IN-DEPTH: IS EUROPE BECOMING MORE PROTECTIONIST ON INFRA?

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With globalisation in retreat, European governments and the EU are introducing stricter screening rules on foreign direct investment. Protecting strategic infra from Chinese state-backed investors is at the front of their minds but the impact on M&A activity could be more widely felt. René Lavanchy reports

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In an age of US trade wars with China, it's tempting to view the doctrine of free trade as in retreat on all fronts. "Definitely the world is getting less globalised and national feelings are running high," says a mid-market infrastructure fund manager, when asked if protectionism has returned.

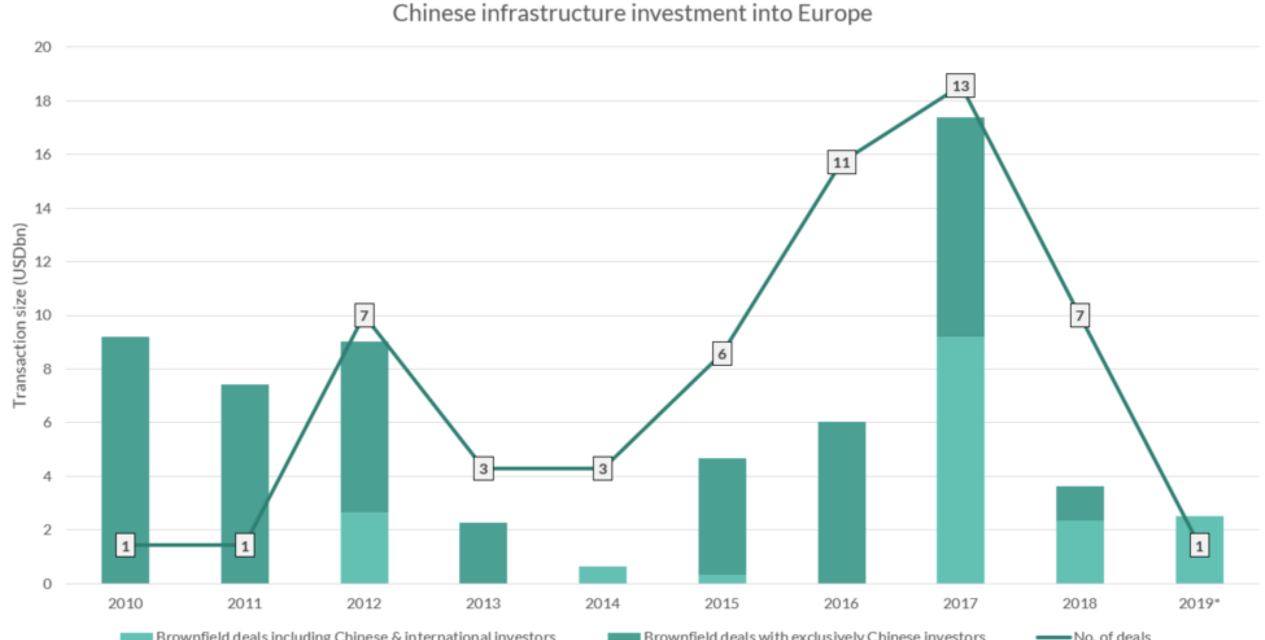
Although Europe has not joined the US trade war, legislators across the continent at European Union and national level have been introducing increasingly strict regulations to screen foreign investments over the last two years.

And it is China perceived to be in the firing line: when in April this year, state-owned China Three Gorges' EUR 9bn bid to take full ownership of Portuguese utility EDP was rejected by shareholders, the move was described by a local newspaper as "already dead", because of the perceived impossibility of persuading regulators across Europe and the US to approve the takeover (despite Portugal's government indicating its assent).

Even the UK, whose government trumpets free trade post Brexit and promises to establish free ports, plans to increase powers to screen foreign investments, against a backdrop of controversy over whether Chinese telecoms supplier Huawei's hardware should be used in building the forthcoming 5G mobile networks.

Given its strategic nature, and the potential for issues of national security to arise, governments have a spotlight on their infrastructure.

