Chinese investment into Canada: balancing openness and security

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Canada has become an attractive and important investment destination for many Chinese companies as a result of opportunities in a wide range of sectors, Canada's general openness to foreign investment and its stable political environment.

At the same time, the overall economic and trade relationship between Canada and China has continued to grow and take on greater importance in light of Canada's desire to diversify its trading relationships. However, the federal government's rejection of the proposed acquisition of leading Canadian construction firm Aecon by China Communications Construction Company (CCCC) and recent controversies involving Chinese telecoms giant Huawei highlight important questions about the future of Chinese investment in Canada. The current strained relations are likely to dampen deal activity in the short term.

Given the inherent and long-term mutual benefits of the economic relationship between Canada and China, we believe these short term challenges will be overcome, Chinese investment will continue to grow and significant transactions will continue to be completed. However, some transactions will face heightened scrutiny and the ambit of potentially security sensitive sectors may grow. As a result, it will be increasingly important for parties to identify issues early in the planning stage through effective legal, commercial and political due diligence. They should also establish a proactive strategy for addressing those issues and carefully manage the political and government relations aspects prior to announcement, as well as through the implementation phase.

Background

China's outbound M&A investment has grown exponentially over the last decade, placing it among the most active acquiror countries globally. Initially focused on resources, Chinese companies' investments now encompass a full range of industry sectors, including manufacturing, technology, real estate and sports and entertainment. The nature of the acquirors has also evolved, with Chinese private sector companies emulating their state-owned enterprise (SOE) peers in pursuing international investment opportunities. Transactions are now increasingly targeting the technology and advanced manufacturing sector in conjunction with the "Made in China 2025" initiative which seeks to significantly increase China's technology and advanced manufacturing capability.

In Canada, like elsewhere, investment from China often raises concerns relating to the size and quantity of transactions, and their impact on the domestic economy; the economic and strategic competition between China and western countries; the acquisition of technology and know-how; the absence of reciprocal market access by foreign investors in China and the fact most Chinese investors are either state-controlled or state-influenced. There is concern that state-controlled or influenced entities are not solely driven by commercial considerations and could act to further the interests of, or pass along information and/or technology at the direction of, their own government. Host countries around the world have been working to address these concerns while seeking to maximize the benefits of investments from China. These concerns have engaged and shaped the development of the foreign investment review process of Canada and other western countries, including by the Investment Review Division under the *Investment Canada Act* (ICA), the Committee on Foreign Investment in the United States, the Australian Foreign Investment Review Board, and the new review frameworks in the United Kingdom and European Union.

Canada's approach to foreign investment

Canada's approach to foreign investment under the ICA focuses on reviewing large transactions for "net benefit" to Canada and any transactions which could potentially be "injurious to national security."

Net benefit reviews focus on the impact of the investment on the Canadian activities of the target business. Of particular importance are post-acquisition matters such as employment and management roles for Canadians, capital expenditures and other investments in Canada and head office location. Reviews result in investors giving binding undertakings on matters lasting for a period of five to 10 years.

Based on 2019 thresholds, transactions involving a target with enterprise value in excess of $1.045 billion (or $1.568 billion for transactions involving investors from countries with which Canada has a free trade agreement) are subject to net benefit review. Where the acquiror is an SOE (being a government controlled or influenced entity) the current review threshold drops to $416 million and is based on net book value. In the case of SOEs, the net benefit review also includes an assessment of the nature and extent of foreign government control or influence, whether the target will adhere to Canadian standards of corporate governance, and whether the Canadian business will continue to operate on a commercial basis following the acquisition. With a flexible approach, Chinese investors have been successful in negotiating undertakings to address the net benefit criteria. Going forward, we expect this to continue to be the case.

In considering the overall impact of Canadian foreign investment review, it is important to note that the majority of investments from China have been approved in the ordinary course.

Additionally, any transaction (including joint ventures, non-controlling interests and the establishment of a new business) can be reviewed on national security grounds. The government has broad discretion to determine whether a particular investment might be "injurious to national security." Investments from China, as well as Russia, are more likely to be reviewed than those from other countries. Sectors with the highest risk include defence, aerospace, critical infrastructure, high tech and telecommunications. Canadian businesses that have security clearances or supply controlled goods will also typically be subject to review.

The rejection by the Canadian government of CCCC's proposed acquisition of Aecon—one of Canada's largest construction companies and a builder of critical infrastructure—highlights the expansive ambit of the national security review power and the breadth of the sectors that may engage it. It also highlights the willingness of the government to block large, high-profile transactions where there is a perceived risk, regardless of potential economic benefits.

In considering the overall impact of Canadian foreign investment review, it is important to note that the majority of investments from China have been approved in the ordinary course. Investments in the natural resources and real estate sectors in particular are typically non-problematic. Many technology sector investments have also been approved.

Recent developments

The outlook for Chinese investments in Canada has recently been clouded by the rejection of the Aecon transaction and the controversies surrounding Chinese telecom giant Huawei. There is ongoing public debate over whether Canada (like the United States, Australia and New Zealand) should ban, on national security grounds, Huawei's participation in the development of next-generation 5G telecom infrastructure. Further, there is also tension over Canada's arrest of Huawei's CFO Meng Wanzhou on U.S. charges of sanctions violations and retaliation by China. These developments have caused significant concern in both Canada and China, highlighting important questions about the overall Canada-China relationship and trade and investment matters in particular. These challenges are broadly similar to those being experienced by other developed western countries in their own relationships with China. The current strained relationship between Canada and China requires parties considering transactions to exercise a higher degree of caution and be prepared for delays.

We believe the overall importance of the economic relationship between China and Canada, the complementary nature of the two economies, China's desire for stable investment destinations and Canada's desire to diversify its trade relationships, will allow the relationship to overcome these short term challenges and facilitate the overall expansion of Chinese investment into Canada. Although transaction volume will grow, a high degree of scrutiny for some transactions, especially significant ones, should be expected. Transactions involving Canadian "national champions" will be subject to heightened review as well as a greater degree of political sensitivity, which could make approvals more difficult to achieve. In addition, transaction reviews are likely to take a significant period of time, with three to six months or longer being the norm for Chinese investors.

How to get deals done

Recognizing the complexity of this environment, parties to transactions—both Chinese investors and Canadian targets—and their advisers should take the following steps to enhance their ability to get transactions approved and completed.

- **Diligence:** Identify issues at an early stage through effective legal, commercial and political due diligence, focusing on the important areas from a net benefit and national security perspective. For example, developing a strong and expansive understanding of the importance of the acquisition target to its industry and community, the local and national political sensitivities that are likely to arise, and any potential national security implications—such as whether the target operates entirely or partially in a sensitive sector, whether it has facilities near military or other sensitive sites or if it engages in activities involving controlled goods or technologies.

- **Preparation:** Establish a proactive strategy to address the issues that have been identified; for example, advance consideration of robust undertakings that can be proposed, plans to address/mitigate any political and national security issues and working with counsel and governmental relations advisers to put forward a positive narrative for a transaction. In sensitive cases, parties should consider approaching the federal government for preliminary consultation before a transaction is announced.

- **Execution:** Work with government relations advisers on the announcement and implementation of the transaction to put forward and maintain a positive public narrative. Consider outreach to affected stakeholder groups (media, unions, industry associations, customers and suppliers) to mitigate their concerns leading to political issues. Work proactively with the federal and provincial governments to address their concerns early and in an appropriate manner.

While challenges will persist in the relationship between China and Canada, we believe that the level of Chinese investment will resume its growth and significant transactions will continue to be completed. With appropriate diligence, preparation and execution, parties will be best positioned to get their deals done.