” noted Mr. Hong. He explained that bank financial statements in China do not mark-to-market so assets are unlikely to be overstated as we saw in the west. Furthermore, he believes that the move to urbanization and recent relaxation of the one-child-only policy will create sustained demand for new housing.

Sacks moved next to the Shanghai Free Trade Zone (FTZ) launched in September 2013 as part of an experiment to diversify China’s financial services industry. The FTZ introduces a number of reforms to attract foreign investment and to allow investors access to redeploy those assets in the zone. Sacks noted that it will likely take several years for China to develop the infrastructure for mutual funds and rated municipal debt within the FTZ, but the results of this experiment will likely serve as a model for a rollout of broader financial service products to the rest of China.

Alex Hao says his firm is keeping a close eye on the FTZ and “it remains to be seen what impact the FTZ will ultimately have on foreign investment into China.” Hao continued, “In general, there have been high expectations for investments from funds, hedge funds, private equity funds, going into China by going into the FTZ and getting easier access to China proper, but that hasn’t materialized to a large extent.” One challenge with the FTZ, according to Hao, is the so-called “negative list.” The reforms also include a list of industries that receive more relaxed policies in the FTZ, those industries where investment is allowed and those where investment is prohibited (negative list). “The negative list is supposed to be the opposite to the industry catalog, but it is very confusing and some people think that there is 90% overlap between the negative list and the industry catalog.”

Despite these early challenges, Hao is optimistic, “The trend is clear. The Chinese government is trying to create an even more favorable investment environment for foreign investors and we cannot live without continued foreign investment and enthusiasm in China.”

Wrapping up issues related FDI into China, Sacks segued briefly to the topic of shadow banking, which arose in an earlier session. “Shadow banking in China, from the statistics I’ve seen, is estimated at 10% of GDP in 2012, compared with 150% of...”
GDP in the U.S. But shadow banking is an issue that China is going to have to deal with, and regulate and bring into the financial services system."

Moving to outbound investment from China, Sacks pointed to rapid gains in recent years, "In 2013, Chinese outbound direct investment (ODI) in non-financial assets into the U.S. totaled $14.6 billion." Worldwide, Chinese ODI totaled $90.17 billion into some 156 countries or regions and 5,090 different enterprises. Sacks continued, "What I think is key about the U.S. is that you will see the continuing presence and participation of the Sinopec, the CNOOCs of this world in the energy and other sectors. The story here is the private companies and their emergence as a dominant force in investment in the U.S. The largest deal done here last year was Smithfield. The year before it was Wanda’s acquisition of AMC Entertainment. To put it into perspective, 76% of the non-financial investment into the U.S was from private companies. I think we are going to see it in real estate. I think we will see it in healthcare."

Sacks then asked the panelist which areas they believe Chinese investors will find attractive in the U.S. Mr. Tian provided some historic perspective noting, "Five years ago the U.S. saw more M&A of size in the oil and gas space from state owned enterprises. More recently, the money comes from the private sector and focuses on real estate projects such as Fosun buying the Chase Manhattan building and Greenland Group’s investment in Brooklyn’s Atlantic Rail Yards." Tian sees further investment diversification into areas like farming, biotech, automotive parts and shale gas, "Diversification will be the new trend."

Mr. Hong’s firm, ICBC is lending to SOEs (state-owned enterprises), small-to-medium enterprises (SMEs) and even companies that it doesn’t have banking relationships with in China but are considering financing their investments in the U.S. Hong commented, “That is one of the major reasons why ICBC is opening a branch here [in New York] is to facilitate Chinese acquisition and investment here.”

Sacks turned to Ms. Chen to discuss the challenges of cultural differences between China and the West and asked if those differences have narrowed, “Is there a better understanding by the Chinese companies of the rules – whether there is a bankruptcy process or a controlled bidding situation as well?” Chen responded that many challenges remain – particularly from a tax perspective. First, Chinese companies often follow their peers and set up holding companies in Hong Kong or the Caymans – areas where there is not a tax treaty with the U.S. As a result, those holding companies are subject to 30% withholding, whereas they could receive better tax treatment in a different jurisdiction. Second, Chinese investors will often organize as an LLC, but are not automatically treated as a partnership or as an S-Corp in the U.S., unless they file the appropriate paperwork which makes the LLC subject.
to double taxation. Chen commented that better planning can go a long way, “While these structures can be corrected, it takes time and expense.”