Is Europe simply refining its laws on foreign investment, or is a new protectionism taking hold, and what does this mean for international investors?



**Until 16th Sep 2019*
Source: Inframation

Brussels compromises

The EU's new foreign direct investment (FDI) screening regulations – which will take full effect in November 2020, but will then apply retrospectively to deals that closed up to 15 months previous – represent a compromise between some member states, who reportedly wanted to see US-style blocking powers, and others, such as the Nordic countries, who were opposed to any kind of legislation.

The resulting legislation empowers member states, and in some cases the European Commission, to request information on deals in other member states and to voice opinions, but they cannot stop them; that power remains with national governments.

The commission's opinion is reserved for deals affecting projects of strategic importance to the EU, such as projects under its Trans-European Networks programmes in energy, transport and communications; this includes new electricity interconnectors in the Baltic region and the three-pipeline Southern Gas Corridor linking the Caspian region to southern Europe. When a commission opinion is issued, governments must provide an explanation if they choose not to follow it.

The new rules will have an impact, say observers.

"[Information sharing] in itself, we think, is going to lead to more transactions being identified as national security risks," says Dan Harrison, knowledge director at Clifford Chance, who regards the information-sharing provision as the most important aspect of the regulation. He cites the example of a Chinese company's attempt in 2016 to acquire the German chip equipment manufacturer Aixtron; although the German government initially approved the transaction, it withdrew its approval after the US government pointed out national security concerns. The deal was abandoned.

Harrison also argues that the regulation is likely to give national governments increased confidence to vet foreign takeovers in their own country (albeit only from investors outside the EU, to which the regulation exclusively applies).

Some member states, such as Sweden and the Czech Republic, are responding by adding to their own screening regimes. Hungary already introduced its first dedicated FDI screening rules in January 2019, which are similar to the EU rules, but allow ministers to veto takeovers in certain strategic sectors on security grounds.

Britain joins the fray

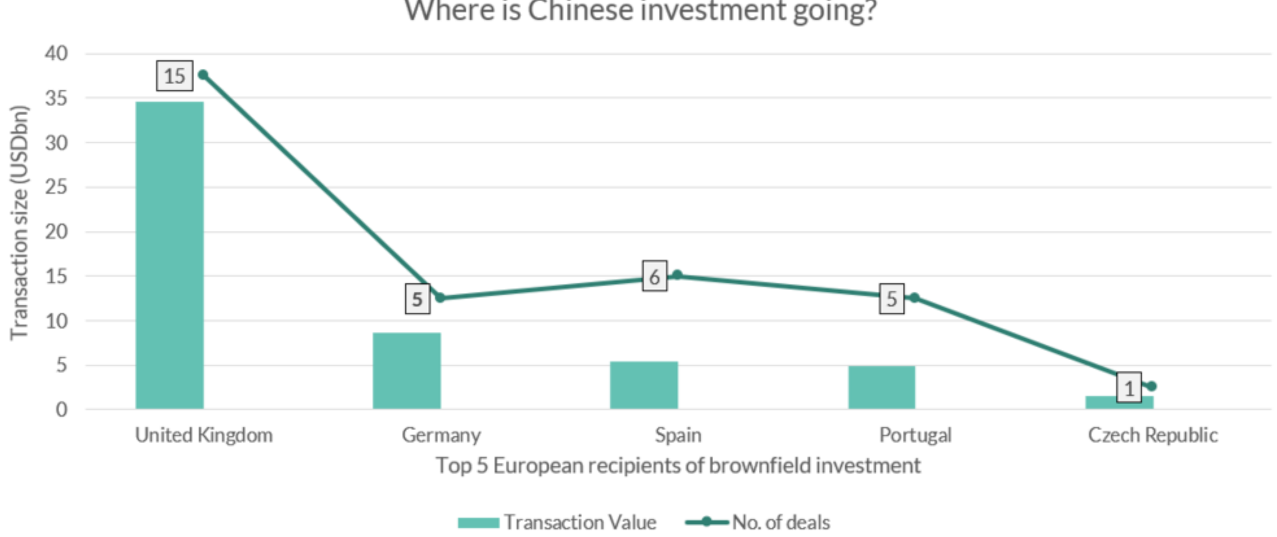
Germany and France, two countries cited as pushing for the introduction of the EU regulation, have both tightened up their domestic rules on screening FDI in the past nine months.

