The U.S. and China Start an M&A Cold War

After the failed Unocal bid, deals between American and Chinese companies have fallen off a cliff.

BY PARITOSH BANSAL, SOYOUNG KIM AND BENJAMIN LIM
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Zhang Guobao didn’t mince words. More than 18 months after U.S. lawmakers killed an attempt by China National Offshore Oil Corp to buy Unocal in 2005, the senior Chinese official gave the American ambassador a piece of his mind.

“If the United States would not allow CNOOC to purchase Unocal, will not itself guarantee China a steady energy supply and opposes Chinese purchases of Iranian oil and gas, how can China survive?” he asked, according to a summary of his comments in a U.S. diplomatic cable obtained by WikiLeaks and made available to Reuters by a third party.

The decision to block the purchase of the California oil company “will have many after effects,” Zhang said in the February 2007 meeting with Clark Randt, then U.S. ambassador to China.

His warning was worth heeding. Ever since strident political opposition killed the $18.5 billion Unocal deal on the grounds that it could damage U.S. national security, deal making between the world’s two largest economies has been in limbo.
A series of planned acquisitions have died in the hands of bureaucrats or politicians in Beijing and Washington, and other ideas haven't seen the light of day because of fear they will also be blocked.

Last year, U.S. companies in China struck dozens of small deals but they were collectively worth just $3.2 billion, while Chinese companies spent only $3 billion on U.S. acquisitions, Thomson Reuters data shows. That is a remarkably trivial amount given the two nation's deepening economic relations: China is one of America's top creditors and the U.S. is by far China's largest export market.

Last week, China's biggest metals trading firm, Minmetals Resources, said it had offered more than all those deals put together -- $6.5 billion -- to buy one company, but it wasn't American. It was the Sydney and Toronto-listed African copper producer Equinox Minerals.

All told, Chinese companies made larger investments in countries such as Brazil and...
Argentina last year than they did in the United States.

The optimism that led to deals such as the acquisition by China’s Lenovo Group of IBM’s ThinkPad PC unit in May 2005, despite questions from U.S. regulators, seems very distant now. What has emerged instead can be likened to an M&A Cold War.

And it’s not just bankers who are suffering. The lack of dealmaking could prevent the two countries from shifting to a more mature relationship that doesn’t just depend on Americans buying massive amounts of cheap Chinese goods and the Chinese buying American debt to fund a huge U.S. budget deficit.

The Cold War will also likely hamper U.S. companies as they try to penetrate the fast-growing Chinese market.

For its part, China is missing out on not just unfettered access to the American consumer market but the chance to pick up global brand names, technology and management expertise.

The diplomatic cables reviewed by Reuters underscore Beijing’s growing frustration with the situation.

Zhang, who recently stepped down as China’s top energy official and was at the time of the cable a vice chairman at the powerful ministry-level planning body, the National Development and Reform Commission (NDRC), had taken the CNOOC rejection personally, in the view of U.S. officials. He had approved the energy company’s bid for Unocal after being told by consultants in the United States that there wouldn’t be any problems, the cable indicates.

This was no ordinary Chinese technocrat who had been snubbed. A self-described humorous raconteur, he told the ambassador he would often walk out of meetings early after having his say, or if he felt forced to stay he would write poetry rather than take notes. “Zhang, who clearly relishes his reputation for success, would appear to still feel the sting of that very public failure,” the cable concluded.

Such bitterness is shared among a lot of those involved in thwarted deals who appear in dozens of U.S. diplomatic cables written between 2006 and 2010 and recently reviewed by Reuters. The pattern has begun to resemble Mutually Assured Deals Destruction -- that is, each time a deal gets killed it seems to have repercussions for the next.

Some of the sources who provided information to U.S. diplomats have not been fully identified in this report for their own protection.

BEATEN TO A PULP

CHINA HAD ITS TURN in 2008, when Coca-Cola Co made a $2.4 billion bid for Chinese juice maker Huiyuan.

Initially, the soft drinks behemoth was confident there would be no major problems. After all, it had the backing of Huiyuan’s largest shareholders, had offered a 200 percent premium and the fruit drink business was officially listed as a sector where foreign investment was encouraged. It even thought
a new anti-monopoly law in China would work in its favor.

Coke had heard informally that the Ministry of Commerce planned to take a "market-based view" of the bid, Coca-Cola Pacific Deputy Group President Paul Etchells told U.S. officials in a Sept. 17, 2008 meeting.