Final word went to Alex Hao on the capital markets outlook particularly for Chinese companies outside the TMT space. “The stock market is recovering both here and for the prospects of Chinese companies getting listed here. For the past few years there’s been a freezing of Chinese companies coming to list here and for many that were already here, they got delisted or sued [often on allegations of inappropriate accounting or other business practices]. It was an unfortunate phenomenon. But if you look at the Chinese companies in general, there are many good companies for each bad company. There are probably ten good investment opportunities for each bad company. We are beginning to see more Chinese companies coming here to get listed. And after the fiasco of the past few years, we are all starting to realize that if we all do more due diligence work as investors and as professionals, we are going to weed out the bad ones, keep the good ones and there is going to be a lot of opportunity.”

In summary, China’s role in M&A has made vast strides in recent years and China remains a powerful engine in global GDP. The Chinese are committed to both in-bound and outbound investment and are expected to stay the course despite bureaucratic and corporate missteps. The Chinese government is actively courting FDI in areas such as healthcare and green technology and if those investments are greenfield and create jobs, so much the better. The new Shanghai FTZ has not yet met early expectations due largely to confusion over what types of investments get preferential treatment and which investments are prohibited. Outbound investing continues to mature. Privately-owned Chinese companies are leading ODI efforts into a range of new industries such as biotech, automotive parts and agriculture and despite several well-publicized corporate scandals, Chinese companies are eager to get listed on U.S. exchanges and win back investor confidence.

“If we all do more due diligence..... we are going to weed out the bad ones, keep the good ones and there is going to be a lot of opportunity.”

– Alex Hao
To watch candid interviews with industry stalwarts on the “China By The Numbers - An M&A Market Update” click on the photos below

Alex Hao  
Partner  
Jun He

Yuan “Lawrence” Tian  
Chairman  
CIFCO USA

Melanie Chen  
Managing Director  
UHY Advisors

To watch the “China By The Numbers - An M&A Market Update” Symposium Session click on the photo below
CONTRIBUTOR BIOGRAPHIES

Selig Sacks is a Partner and Co-Chair of the International Practice, Foley & Lardner LLP and Chair of the Business Law Department for the New York office. He is also a member of the firm’s Transactional & Securities, and Private Equity & Venture Capital Practices. He works closely with the industry teams at Foley, including Automotive, Food & Beverage, Health Care and Life Sciences. Mr. Sacks is also a leader of Foley’s Next Generation Manufacturing Initiative. Mr. Sacks focuses his practice on cross-border transactions primarily involving FDI (foreign direct investment) by Chinese and other Asian companies in the U.S. and companies engaged in FDI into China and Asia generally. His clients span a broad cross section of industries and sectors. Mr. Sacks is a frequent speaker at Sino-U.S. and Cross-Border conferences. Mr. Sacks graduated from Stanford Law School where he was executive editor of the Stanford Journal of International Studies. He serves on the Board of Visitors of Stanford Law School. He graduated from Northwestern University with honors and serves on the Northwestern University Regional Leadership Board.

Yuan “Lawrence” Tian is one of the top thinkers, former policy maker and entrepreneurs in China. He is the Chairman of influential “China Entrepreneurs Forum”, the Founder and former Chairman of China International Future Ltd. (CIFCO) - the largest financial company in China's history. A pioneer policy maker for pricing reform in 1980’s, he served as the director for foreign economic collaboration in the 1990s facilitating international business between China and the world. From 1997- 2002, Dr. Tian also led one of the largest government-owned enterprises – China Chengtong Group. In 2011, he won the China Economic Theory Innovation Award, the most prestigious national economic award for his contributions to Doubletrack Price System Reform in 1980s.

Melanie Chen is a Managing Director with UHY LLP and leads the China Group. She directs a variety of services and specializes in tax and business consulting in Mainland China, Hong Kong and Taiwan. For U.S. multinational companies, Ms. Chen advises on complex tax, financial, and operational issues related to doing business in the Greater China Region and on identifying suppliers, manufacturers, licensees and investors in China. Ms. Chen assists China-based U.S. publicly traded companies with U.S. GAAP financial reporting and financial statement preparation in addition to helping Chinese companies with acquisitions and investments in the U.S. Additionally, Ms. Chen is a member of the Management Committee of UHY Advisors NY, Inc. and a former member of the Board of Directors of UHY International, the global organization of UHY-related member firms. Prior to joining UHY, Ms. Chen held positions with Deloitte and EY. Ms. Chen is a licensed attorney in both New York and China. She received degrees from Harvard Law School, University of Florida School of Law and Peking University School of Law.
Qing Hong is Deputy General Manager at Industrial and Commercial Bank of China (ICBC) in New York. Hong has been with ICBC since 1996 and was the bank's Chief Risk Officer in New York before being promoted to his current position in 2012. He was awarded degrees from Fudan University and Zhejiang University.