More Chinese M&A deals in the German SME sector – but the share remains negligible

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When the 'Going Out' strategy was introduced in the year 2000, Chinese enterprises also began to invest more in the global market. Since then, the volume of foreign direct investment (FDI) from China has grown from USD 28 billion in 2000 to around USD 1,500 billion in 2017. Chinese mergers and acquisitions (M&A) accounted for a substantial share of this growth.

Chinese investors also have their eye on German SMEs, according to analyses conducted by KfW Research on the basis of the Zephyr database. Averaging 2.2 % in the period from 2005 to 2017, the share of Chinese acquirers of small and medium-sized enterprises (SMEs) in Germany has been modest but growing since 2010. It peaked at 5.9 % in 2016, its highest level yet.

Until 2010 transactions clearly focused on the manufacturing sector (80 %) and mainly on the engineering segment (44 %). As Chinese M&A activities began to expand from 2011, however, so did the sectoral focus. The 'Made in China 2025' strategy, which was adopted in 2015, also contributed to this greater diversification. Chinese investors' M&A activities have since focused increasingly on the ten key sectors defined in this strategy, under which China intends to become the global technological leader in areas such as renewable energies and biotechnology.

In their M&A transactions between 2005 and 2017, Chinese enterprises preferred to acquire complete businesses (48 % share) and majority shareholdings (18 %). Chinese acquirers took over German SMEs that were insolvent exceptionally often compared with investors from other countries (14 %).

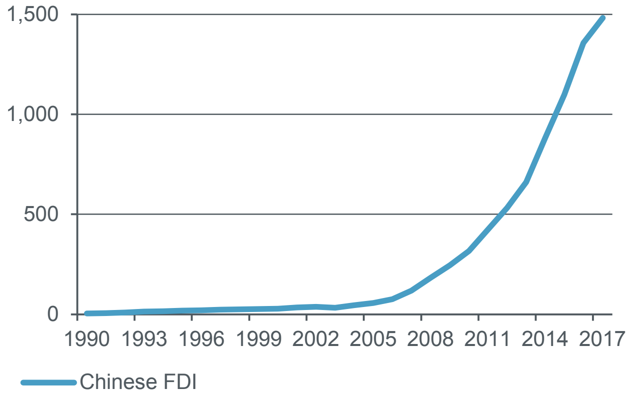
The growth in Chinese firms' M&A activities since 2011 has prompted growing concern over a loss of key technologies. Such transactions have therefore been facing stiffer opposition from policy-makers. This is likely to make Chinese investors' operations in the German M&A market more difficult in the future. Noticeably fewer M&A deals have been registered since 2017.

'Going Out'– China's emergence into the world

In the year 2000 the Chinese government adopted the Going Out strategy, which aims to promote foreign direct investment by Chinese enterprises. This has made it possible for Chinese enterprises to increasingly act as investors on the world stage. The key objectives of the Going Out policy included tapping into foreign markets, expertise and resources and expanding technological partnerships with other countries.[1] Foreign direct investment by Chinese firms grew rapidly after this strategy was adopted (Figure 1).