In December 2018, Germany lowered the acquisition threshold for initiating a review into an investment from 25% to 10%, in a move which has been linked to State Grid Corporation of China's thwarted 2018 attempt to buy a 20% stake in electricity transmission operator 50Hertz, which fell outside the regulations then in force. The 10% threshold only applies to certain sectors, including critical infrastructure and telecoms.

France's new rules, which came into force in May, focus on adding teeth to the sanctions against unwanted investments: for example, in addition to existing powers to nullify unauthorised closed transactions, the minister can now order an investor to unwind the deal at their own expense, as well as freezing dividends at the acquired company, blocking disposals and appointing a company representative. Sectors covered by the rules have also been extended to include data storage, software-based security systems and various kinds of research and development in emerging technologies, such as artificial intelligence. This last change mirrors the latest update to Italy's FDI controls, which came into force in 2017.

The UK's proposed FDI screening rules represent a step change for a country that was previously relatively relaxed about foreign takeovers. Last year, the Conservative government published a consultation paper on national security and investment, which proposed to introduce for the first time a screening mechanism comparable to those in other countries.

The proposals would make it voluntary for investors to report their transactions to the government, but would allow government to investigate closed transactions within a six-month window and, if necessary, order that they be unwound. Events that could trigger a review would include acquisition of a 25% stake or of a controlling influence in a company. Within core infrastructure, the paper defines sectors that are most likely to be affected, namely transport, energy, defence, communications and civil nuclear. But in theory, a deal in any sector could trigger a review.



From 1st Jan 2010 - 16th Sep 2019
Source: Inframation

Tweaks or tightening?

According to the industry players interviewed for this article, there appear to be two schools of thought as to what these changes mean.

Investors tend to view the increase in regulation as essentially a function of increased FDI in Europe, notably from Asian investors, motivated by a desire to formalise screening regimes rather than any wish to curb certain types of investment.

“There hasn’t been a great deal of change,” says Adam Ringer, London-based principal at AMP Capital, who thinks that “noise” around perceived protectionism has not been reflected in the policy framework. “A couple of things there I would describe as tweaks, which haven’t really made a whole lot of difference to how we behave or how we see others behaving”.

Others say similar. “There’s been an increase in investors from Asia in infrastructure and I think they are just conscious of that and just want to understand who the investors are,” says Spence Clunie, managing director of Ancala Partners, who holds back from suggesting that attitudes to FDI have hardened. A second mid-market asset management source who covers Europe agrees with this analysis; a third, from outside Europe, does not see any distinct trend to raise barriers to FDI. Against this perspective, it might be argued that mid-market investors are subjected to screening less often than big players, as their deals are usually too small to attract attention.

But not all investors agree.

“More than a change in sentiment, I think we start to see evidence of that [foreign ownership] becoming more and more the concern from a national interest protection point of view,” says Stephane Kofman, director at InfraRed Capital Partners, who rejects the idea that regulatory activity has simply increased with deal flow, and cites the 50Hertz case as an example.

Lawyers spoken to for this article agree. “Yes there are more deals, and there’s an argument that the investor market has broadened considerably over the last five years, and there are more Asian investors entering the market… but I don’t buy the argument that there’s nothing behind it, no change in the underlying political environment,” says a London-based partner who has represented Chinese investors on one of the UK's largest infrastructure deals.

“I think you only have to look at the rise of populism around the world to understand why politicians are increasingly focused on foreign ownership of key infrastructure,” he adds, putting the changes in Europe in the context of other countries, such as the US and Australia, which are also tightening their rules. “You’ve got to be a bit of an optimist to view that as… not linked in some form to an over-arching change in sentiment.”

Reasons to be fearful

While they may be responding to populist pressures, governments that strengthen FDI controls don’t need to be populist themselves; indeed the governments that are doing so range across the political spectrum from populists and social democrats to conservatives.

