

A conversation with...

Feng Xue of Katten Muchin Rosenman



Feng Xue
Katten Muchin
Rosenman

Over the past several months, The M&A Journal has spoken several times with Feng Xue, the chairman of Katten Muchin Rosenman's Asia/China practice. Mr. Xue concentrates on private equity, mergers and acquisitions, securities regulations, and general corporate transactions, with an emphasis on China-related investment transactions. Mr. Xue has worked with major international law firms in Chicago, Shanghai, and Beijing, and has extensive experience in a wide variety of the legal issues that affect investing in China.

Our first interview with Mr. Xue was conducted in the late fall—and the second in early winter. It is interesting to compare the substance and tone of our two conversations—in many ways, they serve as a barometer of the international M&A climate in early 2009.

Tell us about your background.

Before I attended law school in the U.S., I was a Chinese lawyer who worked for the Chinese government and the Chinese Congress for four years. Now, I have spent the past several years working on China deals—either from the U.S. offices or from the Chinese offices of international law firms. Between 2002 and 2005, I was based in China and then came back to Chicago. And I still focus most, if not all of my time on China transactions. The focus of my practice is mergers and acquisitions and private equity transactions between China and the U.S.

Increasingly, I am working with a lot of inbound Chinese investments—Chinese investments coming into the U.S. In the past, all the work that I did was representing U.S. and European investors and multinational companies interested in doing business in China. But recently I have been getting more and more work from inbound Chinese investments into the U.S.

Let's back up and track historically the movement of Chinese investments into the U.S. What has been some of the attraction for chinese investors?

Needless to say, this is a very interesting area of discussion, given the general environment of the credit crunch and the U.S. economy. In my work, in terms of Chinese companies

coming into the U.S., this is actually a relatively bright spot in the current environment. As I said, we have had more and more engagements from inbound Chinese investors into the U.S. There are different reasons. Number one, the Chinese currency is appreciating dramatically over the U.S. dollar. That means that buying U.S. companies becomes much cheaper for Chinese companies. Not only the private companies, but the public companies, as well, have become very good deals for Chinese companies. This is especially true with those small and middle market companies that are struggling with financial troubles.

So there might be distressed sales?

Exactly. Some companies might sell at a very cheap price. I have been working on one transaction, in which the company has good potential, but they need cash. Situations like that are attracting a lot of Chinese companies. And it also has something to do with the credit crunch. When a Chinese company comes to the U.S. to buy a U.S. company, in the old days they were competing with private equity investors in the U.S. who are very aggressive. They know the market very well, and they will buy interests in U.S. companies and turn them around.

But now because of the credit crunch, the private equity market in the U.S. is not as active as it used to be. And that has created something of a vacuum for the U.S. companies that are in dire need of financing. So that means less competition from the perspective of the Chinese companies. Historically, Chinese companies have been manufacturing and sending production into the U.S. through U.S.-based distribution firms. However, Chinese manufacturers realized that a lot of profit was actually earned by the middlemen, the U.S. distribution firms.

And on top of that, Chinese exports are having big problems now because of the rising costs and the disappearance of government subsidies for exports. So the Chinese manufacturers are having trouble continuing with their old way of doing business—*i.e.* manufacturing and then selling through U.S. middlemen. And so now they are thinking instead of doing that, why

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don't we go into the U.S. and acquire the distribution firms. And turn the distribution firm into my own distribution arm. Distribution firms in the U.S. are traditionally not very large. They are family-owned, maybe have 20-30 employees, so it doesn't cost a lot of money to buy them. We have been doing a lot of work for Chinese companies interested in buying their distributors.

So if I am a Chinese exporter, in this current climate I might be interested in buying the actual entity that has been distributing my materials into the U.S.

That's right. This issue has become more compelling, given the U.S. economy. A lot of distributors are in big trouble now. Not too long ago, I gave a talk to the Chinese Consulate in Chicago about aiding Chinese companies here. The Consulate people told me that they actually got calls on a daily basis from Chinese companies based in China asking for referrals or guidance as to possible acquisition targets in the U.S. Europe is also in trouble. There have been reports of some 30,000 small companies in Europe up for sale to be purchased by Chinese companies.

