China Outbound Investments Q2 2013

Quarterly Feature – "What a Diff'rence Two Years Made"

While the world's financial markets are focused on the declining economic trends currently coming out of China (lower GDP growth, PMI hovering around 50) and more recently, the unease caused by tightening of credit, we would like to focus our Quarterly Feature on what we perceive to be huge improvements Chinese have made in global M&A as evidenced by the Shuanghui's USD 7.1bn announced transaction to acquire Smithfield. If this transaction closes, it would be the largest Chinese takeover of a US based company to date.

The strategic rationale underlying the transaction was straight forward:

1) Acquiring Smithfield gives Shuanghui control of 460 farms that raise nearly 16 million hogs / year. Smithfield gives China's largest pork producer - in a country which slaughters over 600 million hogs / year - the ability to diversify its supply.

2) Smithfield's technology helps improve food safety practices back to China's food industry (as well as to Shuanghui) which has been shaken by prior quality scandals (in dairy and pork).

While the commercial logic was not difficult, this actual transaction was complex. We found that the Chinese use of globally accepted M&A tactics in large public transactions as well as the financing involved marks a step change in China's M&A sophistication and thus want to focus on this as our Quarterly Feature.

As readers of our research will recall, our Q2 2010 Quarterly Feature analysed selected China outbound announced but not completed M&A transactions, both public and private. We concluded that the failure of the deals to complete included tactics, lack of securing firm financing and securing government / regulatory approvals.

In our Q2 2011 Quarterly Feature we commented that we had already seen improvements in sophistication in M&A tactics Chinese based acquirers had made since our 2010 analysis. In this Quarterly Feature, we conclude - in paraphrasing the Dinah Washington's 1959 recording – "What a Diff'rence Two Years Made".

The initial contact between Smithfield and Shuanghui was made in 2009. Since then, Smithfield, which had seen its share price perform below its peers, had explored a number of strategic options including a major merger and possible acquisitions. Earlier this year, it had to face calls led by one of its leading shareholders (ContiGroup Companies) for a break-up of the company earlier this year. Ironically, one of the contributors to its poor share price performance (down 18% over the past few years) related to declining margins in the hog business, due to the rising cost of feed ingredients.

Arguably, it was ContiGrains' March activist letter which ultimately led to attracting corporate interest and ultimately a controlled auction won by Shuanghui.

This auction of a sizeable US publicly traded company needed to satisfy a number of deal related / process issues.

- The offer had to be made within the context of a formal auction with timetable constraints (widely thought to be a deterrent to Chinese bidders in public auctions).
- The winning offer had to be within "the range of fairness" in order to permit Smithfield's adviser to provide a Fairness Opinion to the Board. Shuanghui's offer represented a 31% premium to the closing share price the day before announcement, which helped satisfy this condition.
- Shuanghui's offer agreed to honour all labour union agreements, existing wage and benefits for non-union workers and no plants would be closed. Shuanghui also agreed to keep Smithfield's CEO as CEO in the future.
- Securing firm financing from credible lenders - all debt - permitting Shuanghui to make this acquisition without issuing any equity - solely by using the balance sheets of the buyer, the target and the two banks.

USD 7bn debt was committed by two globally recognised banks: USD 4bn by Bank of China ("BoC") and USD 3bn by Morgan Stanley. The BoC acquisition facility is secured by Shuanghui's (China based) assets (100% financing secured against Chinese assets is the norm for Chinese banks) while the Morgan Stanley facility is secured by Smithfield's (US based) assets. By matching the debt to the specific geographically based assets, it facilitates recovery by the relevant banks should a default occur.

The offer also had to satisfy a number of regulatory issues in both the US and China.

- The transaction occurred in the pork industry which is not considered as high national security such as the defence or telecoms industries.
- Shuanghui's shareholders possessed considerable government contact with both the US and Chinese Governments which should help facilitate approvals. These included:
    - CDH Investments ("CDH"), a well respected USD 7bn China based PE fund. CDH had been active in the Chinese food industry previously and has principals with extensive experience in both the Chinese Government and the World Bank and the IMF (as well as in numerous industries).
    - In 2006, Goldman Sachs and CDH were members of a consortium which acquired the Chinese Government's USD 250m stake in Shuanghui. Goldman Sachs also owned both equity and debt in Smithfield. As all the readers will have known, Goldman Partners and / or Executive Management have held positions with the US Government for years. Goldman Sachs had also previously acted as financial advisor to Smithfield.

- Another member of the 2006 Shuanghui acquisition consortium was New Horizon Capital, which at that time was managed by Mr. Wen, son of former Chinese Premier Wen Jiabao. New Horizon Capital invested USD 20m in 2006 purchase by the consortium.

While there is nothing certain about a CIFUS (or any other) approval as shown above, much care has been taken to obtain approval for this deal. The terms of the merger agreement include language designed for such approvals in a sophisticated break-up / termination clause.

Shuanghui also had exposure on a 30 clause in which another bidder could top its offer.

While not all of the transactions this quarter necessitated similar standards and tactics, the Smithfield transaction did and we believe shows the improvements Chinese acquirers have come in a short time.

Postscript: It is also worth noting the cleverly structured and very well timed China Taiping Insurance minority stake transaction which was also announced this quarter. This deal was structured with minimal dilution to minority shareholders and with pre-approval from its China based regulator.