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From mid-2015 to 2017, Vanke, one of China's largest real estate developers, became embroiled in a drawn-out hostile takeover bid. The battle started when a relatively unknown Chinese activist investor, the Baoneng Group, quietly began to buy up shares of this star performer. By late 2015, Baoneng emerged as Vanke's largest shareholder. Vanke's major rival, China Evergrande, also joined the takeover effort. Together, both worked to oust Vanke's existing management, including its internationally known founder, Wang Shi. But they did not succeed after the Chinese government stepped in, tightened the leash on debt-driven acquisition strategies and ultimately transformed one of the country's flagship real estate developers into a state-owned entity. Perhaps to no one's surprise, the Vanke case sparked national public debate over the nature of capital markets and corporate governance in China, and of course, the ongoing role of the Chinese government in the economy.

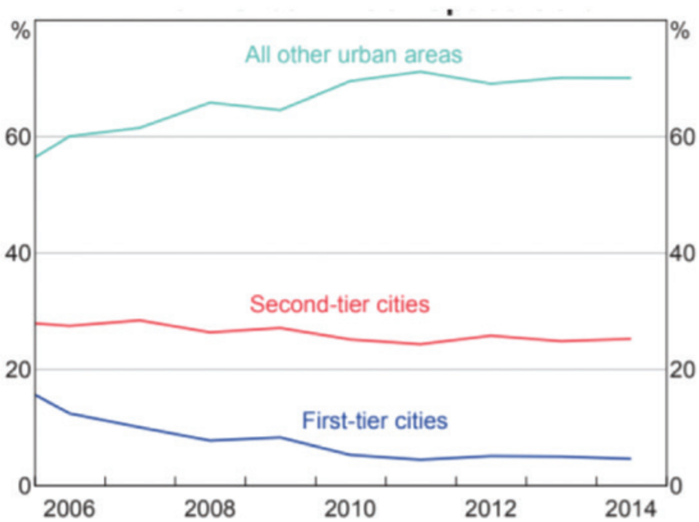
China's View of the Real Estate Sector

The Vanke case must be seen within the context of China's view of its real estate sector. It is important to understand that property development, especially residential property, represents a sizeable share of China's economic activity and has made a considerable contribution to overall economic growth in recent decades. It cannot be overstated that the health of the real estate sector is important to the overall economic and social well-being in China. Underpinning the sector are China's financial markets, corporate governance laws and citizens eager to enjoy the rewards of a booming economy through a home or investment product purchase.

Despite near constant demand, property prices in China nonetheless display strong cyclical patterns. The rate of price increases, for example, can vary widely. Residential property price gains have been particularly strong in the

Tier 1 cities. Growth in Tier 2 and other smaller cities has not been as strong.[1] As a result, the majority of urban property sales, as measured by floor space sold, largely occurs outside of Tier 1 and Tier 2 cities (Exhibit 1).

Exhibit 1: Urban Floor Sales in China



Source: CEIC Data

While the impact of real estate development in China is nationwide, the industry is dominated by only a few giant developers (Exhibit 2). These star performers not only were the beneficiaries of a recent consolidation wave, but also of earlier government policies aimed at stimulating the property market. For example, after a market downturn from 2010 to 2012, the Chinese government (a) provided first-time home buyers with easier access to finance; (b) lowered down payment requirements; (c) reduced mortgage interest rates; (d) unwound certain home purchase restrictions to allow investors to buy additional properties and for non-residents to purchase homes; and (e) redefined first-time home buyers to include those who have already paid off their first mortgage.

Exhibit 2: Top 10 Chinese Developers (2016)

	Contracted Sales ($ billion)	Floor Space Sold (million sqm)
China Evergrande Group	60.5	45.8
China Vanke	57.5	27.6
Country Garden	49.0	37.3
Greenland Group	40.9	20.2
Poly Real Estate Group	33.3	15.9
China Overseas Land & Investment	32.0	13.9
Sunac China	23.8	7.2
China Fortune Land Development	19.0	10.0
Greentown China Holdings	18.0	6.2
CR Land	17.1	7.8

Source: Capital IQ, company annual reports.

