SIMPSON THACHER

CLIENT MEMORANDUM

China Blocks Foreign Acquisition of a Chinese Company in an Early Major Test of the Chinese Anti-Monopoly Law

March 20, 2009

On March 18, 2009, the Ministry of Commerce ("MOFCOM") of the People's Republic of China blocked Coca-Cola's proposed acquisition of a major domestic juice manufacturer, China Huiyuan Juice Group Limited ("Huiyuan"), under the recently enacted Anti-Monopoly Law (the "AML").[1] MOFCOM concluded that the acquisition would adversely affect competition in, and the development of, the Chinese juice beverage market. In particular, MOFCOM raised concerns that, as a result of Coca-Cola's strength in the carbonated beverage sector, the transaction could give rise to potential anticompetitive effects from bundling and tying practices.

This is MOFCOM's first significant decision applying the AML to a foreign acquisition of a domestic Chinese firm. It suggests that MOFCOM may place greater emphasis on maintaining the independence of Chinese firms and protecting domestic competitors from foreign rivals than regulators in other jurisdictions would. It is still too early to predict whether MOFCOM's Coca-Cola decision represents a fundamental difference in the application of competition law to mergers than followed by other regulators, particularly in the United States and Europe, or whether it reflects the particular facts of that transaction. Nevertheless, MOFCOM has certainly demonstrated that it is willing to chart its own course by blocking a transaction that would likely have been cleared in the United States or Europe.

PROPOSED ACQUISITION

On September 3, 2008, Coca-Cola announced its intention to purchase the Hong Kong Stock Exchange-listed Huiyuan. Coca-Cola offered to purchase Huiyuan for US $2.4 billion in cash,

[1] As Huiyuan is incorporated in Cayman Islands and not mainland China, this proposed acquisition is not subject to MOFCOM's approval requirements that generally apply to foreign investments in China

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approximately three times the value of the shares prior to the proposed acquisition.

The Huiyuan purchase, as Coca-Cola's largest ever foreign acquisition, would have been the U.S. company's most aggressive move in China since Coca-Cola started its operations in the country in 1979, as well as the largest foreign takeover of a Chinese company. Huiyuan, a long-established and successful juice brand in China, is a privately-owned, publicly-traded Chinese company that manufactures and distributes fruit and vegetable juices, nectars, bottled water, tea, and dairy drinks. Headquartered in Beijing, Huiyuan's primary strength is in the Chinese juice sector where it is estimated to have a 42% share. In recent years, Coca-Cola, which has been a well-established soft drink brand in China for some time, has expanded its Chinese product line to include non-carbonated beverages, including teas and Minute Maid-brand juices. Its Minute Maid juice products experienced double-digit growth in China in 2008 and accounted for a significant share of the low-end juice segment according to certain industry reports. However, the proposed acquisition would have provided Coca-Cola a local brand that accounted for a large share of the mid- and high-end juice segment. It also would have expanded Coca-Cola's production and distribution system in China, giving it direct ownership of 31 plants across China. Coca-Cola currently relies on joint ventures and minority ownership interests in local companies to manufacture and distribute its products.

Pursuant to the AML, on September 18, 2008, Coca-Cola submitted its proposed acquisition of Huiyuan to MOFCOM for review. MOFCOM completed a preliminary inquiry into the transaction on December 20, 2008 and determined that further review was necessary. On March 18, 2009, MOFCOM completed its review and announced its decision to block the deal.

SUMMARY OF DECISION

MOFCOM concluded that the proposed acquisition would adversely affect competition in the Chinese juice beverage market and the "sound development" of the juice industry. MOFCOM also found insufficient evidence that the proposed acquisition was consistent with the public interest or that increased competition from the proposed acquisition would be substantially greater than the adverse impact of the proposed acquisition.

In announcing its decision, MOFCOM did not explain how it defined the relevant markets for the purposes of its analysis. However, MOFCOM appears to have identified two relevant markets: (1) juice beverages; and (2) carbonated beverages.

In evaluating the transaction, MOFCOM identified six considerations relevant to its analysis: (1) Coca-Cola's and Huiyuan's market shares in the relevant markets and the market power these companies exercised in these markets; (2) the level of concentration in the relevant markets; (3) the impact of the acquisition on market entry and technological development; (4) the impact of the acquisition on consumers and other relevant businesses; (5) the impact of the acquisition on the development of the Chinese economy; and (6) the impact of the Huiyuan brand on competition in the juice beverage market.