To define this trend as protectionism is misleading, because in some cases, such as the UK and France, it is being delivered by governments who simultaneously want to promote free markets. “Even though there is this legislation coming, the underlying message from the UK government has been ‘don’t worry, we’re not saying we're not open to business with international investors,’” the London-based lawyer says. To the extent that European countries are protectionist, there does not appear to be any correlation to the new wave of regulations.

Inevitably, though, issues of national security, protectionism and the public-private debate sometimes get blurred.

When Danish utility Orsted cancelled a sale process for its Radius electricity distribution network earlier this year, the ostensible reason was political opposition to private ownership of the asset, but people involved in the process say that foreign control was also a risk factor. In France, the state’s proposed sale of its majority stake in airports operator ADP has run into controversy over foreign ownership and privatisation. “I think the airports space is probably closer to being caught by both types of debate,” says Stephane Kofman.

What the changes in regulation all seem to reflect is both greater concern about the implications of foreign takeovers for security and public order, and a view that those risks arise in a greater range of circumstances than before.

Sources agree that the infrastructure sub-sectors most likely to attract screening actions include gas and electricity transmission, citing energy security as a factor. But inevitably, governments are also putting greater

scrutiny on investments with a major digital component. All the new regulations described above either cover or extend into the information and communications technology sectors. Several pick out emerging technologies, such as AI or quantum computing, but in general the regulations are drawn loosely enough for governments to apply them to any new technology that falls within the relevant sectors. In Italy, the foreign investment law has been extended to also allow the screening of agreements to supply goods and services for 5G mobile network providers.

Even if sentiment has changed, however, nobody spoken to for this article says it has become harder to acquire infrastructure due to national security concerns, at least not yet. “The people who got approved 10 years ago still get approved now,” the second asset management source says. “It’s probably fair to say that the increase in deals that have run into problems because of national security concerns probably broadly mirrors the increase in Chinese outbound investment in recent years,” says Harrison at Clifford Chance.

Taming the dragon

Which raises a question on the lips of many observers: is the new wave of regulation all about restraining Chinese investment?

“I think that’s where a lot of the impetus for these laws comes from… it is pretty clear from the enforcement practice in recent years,” says Harrison.

“It’s probably not the same level of scrutiny when you have a US or a Japanese company trying to acquire an asset versus a Chinese one, especially when valuable IP is involved,” says Kofman.

When the European Commission presented its proposed legislation on FDI controls back in 2017, the *Financial Times* called it a “plan to curb Chinese takeovers”, and quoted the Finnish trade minister as saying that the new rules risked provoking China. Notably, the regulation highlights state control of a foreign investor as one of the factors to consider, something that is bound to apply particularly to China on account of its large stable of state-owned utilities, asset managers and infrastructure developers.

“Comparatively, Europe is much more China-friendly than the US”, says Daniel Hu, managing director at Chinese state-owned mid-market asset manager China Everbright, which co-manages a global infrastructure fund.

Hu denies experiencing any anti-Chinese sentiment in Europe, but notes that this may be because his firm does not invest in cutting-edge digital technologies. Nevertheless, he is distinctly sceptical about the grounds for tightening FDI controls. Hu argues that amending the regulatory framework for infrastructure owners and operators is a better route to preventing malicious behaviour.

Although infrastructure investments in Europe are hardly ever rejected on national security grounds at present, cases from the wider M&A sector point towards Chinese investment being singled out. And some deals (such as CTG’s takeover attempt of EDP) may be being abandoned before they even get to the screening stage.

“Changing attitudes can lead to the reassessment, delay and even termination of Chinese projects,” *Moody*’s noted in an August report in which it said that Chinese investment in overseas infrastructure is expected to slow down in the next few years – which it attributed both to growing awareness of risks, including political risks, and to a refocusing back on China.

Investors maintain, however, that they would not avoid partnering with Chinese bidders on national security grounds – at least, not outright. “I wouldn’t rule it out, to be honest, if we felt it made sense…” says Clunie, “but obviously we’d have to take into consideration the EU framework when making that decision, i.e. do we think that’s going to make a difference to our ability to invest in that asset in a negative way. We’d probably be quite open early on with the vendor and the authorities to ensure it wouldn’t be an issue.”