Figure 1: Chinese FDI has grown rapidly

In USD billion



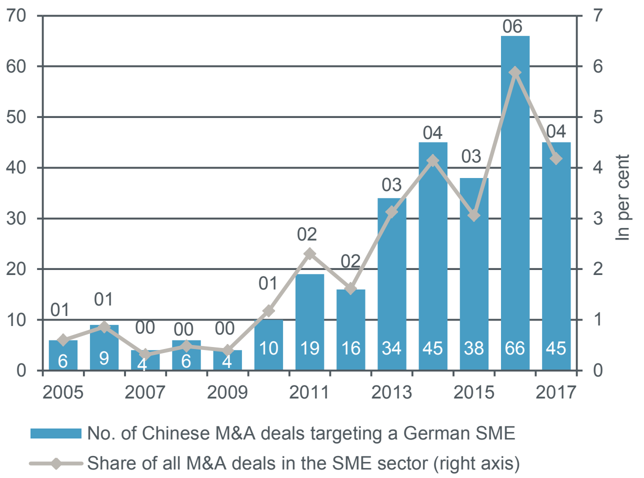
Source: UNCTAD

A new phase of the Going Out policy was ushered in with the announcement of the industrial policy strategy entitled 'Made in China 2025' (MIC2025) in May 2015. The purpose of the MIC2025 is to push forward the restructuring of China's economic structure. The country aims to grow out of its previous role as the 'world's workshop' and evolve into a leading hub of technology and innovation even before the end of the first half of the 21st century. The focus is on the key technologies of the fourth industrial revolution.[2]

Outbound equity investments are a key instrument for implementing the ambitious targets of China's Going Out policy and MIC2025 strategy. M&A deals in developed countries enable Chinese enterprises to relatively quickly access technologies and R&D skills, as well as new markets. They can diversify internationally and acquire global brands as well.

The German business sector is a popular target of M&A for Chinese investors. In around 250 Chinese acquisitions in Europe in 2017, Germany occupied the top position with 22 %. The United Kingdom followed in second place with 18 %.[3] Chinese government institutions regard Germany as an important and politically desirable target country for M&A investment[4] – presumably owing to the high number of highly qualified workers, the existence of key emerging technologies and the stable economic situation. Small and medium-sized enterprises, which make up the vast majority of Germany's businesses at around 99 %, are particularly sought-after.

Figure 2: Significant increase in activities since 2010



Notes: M&A deals with German SMEs as target enterprises and Chinese firms as acquirers

Source: Zephyr, own calculations

Against this background, KfW Research analysed the development and structural composition of Chinese M&A transactions in the German SME sector on the basis of the Zephyr transaction database.[5] The analysis covered full and partial acquisitions and mergers targeting German businesses with an annual turnover of up to EUR 500 million during the period from 2005 to 2017 (see box). The acquirers or merging parties (hereinafter referred to simply as acquirer or investor) were companies from China and Hong Kong.[6] The analysis comprised a total of 302 M&A transactions.

Development of Chinese M&A deals

Headlines such as 'On a shopping spree – how China is gobbling up Germany's SMEs'[7] sometimes create the impression that China was buying the entire German SME sector. This is still far off – even if increased activity by Chinese firms in the German M&A market is clearly identifiable (Figure 2).

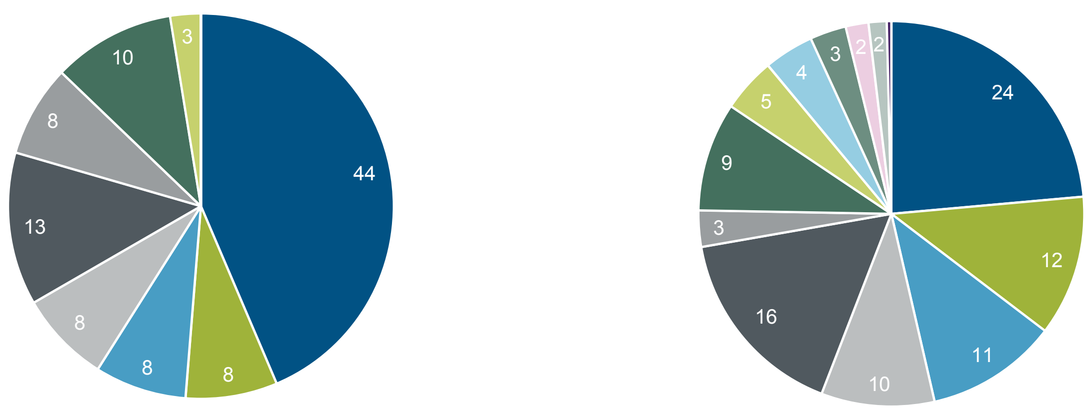
Until the year 2010, M&A deals by Chinese investors targeting a German SME were a rare occurrence. Based on the data available to us, between 2005 and 2010 only around 40 M&A deals in the SME sector could be identified in which an enterprise from China was on the acquirer's side. By way of comparison, in the same period there were around 490 transactions with US acquirers. Accordingly, the proportion of Chinese M&A deals in all transactions in the SME sector was low, ranging from 0.3 % in 2007 to 1.2 % in 2010.