MOFCOM applied these six factors and determined that the proposed acquisition would have three possible anticompetitive effects. *First*, MOFCOM found that, following the acquisition, Coca-Cola would be able to leverage its purported dominance in the carbonated beverage market in the juice beverage market, thereby eliminating or constraining competition from other existing juice beverage competitors and subsequently harming juice beverage consumers. *Second*, MOFCOM concluded that, because brand competition is a key competitive factor in beverage markets, Coca-Cola's post-transaction control of two well-known brands – Minute Maid and Huiyuan – would significantly strengthen Coca-Cola's market power and increase barriers to entry in the juice beverage market. *Third*, MOFCOM determined that the acquisition would be detrimental to the Chinese economy by reducing the space for small- and mid-sized domestic juice competitors, restraining the ability of domestic competitors to innovate and participate in the juice beverage market, reducing effective competition in the Chinese juice beverage market, and harming the sustainable and sound development of the Chinese juice beverage industry.

MOFCOM's announcement did not explain the relative significance of the six factors in evaluating the transaction's anticompetitive effects, nor did it detail the particular facts relied upon in reaching its conclusion.

Upon concluding that the proposed acquisition would have adverse affects on competition, MOFCOM attempted to negotiate restrictive conditions with Coca-Cola in an effort to overcome the identified anticompetitive effects, but failed to reach an agreement. MOFCOM's decision does not identify the remedies proposed by Coca-Cola nor does it explain their inadequacies; the announcement merely notes that Coca-Cola's proposals failed to effectively reduce the anticompetitive effects of the proposed acquisition.

Based on the foregoing, MOFCOM prohibited the proposed acquisition under Article 28 of the AML.

IMPLICATIONS

MOFCOM's decision to prevent Coca-Cola's acquisition has a number of potentially important implications because the decision is one of the first under the AML, which has only been in effect since August 2008.

First, MOFCOM's decision indicates that it views its mandate under the AML to preserve competition as requiring the protection of competitors. One of the six considerations MOFCOM used in evaluating the transaction was the impact of the acquisition on consumers *and other relevant businesses.* This appears to have been a significant factor in MOFCOM's analysis, as it found that the acquisition would eliminate or constrain competition with existing juice beverage competitors and reduce the market space for small- and mid-sized domestic juice enterprises.

Second, the decision suggests that MOFCOM will be more willing than its U.S. counterparts to block mergers on the basis of potential future anti-competitive behavior rather than relying on post-merger enforcement to restrain such conduct. Thus, MOFCOM appears to have placed considerable significance on bundling and tying theories in justifying blocking this transaction. By contrast, these theories rarely serve as the basis for prohibiting transactions in the United States as U.S. authorities are reluctant to deprive consumers of the benefits of such practices. Rather, U.S. regulators are confident that post-transaction enforcement efforts are sufficient to remedy any potential anti-competitive outcome that could arise from such conduct. MOFCOM's reliance on bundling/tying theories as the first factor in its competitive effects analysis may indicate a greater likelihood of bundling/tying enforcement challenges under the AML.

Third, the significance MOFCOM ascribed to the strength of Coca-Cola and Huiyuan's respective brands suggests that this factor may be viewed under Chinese antitrust analysis not solely as a potential barrier to entry, as it is considered under U.S. antitrust analysis, but also as an independent indicator of market power and the firm's potential to engage in anticompetitive conduct. It further suggests that MOFCOM may place greater significance on qualitative indicators in assessing market power and competitive effects, particularly relative to the United States, where quantitative factors, such as market share and detailed econometric analyses are critical components to the evaluation of contested mergers.

Finally, MOFCOM's decision suggests that the AML may be used as a vehicle to promote the development of Chinese companies at the expense of foreign rivals. The focus in the decision on the transaction's potential to squeeze out *domestic* small- and mid-sized competitors, restrain the ability of *domestic* competitors to participate in the juice beverage market, and impede sustainable and sound development of the *Chinese* juice beverage industry makes clear that effects on domestic industry can be a factor in evaluating whether a transaction complies with the AML.

The brevity of MOFCOM's decision, the recency of the AML, and the absence of other precedent to date leave room for the possibility that China's antitrust policy may well develop in ways substantially different to those implied by this decision. However, close attention should

be paid to future decisions under the AML as a number of important differences between Chinese and U.S. competition law may emerge with potentially significant consequences for companies conducting or contemplating business in China.

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