When I was based in Shanghai, I was Lenovo's chief counsel in doing the IBM PC purchase. I was the leading counsel when Lenovo purchased the PC business from IBM. That was the biggest completed acquisition by a Chinese company overseas. But there were a lot of smaller transactions—\$5 million to \$20 million, smaller transactions that were under the radar. And we will see an increasing amount of that kind of transaction in the coming years. In this overall depressed M&A market, that is a relatively bright spot in my practice. That is for now. Nobody knows what is going to happen tomorrow. Eventually I think that the financial trouble will affect the Chinese market. U.S. investment in China has been affected. And I have seen a couple of deals put on hold.

So you think that you are going to see more of this activity from Chinese companies coming in.

Yes. When you talk about cross-border M&A between China and the U.S., on the one side it is U.S. investors going to China, and then, on the other side there are the Chinese companies coming into the U.S. to buy U.S. companies. So the second part, Chinese companies coming into the U.S. buying U.S. companies, has not been as negatively affected. In fact, I think we will see more.

This is, I gather, in part because of decreased competition from U.S. companies, correct?

Right. And on the other side, the trend of U.S. companies going to China to purchase companies has been affected, as well—especially in the leveraged buyout practice. I have a couple of deals that have been put on hold because of financial issues. People are just more cautious and more restrained in terms of their financing capacities.

We still see deals getting done in China—just different types of deals. For example, I do a lot of work on transactions for U.S. investors in China, but that type of deal is more like a committed equity investment—not a leveraged buyout. So we are still seeing deals done—but not in the area of leveraged buyouts.

In addition, because of the credit crunch, the Chinese stock market has been hit and the valuation of Chinese target companies has gone down substantially. The valuations have gone down to a more reasonable level, and that has made acquisitions much easier. That is a positive thing. There is another point that I want to make. Not long ago, I went to a conference in China, and people were talking about the affect of the U.S. financial crisis on China. And one point about which people seemed hopeful is that Chinese companies are getting more attention from U.S. investors. It's natural, because people still have to invest and make money. And the alternatives in the U.S. are not as attractive as they used to be, so they are looking for more lucrative and promising high-growth deals in China. And they are not only looking at the fancy, high-tech or media industries. They are also looking at more traditional industries like manufacturing. I think that they are more realistic about the Chinese market. For example, anything that has to do with construction in China is very promising.

You are talking about when you are representing an American company looking to go into China.

That's right.

So we are seeing different signals pointing to different directions. I think that for Chinese companies going into the US, I am confident that that amount of business and those kinds of transactions will increase. For U.S. private equity funds and manufacturers, multi-national companies going into China to do acquisitions, I am not as certain. There are both positive and negative indications.

Can we talk a little bit more about the kinds of companies that are in play in the U.S., i.e., U.S. companies that are in play for a Chinese acquiror?

As we touched on a little earlier, basically Chinese manufacturers are looking for distribution channels in the U.S. I think that in the next few years we will see Chinese companies coming to the U.S. to acquire their distributors.

It is much cheaper to manufacture in China.

Yes. But there are some exceptions. I have a client that is a fairly sophisticated medical device manufacturer in China. Instead of being labor intensive, that business is actually very technologically intensive. There are only a few manufacturers of that in the whole world and my client's price is much cheaper than European manufacturers. The problem is that they have to mark the products as "Made in China" and "Made in China" has a very derogatory meaning in that market. So we have a big problem selling the product outside the China market, so what we want to do is this: Because it is not labor intensive but technologically intensive, we can acquire a U.S. manufacturer, then move the entire company to the U.S. and then start manufacturing in the U.S. And then they can

call themselves “Made in the U.S.” Because technology is the most important part, not labor. So that way they will be able to do very well in the U.S. and European markets.

So companies like that want to get away from the “Made in China” designation.

That is right. Different Chinese companies have different strategies.

One strategy is to buy the distribution arms and another strategy is to actually have it so that it is made in the U.S. You are therefore talking about buying manufacturing plants in the U.S.?

Yes.

In the latter case, the idea is that the product won’t have that “Made in China” stigma attached to it.

That’s right. Chinese companies have become smarter. They are starting to follow the Japanese model. They are realizing that if I want to do business in the U.S., I have to behave like a U.S. company—like Toyota and Honda. So they are setting up plants in the U.S.

Let’s talk about that a little more. You think that the new wave of Chinese acquirors is going to involve more strategic thinking.

Yes, for the really large companies. So we are going to see action in that area, too.