However, a clear increase in Chinese activities in the German M&A market has been observable since 2011. In 2013 there were already more than 30 M&A deals targeting an SME. That raised the share in all M&A transactions to more than 3 %. With 66 identified deals, the peak so far was reached in 2016, raising the share in all M&A transactions to 6 % in that year. China thus moved up to second place behind the US in the list of most active countries of origin, with a share of 7.8 %, ahead of the UK (5 %). But in 2017 the share of Chinese investors dropped again to around 4.2 %. And current figures suggest that Chinese investors appear to be showing restraint again in 2018.[8]

Figure 3: Interest in the manufacturing sector is particularly strong

a) Sectoral distribution 2005–2010 **b) Sectoral distribution 2011–2017**

Sectoral share in per cent (mean) Sectoral share in per cent (mean)



- Engineering
- Manufacturing of computer equipment, electronic and optical products
- Other manufacturing
- Independent professional, scientific and technical services
- Other services
- Energy, water and waste
- Construction
- Automotive engineering
- Metal production, processing and manufacturing of metal products
- Information and communication technology
- Trade
- Finance and insurance services
- Other sectors

Source: Zephyr, own calculations

Interest in engineering sector was very high until 2010

The period until 2010, in which Chinese investors still acted with a great deal of restraint, is now being referred to as a 'learning phase'. The still very sporadic M&A deals focused primarily on manufacturing SMEs, with a total share of 80 %, and mainly targeted the acquisition of technologies (Figure 3a).[9] Chinese acquirers were most interested in engineering SMEs (44 %). Within the manufacturing sector, firms operating in the areas of automotive engineering (8 %), computer equipment, electronic and optical products (8 %) and metal production, processing and manufacturing of metal products (8 %) were also on Chinese investors' shopping list.

In addition to manufacturing, a handful of transactions also targeted retailing companies (10 %), possibly for the purpose of expanding an existing distribution network. Roughly 8 % of M&A deals were aimed at SMEs in the area of information and communication technology (ICT). Chinese firms still exercised restraint in other economic sectors, especially the services sector.

Sectoral focus has broadened since 2011

As Chinese enterprises' M&A activities in the German SME sector increased, their sectoral focus has also widened. Manufacturing still dominated between 2011 and 2017, with a total share of around 73 % but there were more transactions in other economic sectors. Significant growth in activity can be witnessed, for example, in the areas of independent professional, scientific and technical services (share of 9 %). A number of these M&A deals targeted biotechnology enterprises. Transactions were also concluded in the areas of finance and insurance services (3 %), energy, water and waste (2 %) and other sectors (2 %).