Each time property sales reached a new high, these giant firms were only further encouraged to step up their acquisition plans. Indeed, the market was ripe for consolidation. China has more than 90,000 real estate companies, but only 10% of them are profitable, according to the National Bureau of Statistics.[2]

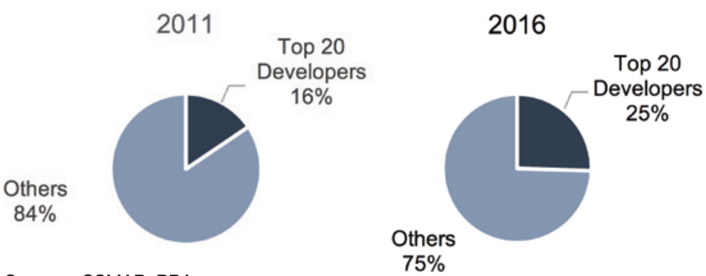
Given this, organic expansion logically gave way to consolidation. In 2016 alone, Chinese real estate developers spent a record US $27.6 billion on acquisitions of competing firms or their assets.[3] As such, the total number of Chinese developers is expected to shrink to just 3,000 by 2020. Indicative of what is to come, the combined sales of the top 20 developers, measured in terms of annual contracted sales, hit US $520 billion, or 3 trillion RMB, in 2016 according to data from the China Index Academy. This accounts for more than 25% of national property sales (Exhibit 3) and is expected to grow to 35% by 2020.

1 First-tier, second-tier and other cities are defined as cities with populations of 17, 9 and 5 million, respectively

2 National Bureau of Statistics of China

3 Data compiled from Bloomberg.

Exhibit 3: Combined Sales of Top 20 Chinese Developers



Sources: CSMAR; RBA

Vanke has long been part of the great story of China's economic growth and transformation. For decades, the company was ranked number one in the real estate industry. Only in 2016 did China Evergrande finally surpass Vanke as the largest real estate developer in China, with reported total contracted sales of 373.73 billion RMB, or US $53.9 billion, an increase of 85.4% from the previous year. Country Garden came in third. These top three developers, all based in Guangdong province, had contracted sales of 1 trillion RMB, or US $160 billion, in 2016.

Vanke's History of Ownership Changes

China Vanke Co. Ltd. was established in 1984. Since then, the company has become a leading real estate company and urban development service provider in China. Vanke's projects are in the country's most vibrant economic centers as well as major hubs elsewhere. In July 2016, Vanke was first listed on the Fortune Global 500 at 356. In 2017, it rose in the ranks to 307th place. In 2016 alone, Vanke sold over 20 million square meters of apartments across more than 25 Chinese cities, with reported contracted sales of 365 billion RMB, or US $56 billion, and a net profit of 28 billion RMB or US $4 billion.[4]

Vanke has gone through several major ownership restructurings. The first began in 1988, with the state increasing its ownership to 60% and the remaining balance held by employees. It was also during this period that Wang Shi gave up his direct management of the firm, opting instead for the company to be led by a professional manager. In 1991, Vanke went public, one of the first companies in China to do so. To be sure, the IPO diluted state and employee ownership.

The second stage of ownership changes came during 1993 to 2011 when several shareholders unsuccessfully tried to remove Wang Shi and his management team. To counter these efforts, Vanke welcomed new investors, specifically China Resources Group, as its largest shareholder. (China Resources is a state-owned conglomerate with a wide variety of businesses and ranked 86th in the Fortune Global 500 in 2017.) China Resources and Vanke's management team developed a positive relationship. The state-owned entity rarely intervened in the management team's day-to-day decision-making, except for a few investments. Of significance here is that Vanke has long partnered with state entities as a means of defending itself.

In mid-2015, the third stage of ownership restructuring came about after a hostile takeover attempt. Once again, there was an attempt to expel Vanke's entire management team. But Shenzhen Metro Group, controlled by the Shenzhen government, stepped in as a 'white-knight' investor and ultimately became largest shareholder of Vanke with a 29% stake, putting an end to this high-profile takeover battle.[5] In 2017, Wang Shi also stepped down from his chairman role — permanently exiting the company he founded 33 years earlier.

Baoneng's Hostile Takeover Attempt

Just a few years earlier, Wang Shi, the founder and chairman of Vanke, was expected to retire with a solid

4 Vanke 2016 Annual Report.

5 "Shenzhen Metro to become biggest China Vanke shareholder as Evergrande cashes out". June 9, 2017. Accessed April 19, 2018. http://www.scmp.com/business/companies/article/2097697/shenzhen-metro-become-biggest-china-vanke-shareholder-evergrande

reputation as the leader of one of China's greatest companies. He is a person with celebrity status in China on par with Microsoft co-founder Bill Gates, Virgin Group founder Richard Branson, and other international corporate legends. Instead, an orderly stepping down was curtailed by the takeover efforts of Baoneng Group, led by its founder Yao Zhenhua.