I would imagine that you expect to see more distressed sales here in the U.S. as well.

Absolutely. Because of the economy and the market, a lot of U.S. companies are becoming distressed and basically they will put up some sort of a fire sale. Chinese companies are going to be very interested. They see this as a good opportunity for them to branch out into the U.S. Some Chinese companies have been looking to the U.S. for a while. Between 2005 and 2007, I actually represented quite a few Chinese companies looking to come into the U.S. for opportunities. But very few deals were completed, because when a Chinese company comes into the U.S., the mentality is “We are looking for bargains.” But for the U.S. companies that are trying to sell, their thinking is, “We have got this buyer from China and if my company is worth \$5, I should ask for \$10.” Think about what the Japanese did a few years ago, they overpaid for everything, so that spoiled the mentality of the U.S. sellers.

Let’s say that the real market price of the company is \$10. A Chinese company would think “I’m going to buy this for \$5, for a bargain”, but a U.S. company would think, “I’ve got this rich buyer from the Far East, I’m going to sell for \$15.”

So there is a disconnect here.

Yes, there is often a huge difference between the asking price and the offering price. I can give you some rough statistics. I think that in 2006 I represented about 20 Chinese buyers in negotiations and transactions in the U.S. and only one deal was closed. Most of the transactions were stopped at the valuations, the pricing.

Do you think it is a cultural thing?

It is a cultural thing. And also I think that both sides have misunderstandings and some other issues. Chinese companies are thinking, “I’m coming to the U.S. for a bargain. And the U.S. companies think that “I’ve got this company from the Far East and I can ask for a big price.”

However, the current market has changed, because a lot of U.S. sellers are distressed. They have to sell. They have to get a buyer or a partner to buy it. So they are more realistic in terms of their bottom-line price. They are more eager to negotiate. As I said, the Chinese companies are coming to the U.S. and looking at different options. Consequently, in China—in the media and at conferences—there are a lot of discussions about whether Chinese companies should come to the U.S. and buy U.S. companies and take advantage of this financial crisis. This time of financial difficulty in the U.S. is an opportunity for them to come into the U.S. and establish their operations in the U.S. As I said, I think we are going to see a lot of activities in the U.S. in that regard.

To sum it up, it is a confluence of events. It’s the credit crisis here that will lead to companies being unable to demand the higher prices that they were demanding even two year ago, correct?

That’s right. And there is also pressure on the Chinese side. As I said, the export business is not doing well. So, basically, they have to come to the U.S. to continue the manufacturing and build their business. So there is pressure on both sides.

So what you’re saying is that there will be more M&A activity between China and the U.S.

That is correct.

But the size of the deals may be different. There may be more middle market deals.

That has something to do with the culture. Chinese companies are more provincial; they are not as experienced in international transactions. They tend to be more timid in the beginning, and they also tend to be very conservative. Basically, they tend to establish outposts in the U.S. to get a familiarity with the U.S. as a first step. All of the Chinese companies I spoke to expressed the concern that they don’t have the experience, they don’t have the knowledge of operating internationally. So they want to spend a small amount of money, come into the U.S., get familiar with the market and then plan out the next step.

So they move slowly.

That is right.

They have to get their feet wet.

Yes, if you look at the history of China, Chinese companies are very different from Japanese companies. Japanese companies are more experienced in international transactions. The economy and regulatory systems in Japan are not very different from the U.S. and Europe. But China is very different. Most Chinese companies are very unfamiliar with the standard western-style regula-

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tory system. They are not as experienced in this regard as the Japanese companies.

So they are going to move a little more slowly.

That is right.

Do you think that's changing?

That could be changing, but slowly. I would not expect them to make a big noise in the U.S. Most of the Chinese companies in the U.S. are very low profile. They want to make money, but they don't want to be too vocal, too active. This definitely will change in a year or two. But in the beginning, they will be more cautious and timid. They will try to keep their head down and study the market.

Let's talk specifically about some of the more interesting deals that you have been working on in recent years.

Well, I mentioned the medical device manufacturer. That is a very interesting example, because that is one where they wanted to move and be headquartered in the US and basically turn themselves into a U.S. company

There are other examples that I can give you. I represented an auto parts manufacturer in China. They manufactured clutches—and they had the biggest market share in China. They are distributed into the U.S. through a U.S. company. In the first few years they were happy with the small amount of profits that they made, but then they realized that the distributors were actually making more money out of their product than they were. So when they were squeezed in terms of the profit, they started to look at the production chain. In their minds, they are thinking that the distributors are making more profit than they we are. So they decided that they wanted to buy out the distributor. And that is what they did. And so far this is a successful story. They have been doing well.