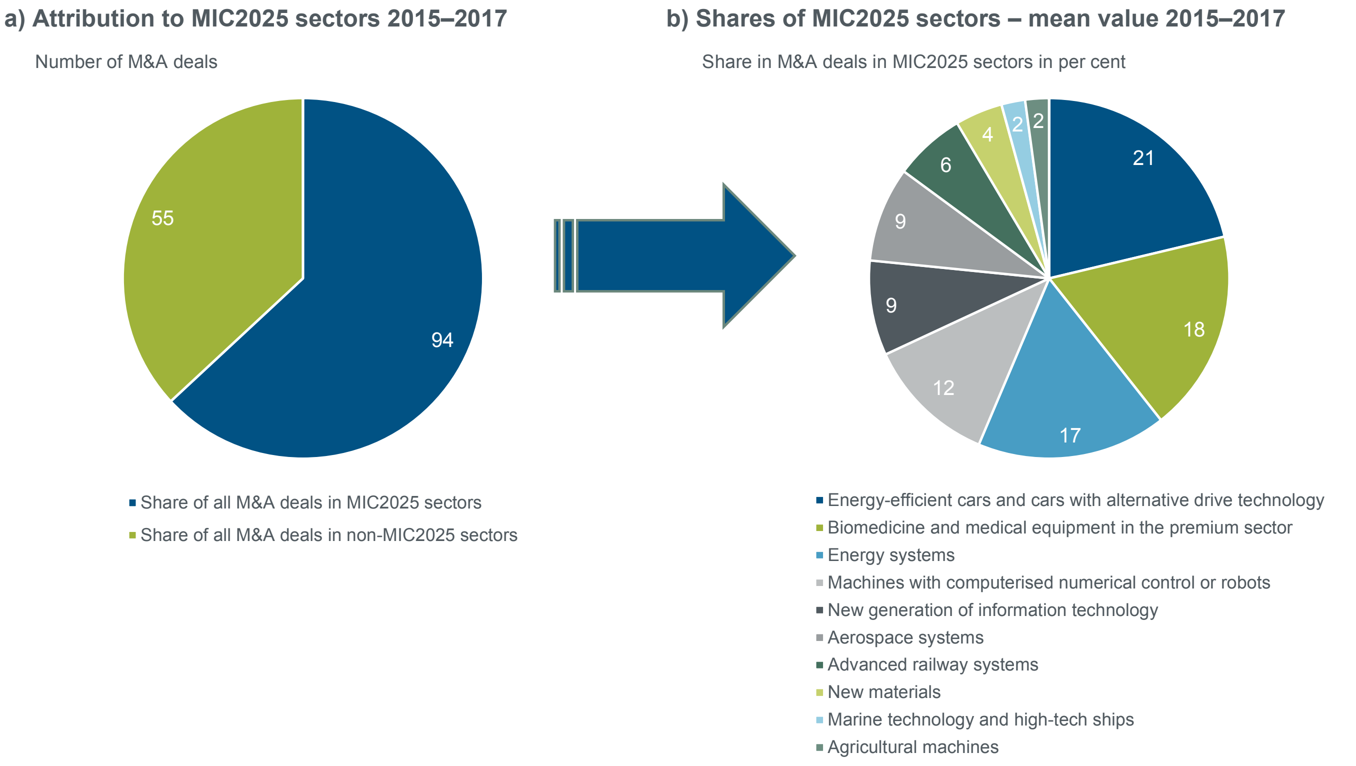
Since 2011, Chinese acquirers have also approached the manufacturing sector in a more differentiated fashion. Their interest in engineering SMEs remains very high (24 %) but activities have shifted slightly towards automotive engineering (12 %), computer equipment (11 %) and metal products (10 %).

Share of MIC2025 sectors in all M&A deals is very high

The growing sectoral diversification of the past years is also a result of the MIC2025 strategy and reflects the new priority areas it has established. MIC2025 focuses on a total of ten key sectors in which China intends to gain technological leadership in the future. Since 2015, a total of 94 of 149 M&A transactions can be attributed to one of the ten key MIC2025 sectors (63 %) (Figure 4a). Activities were particularly lively in the segments 'energy-efficient cars and cars with alternative drive technology' (share in all M&A deals in MIC2025 sectors: 21 %), 'biomedicine and medical equipment' (18 %) and 'energy systems' (17 %) (Figure 4b). More than one in ten MIC2025 deals targeted an SME specialising in machines with computerised numerical control or robots.

Chinese investors were already active in many of these segments before MIC2025 was introduced – segments in which some German SMEs were global technology leaders. But the MIC2025 strategy has also led to growing activities by Chinese investors in areas that had previously played a secondary role, especially biotechnology and renewable