Coke didn’t see the need to lobby senior Chinese government officials. “It was so obviously not a national security issue,” was Etchells’ view.

But U.S. embassy officials saw problems with that view stemming from the M&A Cold War -- as well as Coke’s ignorance. They noted in a cable at the time that Coca-Cola “troublingly was unaware” whether the Ministry of Commerce would consider just the anti-monopoly law for its competitive effects or also look for its impact under regulations that govern takeovers of famous Chinese brands and transactions that impact China’s "national economic security."

“Coca-Cola may not fully appreciate the range of problems the proposed transaction could encounter,” U.S. officials concluded.

On March 18, 2009, the deal was officially dead, rejected by the Ministry of Commerce, which cited competition concerns. The headline of the cable from the embassy got straight to the point -- “Coca-Cola’s bid for juice maker Huiyuan beaten to a pulp.”

Later a senior Chinese foreign policy scholar told U.S. officials the decision to reject the bid was motivated by concerns about domestic food security as well as popular opinion that saw the sale of a well-known Chinese brand as a matter of national pride.

Coca-Cola said last week that it was “disappointed that we did not succeed in obtaining approval for the acquisition of the
Huiyuan juice business, but we respect the Ministry's decision. We are now focused on the growth of our existing brands, including in the juice segment.

**POLITICAL FOOTBALL**

**IN OCTOBER 2005,** just months after the Unocal bid was foiled, U.S. private equity giant Carlyle Group proposed to buy an 85 percent stake in Xugong Group Construction Machinery Co.

The buyout shop first ran into "pushback from bureaucratic interests" and had to revise its offer down to buying a minority stake, but after three years of wrangling it abandoned the bid, according to the cables.

In a June 21, 2007 cable, a Shanghai consulate official quotes a well-connected Chinese businessman as laying the blame on bureaucratic infighting between officials at the Ministry of Commerce and the NDRC.

The ministry had recommended approving the bid to the State Council. A series of other government agencies, including the China Securities Regulatory Commission, also supported it, the businessman told U.S. officials.

But the NDRC threw a spanner in the works, arguing that it should be the entity responsible for approving the bid rather than the Ministry of Commerce. And it forced Carlyle and Xugong back to the negotiating table over the ministry's objections, the cable said.

"Carlyle was tired of being punted around like a political football while the ministries fought over who had control of the deal and the investment approval process generally," the businessman said.

Adding to the intrigue, one source with knowledge of the deal told Reuters recently the deal fell apart because privately owned domestic rival Sany heavy Industry Co had "fanned the flames of anti-foreign sentiment" because it too had its eyes on Xugong. Sany's bid also failed after being rejected by Xugong.

"China welcomes private equity capital and is a great market for Carlyle," the private

**NOT THE RIGHT TECH:** Tengzhong’s bid for Hummer did not qualify for China’s "technology transfer" regulations. The company’s workshop in Deyang, Sichuan province, June 3, 2009. **REUTERS/CHINA DAILY**
equity firm’s spokesman Christopher Ullman said. “We’ve invested more than $3 billion in equity in 50 transactions and are firmly committed to investing for the long-term in China.”

NDRC and Ministry of Commerce did not respond to a request for comment for this article.

Sometimes, it is Beijing itself that has killed bids for American companies by Chinese companies.

In June 2009, a little-known Chinese maker of special-use vehicles and bridge and highway components, Sichuan Tengzhong Heavy Industrial Machinery, emerged as the surprise bidder for General Motors’ Hummer brand.

The only problem -- for the Chinese government it was the wrong deal at the wrong time by the wrong company. Acquiring and then producing a brand built on macho, gas-guzzling vehicles flew in the face of Beijing’s push for greener and cleaner technologies.

Eight months later, the proposed takeover collapsed.

Hummer’s Detroit-based government affairs representative Wei Shen told U.S. embassy officials days before the deal fell apart that the Ministry of Commerce determined the transaction did not qualify for China’s “technology transfer” regulations and refused to accept the application.

Other forces appear to have been at play as well. A vice minister opposed the transaction because of his connections to Chinese automaker Dongfeng Motor Corp, which produced a rival product to Hummer, according to one cable.

Hummer’s Shen also said there was some “bad blood” between Tengzhong and officials in its home province of Sichuan in southwest China that might have hampered the proposal.

GM declined to comment for this article. Sichuan Tengzhong did not respond to a request for comment.