I have been working on a transaction that involves a very large truck company in the U.S. looking to enter the Chinese market. The Chinese market doesn't have huge long-haul trucks—the trucks in China are relatively small. But now because China has better roads and basically highways now, it is possible that U.S. long-haul trucks could be used in China. As a result, our client has been negotiating a joint venture in China to manufacture huge long-haul trucks in China.

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When we spoke several months ago, there were Chinese companies that were thinking about coming into the U.S. in order to take advantage of the fact that they would face less competition from private equity companies. At the same time, some Chinese companies were thinking that it might be wise to acquire the U.S. distribution arms of their companies. Let's talk about what has changed—or hasn't changed—since we last spoke.

When we spoke last time, the economy in the U.S. was slow-

ing down and running into a recession, but at that time the Chinese economy had slowed down a little bit, but wasn't in a serious condition. So at that time everybody in China was very optimistic. When I traveled back to China people there were telling me, "Oh you guys in the U.S. are in trouble, but we are fine here. Don't worry about the Chinese economy." But it quickly turned out that the U.S. is not alone. It became much more global and China was affected. So by December, I spent a decent amount of time in China, and people had gotten very nervous. A lot of Chinese manufacturing companies are laying off people and closing down plants, especially in the export business.

So some of the acquisitions that I was working on were put on hold. Much of this is psychological. People become insecure, they don't know what will happen, so they say let's wait for a couple of months to see what will happen. The fundamentals are still there—they still want to do the deal but, given the uncertainties, they decide to wait for a while. So in December a couple of the deals that I was working on were put on hold.

But then starting from January, I think the Chinese companies decided that it still made sense for them to make investments in the U.S. Consequently, the deals started moving forward again. So people took a month to assess the situation: How bad was it in the U.S.? Did it still made sense to invest in the U.S.? And now I have gotten instructions from clients that we can move forward again. This all because of the price—the valuations.

So they can get some good deals and going forward as well.

Absolutely. They are not expecting to make money this year. What they want to do is—given that the prices are so low—negotiate a very good acquisition price, make the investment and wait for the economy to recover. That is basically their strategy.

When I was in China last fall, everybody was saying, "Well, you guys in the U.S. are in trouble, but we're fine here. Everything will be fine here. China has a big market, so don't worry about that." But the tone completely changed when I went back to China in December. It was almost like everybody got the same memo on the same day, so everybody got panicked.

But then, after the Chinese New Year, which is Jan. 25-26th, Chinese companies started to look around and realize that some of the transactions were worth pursuing, especially given the U.S. stimulus plan, so they want to move forward again. For example, the Chinese computer manufacturer Lenovo recently made a small acquisition in California. And earlier this year there were a couple of other smaller transactions. And also some of the Chinese car manufacturers are thinking about buying the Volvo brand. Obviously, they have to get financial support from the Chinese government to do the deals, but they are actively considering this. I went to Detroit in the beginning of February to meet with a couple of the Chinese representatives to talk about their interest in the U.S. auto industry. The event, which was put together by several Chinese companies, was called "Revitalize the Detroit Region." It is an event put

together by some Chinese companies. There are actually about 70 or 80 Chinese companies that have already set up subsidiaries or representative offices in the Detroit area.

That's interesting. That touches on something that we talked about last time—and that is that the Chinese more and more are adopting the Japanese model of doing business in this country—actually coming into the U.S. with production plants based here.

Yes. Not just manufacturing in China and shipping to the U.S. Instead, they are going to invest in the U.S. and manufacture in the U.S. They see that, to them, the profit margins in the U.S. still make a lot of sense. In China, the margins in the automotive industry are very thin—much smaller than in the U.S. So they are thinking that money is money, and if we put money into the U.S., we will receive bigger profits. They see the U.S. as a very profitable market and they want to come here and make money. For smaller acquisitions, it is really capitalism in action.

Well, look what happened to retail sales in this country at the end of the year.