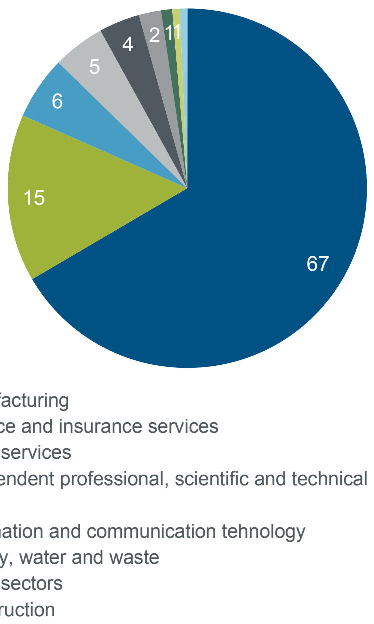
Figure 4: New focus on MIC2025 sectors



Sources: Zephyr, Jungbluth (2018), own calculations

Figure 5: Many acquirers are manufacturers

Sectoral share in per cent (mean value 2005–2017)



Source: Zephyr, own calculations

energy. It is to be expected that MIC2025 will shape the sectoral preferences of Chinese investors in the German SME sector in the future as well.

Manufacturing also predominates on the acquirer side

In line with the high share of manufacturing in the target enterprises, this sector also dominates the acquirer side (Figure 5). In more than two in three M&A deals, Chinese investors were firms from the manufacturing sector. This share is more than twice as high as in all (domestic and foreign) acquirer groups of German SMEs combined (29 %).

Investors in financial and insurance services come in second, with a share of 15 %. They have appeared significantly more frequently in the German M&A market since 2014 in particular. Most of them are portfolio and investment companies. Firms from other sectors are rarely active.

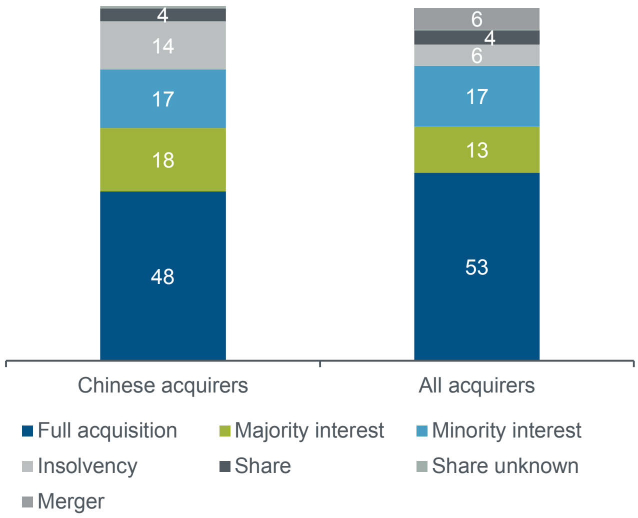
Many acquisitions of insolvent businesses

An analysis by type of M&A illustrates that around one in every two M&A deals involved the 100 % acquisition of an SME, which is comparable to the M&A activities of other acquirer groups (Figure 6). Full acquisitions of insolvent German SMEs are not included here. Chinese investors are involved in an unusually high share of such distressed M&A transactions (14 %). This share is only 6 % for all acquirers of German SMEs combined.

In more than 18 % of the M&A deals concluded in the period under review, the Chinese acquirer took over more than 50 % of the capital of the acquisition target. Such a majority interest gives the investor controlling influence over the target enterprise. This type of investment is also more common among Chinese investors than among other acquirer groups (share of 13 % for all acquirer groups).

Figure 6: Full acquisition is most common

Percentage share of M&A type (mean value 2005–2017)



Source: Zephyr, own calculations

Chinese acquirers taking less than 50 % of the capital of a target enterprise (minority interest) accounted for a slightly lower share – around 17 % of M&A deals. In this case they have limited possibilities to exert an influence on the business activities of the target enterprise. Only sporadically (in 4 % of cases) did Chinese investors acquire parts of an enterprise, such as a business area. Mergers of enterprises could not be observed in the period from 2005 to 2017 on the basis of our data.

Outlook

The share of Chinese acquirers of small and medium-sized enterprises in Germany between 2005 and 2017 was at a negligible level of 2.2 %. That trend, however, has been rising since 2010. The share of Chinese acquirers peaked at 5.9 % in 2016.