**MILITARY THREAT**

**THE CHINESE AREN’T FARING any better in the United States.**

In Washington, it is often fear of China’s increasing military strength that gets lawmakers and top government officials to agitate against deals.

Perhaps the biggest victim of this has been China’s telecommunications equipment company Huawei Technologies Co [HWT. UL], which competes with the likes of Cisco Systems and is one of the few Chinese companies that has built a truly global brand name.

Huawei’s first public setback came in March 2008, when U.S. private equity firm Bain Capital broke off a joint bid for U.S. network equipment maker 3Com Corp because the U.S. government’s Committee on Foreign Investment in the United States (CFIUS) had said it would block the $2.2 billion deal.

Several U.S. lawmakers complained the transaction, which would have given Huawei up to 21.5 percent of 3Com, threatened national security due to Huawei’s alleged ties to the Chinese military and given that 3Com sold security technology and network equipment to U.S. government agencies as well as businesses.

Huawei has maintained that it is a private company owned by employees, but acknowledges that founder Ren Zhengfei was once in the People’s Liberation Army. Just a few days before the bid was abandoned, Ren met U.S. officials in China and denied claims that either Huawei or he had close ties to the...
Chinese government or the nation's military.

"Ren complained that neither the U.S. nor the Chinese Government trusted Huawei," the cable from the Guangzhou consulate reads, adding that he said Huawei has had to slow its expansion plans on more than one occasion as a result.

The company's status shows little sign of improving. Indeed, it was thwarted earlier this year in the bid it launched last May to buy tiny Santa Clara, California-based server technology firm 3Leaf for $2 million. After completing its review of the deal, CFIUS suggested in February that Huawei should sell off the assets.

Huawei has also lost out on at least one telecom contract in the U.S. on the same grounds.

The company gave up on the 3Leaf deal but this time it has challenged the United States to launch a formal investigation so that it can try to clear its name. And last week as it opened a new R&D facility in Silicon Valley it expressed hope that its U.S. government relations were improving.

Ratcheting up the tension, Beijing on Feb. 21 complained formally that Washington was blocking Chinese investment in U.S. companies.

"The U.S. side has used all kinds of excuses, including national security, to engage in obstruction and interference in the trade and investment activities of Chinese businesses in the U.S.," the Ministry of Commerce said.

"To some extent, this obstruction and interference is affecting China-U.S. trade and economic cooperation," the ministry cautioned.

POLITICAL RISK
IT'S NOT JUST MILITARY QUESTIONS that up-end deals.

China's sovereign wealth fund, China Investment Corp [CIC.UK], was prepared to pump billions of dollars of new capital into Morgan Stanley to raise its stake to 49 percent from almost 10 percent at the height of the financial crisis in 2008 when the investment bank was fighting for its survival.

But the deal was nixed. And Chinese officials came away believing the worst.

Reports circulating in Beijing suggested that U.S. Treasury Secretary Timothy Geithner, who was then the president of the Federal Reserve Bank of New York, had stepped in to block it because he did not want to have "funny money" own nearly half of one of America's biggest and best-known investment banks, Charles Liu, a well-connected executive of a Chinese private equity firm, told U.S. embassy officials.

Liu said CIC Chairman Lou Jiwei had become very cautious about further investments in U.S. financial businesses, in part because of what "he regards as the hostile regulatory environment to Chinese investment in that sector," according to one cable from February 2009.

CIC did not respond to a request for comment. A Treasury official said the assertion that Geithner stepped in to kill the CIC-Morgan Stanley deal was "nonsense" and that the Treasury secretary never expressed such an opinion.

For the Chinese, the lack of transparency in reviews by CFIUS and its secretive nature are tough to cope with.

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The committee, which is led by the treasury secretary and includes the head of the Department of Homeland Security, reviews cross-border deals for their impact on national security, but almost never comments on deals that come before it until a decision is made. That makes it difficult for companies and their lobbyists to handle any misperceptions.

And none of this is getting any easier.

Indeed, the Chinese seem to be aping some of the more questionable parts of the American system. In March, Beijing launched a state-level investment review body to ensure deals involving foreign firms do not endanger national security, installing a new red-tape barrier for doing business in China.

Even before this came in, some U.S. companies had found creative ways to structure deals to avoid regulatory headaches.

Eric Zhang, a Carlyle executive, told embassy officials the private equity giant only files anti-monopoly paperwork when specifically told to by Chinese regulators, despite being encouraged to file for every investment, according to a Dec. 2009 cable.