Deals getting difficult

So what impact is the current investment climate having on foreign investments?

"It isn't necessarily impacting deal flow but it is impacting investors' early-stage thinking", says Toby Parkinson, who before rejoining Clifford Chance was a legal director at Omers Infrastructure. "Those types of large institutions that are heavily invested in Europe… are also thinking about their own levels of stakeholder engagement with regulators, whereas historically they've kept relatively low-key in terms of discussions". Increasingly, he says, investors are assessing the FDI regulatory risk even before the non-binding bid stage.

Some investors are spending increased amounts of money on stakeholder engagement, including hiring major lobbying firms, to help square deals with politicians and the media, say sources.

To see what happens when stakeholder engagement is insufficient, Stephane Kofman points to Chinese investor Shandong Hi-speed Group's unhappy investment in France's Toulouse-Blagnac airport, which the buyer has been trying to exit after falling into a dispute with regional shareholders over upstream dividends. The French government had approved the sale, but that was not enough to win support at regional level. "This was a classic example of where you cannot be successful in infra investment without the buy-in of your various stakeholders, and one local stakeholder group was clearly not on board," he says.

Even with greater preparation, transactions are likely slowing down as a result.

"When we are managing offers and bids as a seller of assets, we spend more time on the legal side to get to the bottom of what the likely process is that our buyer will have to comply with," Kofman says. He adds: "If you look at the nature of the players involved, [Europe is] still well-diversified, with capital inflows coming from North America, Asia, or the Middle East… so I don't think we can say that this has caused any reduced appetite from the buyers".

But the London-based lawyer warns that, even if non-European or Chinese-based infrastructure deals into Europe are not yet drying up, that could be about to change. "A lot of the [investors] you're talking about are investors that are looking at the US, Australia and Europe, and so Europe is competing for investments against those jurisdictions. People do draw comparisons against the regimes both within Europe and outside Europe with key investment destinations."

Another way investors are starting to respond is to think more carefully about partnering with local investors to reduce political hostility to their deals. Citing the abortive Orsted Radius sale, the lawyer says: "Many bidders were focused on trying to ensure that they had a Danish element in their bidding consortium. Advisers on the ground were absolutely crystal clear, saying 'do not come to this with a foreign consortium; make sure you've got a Danish element'".

"Partnering with local partners is a means of trying to reduce some of the optics of this; sometimes it's investors going in via domestic asset managers… Dalmore and Equitix represent a lot of Asian money, but they will be seen ultimately as a UK owner – or will they?"

Profound implications

It is a pertinent question for Daniel Hu, who is considering whether his fund should respond to greater FDI screening procedures by becoming an indirect investor. "It's likely for me and other people," he says. "Hopefully it's not going to happen any time soon. At this point we are not actively studying it yet. If we have to do it indirectly, we will become less active, or even passive. Maybe we will even become an LP or fund of funds. We are yet to see how it will develop. Depending on how the regulations evolve, the implications could be very profound."

Sources agree that a local partner makes a bid more attractive. However, the second asset manager cautions that there are limits: being an unacceptable investor with a local partner does not make them acceptable.

While nobody spoken to for this article would describe Europe as closing its markets to foreign investment, it looks inevitable that deals will be more scrutinised and attract adverse attention more often in future, because the reasons for doing so have multiplied.

"I would say it could be more inconvenient," says Hu. "For European markets, it would be much more convenient for European investors to invest rather than from elsewhere. I would say that's a trend – getting more inconvenient".

From within Europe, Stephane Kofman says: “It’s painful, probably harder than before, but whether the outcome is now a 50:50 chance – I think we are still very far from that level, with most of the deals ending being approved.”

If Chinese, or indeed other international infrastructure investors, are forced to pull back, it will be a sign that Europe has lost at least some of its advantage over Australia and the US in its receptiveness to foreign capital. If anyone benefits, it will be European infrastructure funds, who may just find increased interest from LPs outside Europe, in addition to some diminished competition for homegrown assets.

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