Policy-makers and the general public are keeping a close eye on this development. Concerns often prevail that these acquisitions may lead to the migration of jobs and expertise to China and a loss of technologies and patents. The often intransparent ownership structures of Chinese acquirers and the formal and informal links between the state and businesses in China contribute to these concerns.[10] But given the short observation period, no statements can yet be made on the medium to long-term impacts on the acquired enterprises. So far, anecdotal evidence does not generally support these misgivings.[11]

Nevertheless, Chinese investors have felt increasingly stronger headwind in the past years, also at a political level. Growing concerns over a loss of key technologies led to an amendment to the German Foreign Trade and Payments Ordinance in July 2017. The German Federal Government expanded its right to veto acquisitions by non-EU investors in sectors of the civil economy that are of particular relevance to national security. This amendment was applied for the first time in early August 2018, when the federal government opposed the sale of the engineering SME Leifeld Metal Spinning to the Chinese firm Yantai Taihai. The company then withdrew its proposal. The new framework can be expected to make it more difficult for Chinese investors to operate in the German M&A market in the future. ■

Box: Database

The analysis was based on the Zephyr database of Bureau van Dijk. Zephyr supplies up-to-date detailed information on M&A, IPO and private equity transactions around the world. Our research covered only M&A transactions with target enterprises in Germany that generate an annual turnover of not more than EUR 500 million. The head office of the acquirer or its parent company had to be in mainland China or Hong Kong.

The analysis did not include start-ups or the sale of specific assets such as restaurants, factories, branches, etc. It covered around 302 M&A transactions during the period from 2005 to 2017. The figures used here refer to transactions completed during the period under review.

[1] Jungbluth, C. (2016), Challenge and opportunity – Chinese direct investment in Germany, Gütersloh.

[2] Jungbluth, C. (2018), Kauft China systematisch Schlüsseltechnologien auf? – Chinesische Firmenbeteiligungen in Deutschland im Kontext von „Made in China 2025“ (*Is China systematically buying up key technologies? An analysis of Chinese acquisitions in Germany in the context of 'Made in China 2025'* – in German only), Gütersloh.

[3] Ernst and Young (2018), Chinesische Unternehmenskäufe in Europa - Eine Analyse von M&A-Deals 2006–2017 (*Chinese acquisitions in Europe - an analysis of M&A deals 2006–2017* – our title translation, in German only).

[4] Jungbluth, C. (2013), Aufbruch nach Westen – Chinesische Direktinvestitionen in Deutschland (*Expanding to the West – Chinese direct investment in Germany* – our title translation, in German only), Gütersloh.

[5] The transaction database used is subject to subsequent amendments and supplements. The database analysed by KfW Research therefore does not claim to be exhaustive.

[6] Hereinafter referred to only as Chinese investors or acquirers. This refers to enterprises from both mainland China and Hong Kong.

[7] Handelsblatt (2016), Auf Einkaufstour – Wie China den deutschen Mittelstand frisst, 1 April 2016 (*On a shopping spree – how China is gobbling up Germany's SMEs* – our title translation, in German only), URL: [https://www.handelsblatt.com/unternehmen/industrie/auf-einkaufstour-wie-china-den-deutschen-mittelstand-frisst/13388232.html?ticket=ST-609730-LRu0qhywECj2I3JMtgUD-ap1], last accessed: 7 August 2018.

[8] Ernst and Young (2018), Chinesische Unternehmenskäufe in Europa - Eine Analyse von M&A-Deals 2006–2018 (*Chinese acquisitions in Europe - an analysis of M&A deals 2006–2018* – our title translation, in German only).

[9] PWC (2016), Chinesische M&A-Aktivitäten in Deutschland (*Chinese M&A activities in Germany* – our title translation, in German only) – May 2016.

[10] Wirtschaftswoche (2016), Mittelstand: Die Eroberung (*SMEs: the conquest* – our title translation, in German only), 3 June 2016.

[11] Jungbluth, C. (2016), Challenge and opportunity– Chinese direct investment in Germany, Gütersloh.