Well, retail sales in China are still booming. Fundamentally, there isn't much of a problem with the Chinese economy itself. The banks are very safe. And retail is still doing fine. Real estate is doing fine—not exciting but doing fine. And the government is spending billions of dollars to build up the infrastructure. So the Chinese economy itself is doing fine. I think that it is more a psychological or global thing. And, of course, the exporters and the manufacturers have been hit pretty hard, because the orders suddenly disappeared.

From companies in this country?

Right. Interesting in December, the Chinese government issued a warning to all the Chinese manufacturers about the credit risk of U.S. buyers. And a lot of Chinese clients called me. Because, on the one hand, some of the orders simply disappeared. The U.S. buyers stopped buying. For the U.S. companies that are still buying in China, when the Chinese companies received the orders, they become very sensitive as to whether the U.S. buyer would have the money to pay. So this started to slow down the process. Previously Chinese companies could start the manufacturing process without getting a penny from the U.S. buyer, because when they shipped the product, within thirty days they would receive payment from the U.S. company. Now, because they are not sure whether or not the U.S. company will be able to pay, they are requesting that the U.S. buyer give a 15% down payment before the Chinese company will even start production.

So it is a very complicated situation. On the one hand, some companies just don't get any orders at all. On the other hand, companies that do get orders from the U.S. buyers become very reluctant to finish the transaction immediately because they are afraid that they won't get paid.

They are afraid that the U.S. company won't get the financing it needs to continue to do business.

Right. It is actually a nationwide thing, because the Chinese Minister of Commerce issued a warning to Chinese manufacturers asking them to check the credit of their U.S. partners. That has never been a problem in previous years.

Things are very different in China. We heard that during the Chinese New Year (at the end of January), people actually spent 28% or more on fireworks than they did last year. The restaurants are all crammed, and people are still spending. That is the good thing about the Chinese economy.

But, on the other hand, of course, export-driven manufacturing activities have been hurt. Although it looks like they have not been hurt as badly as we have here. People are projecting that the Chinese economy will pick up earlier than the U.S. Based on what I have heard from economists, government agencies and scholars, the growth rates for China in 2009 is projected to be about 8%-9%. That is a bad number for China, but that sounds decent compared to the U.S. China's economic growth rate last year was 14%. So there has been a slow down, but compared with the U.S., a growth rate of 8%-9% is still very attractive.

And that touches upon another part of our practice here. I also work with U.S. private equity funds and U.S. companies in doing deals in China. And, based on the deal flow that I've seen, people are still working on deals. I haven't closed a single deal since December, but I think that people are still sending representatives to China for negotiations. The deal flow will reduce a little bit, but I think that the interest is still there. On one occasion, I was working with a very large Fortune 500 company interested in doing a large joint venture in China. Originally, the deal size was an investment of \$80 million. Now I have heard from the Board that they want to cut back a little bit and make a smaller investment. They see that manufacturing products in China for the Chinese market is a positive thing for 2009-2010, because sales numbers in the U.S. have gone down so dramatically.

Let's revisit the interest that U.S. companies have in going into China to do deals. There is probably less of that than there is interest on the part of Chinese companies moving into the U.S. It's there, but a bit skittish, or on hold.

That is right. I work with a lot of U.S. private equity clients. And I have been working with some of these clients for five or six years. Normally they would do ten to twelve deals a year, but now—say, from November to January—they basically have been sitting there and waiting. They don't have the green light to make any investments in China. So they are basically sitting around with nothing to do.

Well, let me clarify that. Private equity funds that have been active in China for years—they may have five or six companies that they can manage, so that they have something to do. But for new PE funds that have come into China, they have nothing to do. They haven't made any investments. And they can't make any investments.

But for the Chinese companies, I think that this is a situation that makes them try to think outside the box and come to explore the U.S. markets—especially given the devaluation of the U.S. companies.

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So they would really like to look into the possibility of coming to the U.S. and acquiring U.S. companies.

Because they can get the bargains.

That is right.

Take the temperature of the deal market now.

I am in the transactional business, of course, and I have spoken to many partners in different law firms. And I think that many people are in a panic, and they just don't want to do anything now. They are just watching to see what happens. But I think that after things get stabilized, we will see a small amount of transactions. But for now—for example, in my practice a lot of deals are being discussed and people are still talking cautiously. But you won't see a lot of closings or big mergers and acquisitions in the next few months. It is more like people are still working and talking and negotiating deals, but tentatively.

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