"It just causes too many headaches and we'd never get anything approved," the executive said.

Some of the resistance to U.S. acquisitions may lie in an increase in patriotic sensibilities in China.

The cables show, for example, that a speech then U.S. Treasury Secretary Hank Paulson gave at the Shanghai Futures Exchange in March 2007 didn't go down well
with everyone in the audience.

A top Shanghai financial department official, Fang Xinghai, admonished Paulson for his assertion that he had never seen a successful joint venture securities firm. This was seen as a “direct attack” on the Chinese model that had allowed Goldman Sachs to set up the joint venture when Paulson was CEO of the Wall Street firm.

In a meeting with the Shanghai consul general, Fang was also reported as saying: “Some Chinese officials questioned the tone of Secretary Paulson’s remarks, noting that he had spoken ‘very directly’ and ‘was telling us what to do.’”

“It had caused some in the audience to react in a ‘nationalistic’ or defensive manner,” Fang and Shanghai Futures Exchange CEO Yang Maijun were reported in a cable as concluding.

Such nationalistic sentiments got a boost after the financial crisis. Some financial services and private equity executives cited in one Feb. 2010 cable from Hong Kong pointed to “China’s rising assertiveness in light of the country’s continued growth and positive role in the global recovery.”

“Although the U.S. still had considerable influence in the region, security reviews that made it difficult for some travelers to obtain U.S. visas and high profile CFIUS-related cases had damaged America’s reputation in Asia for openness,” one executive said in the cable. “Following the financial crisis, Asians’ tolerance for being lectured by the West had markedly declined.”

Of course, not every deal gets shot down.

Late last year, state-owned China Huaneng Group Corp agreed to buy a 50 percent stake in Burlington-based electric utility InterGen for $1.2 billion in cash. CNOOC came back to the United States in recent months as well with joint venture investments in Chesapeake Energy Corp shale projects.

Last week, executives from CNOOC and Huawei were on a charm offensive on the U.S. West Coast.

CNOOC Chairman Chengyu Fu said in Los Angeles the atmosphere for foreign investments in the United States was welcoming and it planned to make more through partnerships, while Huawei U.S. division group chief technology officer Matt Bross said that after the 3Leaf deal disappointment, more formal channels had been created between the company and the U.S. government and there was now “a better understanding.”

But in many ways the picture in Washington may be deteriorating.

Lawmakers on Capitol Hill indicated in a series of interviews that they are far from feeling more receptive to Chinese takeovers of anything remotely sensitive in terms of military or technological value. And fears that China is starting to pour its economic might into a more powerful military is adding to the wariness.

“The Chinese buildup of its military, particularly its naval fleet, has made people more concerned about what China’s ultimate intentions are,” said Republican Senator Susan Collins when asked about the sensitivity of Chinese acquisitions. “So, I think there is a great deal of concern.”

Collins said she was particularly worried about inroads China has made into the U.S. telecommunications industry based on classified briefings she has received. Cyber attacks emanating from China and seemingly aimed at the intellectual property of U.S. companies were another concern, she said.

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The U.S. Presidential and Congressional elections are due in November 2012. And in China towards the end of next year, President Hu Jintao is expected to hand over the reins of power to his heir-apparent Xi Jinping. "We could see a deterioration next year that is politically motivated in both countries -- in that case I think you have a potentially very serious problem," Reinsch said.

(Reporting by Paritosh Bansal and Soyoung Kim in New York, Benjamin Lim in Beijing, and Thomas Ferraro and David Lawder in Washington; Editing by Martin Howell and Jim Impoco)

MUSCLE CAR: Producing a brand built on macho, gas-guzzling vehicles flew in the face of Beijing's push for greener and cleaner technologies. REUTERS/JACKY NAEGELEN

COVER PHOTO: U.S. President Barack Obama with Chinese President Hu Jintao at the White House on Jan. 19. A series of planned acquisitions have died in the hands of bureaucrats or politicians in Beijing and Washington in the last few years. REUTERS/KEVIN LAMARQUE

FOR MORE INFORMATION CONTACT:

JIM IMPOCO,
ENTERPRISE EDITOR, AMERICAS
+1 646 223 8923
jim.impoco@thomsonreuters.com

CLAUDIA PARSONS,
DEPUTY ENTERPRISE EDITOR
+1 646 223 6282
claudia.parsons@thomsonreuters.com

PARITOSH BANSAL
+1 646 223
partosh.bansal@thomsonreuters.com