Baoneng Buys Up Vanke Shares

On July 10, 2015, Baoneng bought 5% of Vanke A shares through its subsidiary, Foresea Life Insurance. In the following 160 days, Baoneng kept accumulating Vanke's shares until it surpassed China Resources to become Vanke's biggest shareholder with a stake of 24.26%.

Before its attempted takeover of Vanke, Baoneng had been a low-profile Shenzhen-based conglomerate, with businesses ranging from real estate and microfinance to insurance. The company and its founder Yao Zhenhua were little known to the public. But as a result of its investment in Vanke, Yao has since become China's fourth richest man.

Wang Shi strongly resented the unsolicited, hostile takeover, bid. In response, Vanke halted trading in both its H and A shares on Dec. 18, 2015, pending a major restructuring. On Jan. 6, 2016, its H shares resumed trading in Hong Kong but the Shenzhen-listed A shares remained suspended for half a year to ward off Baoneng's attack (Exhibit 4). When A shares resumed trading, there was an immediate selloff.

Resisting Baoneng: A Multi-party Tussle Ensues

The battle between Baoneng and Vanke soon turned into a multi-party tussle. In March 2016, Vanke signed a memorandum with state-backed Shenzhen Metro to fend off Baoneng's potential hostile takeover. Vanke would acquire the subway operator's property projects and pay for it mainly with new shares issued. The move

Exhibit 4: China Vanke A Shares

Source: Yahoo Finance

would dilute Baoneng's stake and make Shenzhen Metro the biggest shareholder.

But Vanke's proposal was challenged by its second-largest shareholder, China Resources Group, which had been the biggest investor from 2000 to 2015. Bringing on Shenzhen Metro as a major investor also would dilute China Resources' stake and weaken what had been a very positive relationship between the two companies. In June 2016, Baoneng and China Resources joined forces to block Vanke's proposal to bring in Shenzhen Metro. Baoneng then filed a motion to oust Vanke's board but it didn't succeed.[6]

The battle heated up as a growing cast of large companies joined the bidding, which included Vanke's rival developers. On Aug. 4, 2016, China Evergrande announced that it bought 517 million Vanke A shares. By mid-August 2016, China Evergrande Group had acquired 6.82% of Vanke's shares, making it the company's third-largest shareholder. In late November 2016, China Evergrande further raised its stake in Vanke to 14.07%.

Government Intervention

In early December 2016, China's regulatory authorities began to clamp down on leveraged buyouts and sent inspection teams to the insurance units of both Evergrande and Baoneng to identify non-compliant activities. The China Insurance Regulatory Commission (CIRC) suspended sales of 'universal life' insurance products at Baoneng's unit Foresea Life Insurance until it resolves issues with risk monitoring and customer accounts management. (Regulators also stopped online sales of universal insurance products at other insurers.) It then banned Baoneng Chairman Yao from the insurance industry for 10 years. The commission also barred Evergrande Life, the insurance arm of Evergrande, from investing in stocks. Authorities were concerned that funds generated from such activities were used to finance highly leveraged takeovers.

After regulators got involved, the main protagonists began to reposition themselves. Evergrande soon clarified that it had no intention of taking control of its rival Vanke, according to news reports by JRJ.com, one of the major financial media outlets in China.[7]

Vanke as a Local State-owned Enterprise

After the government stepped in, Vanke's major investors began to unload their shares. In 2017, Vanke's long-standing investor, China Resources, sold its entire 15.3% stake to Shenzhen Metro at a

Exhibit 5 Vanke's Ownership Structure Before and After the Takeover

Before Takeover (2014)	
Shareholders	% of Shareholding
China Resources	14.91%
HKSCC Nominee Limited	11.91%
Guosen Securities	3.30%
Anbang Life Insurance	2.13%

Post Takeover (Oct 2017)	
Shareholders	% of Shareholding
Shenzhen Metro	29.38%
HKSCC Nominee Limited	11.91%
Baoneng	8.39%
Foresea Life Insurance	5.15%
Guosen Securities	4.14%

Sources: company interim report, company annual reports.

6 Source: company filings.

7 http://money.jrj.com.cn/2017/06/13142022603696.shtml

loss.[8] China Evergrande also sold its 14% stake in Vanke at a loss of 7.1 billion RMB (US $1 billion) to Shenzhen Metro, declaring that the divestment was done out of consideration for "the strategic development requirements of the company." But since China Evergrande opted to sell at a loss and to a state-owned entity, most observers took the move as an indication that the company was pressured to exit or risk government sanctions. In turn, Shenzhen Metro gained majority control with an ownership of 29.38% (Exhibit 5). Baoneng said it welcomed Shenzhen Metro, but its ability to control Vanke's future was now considerably weakened.

Significance of Vanke's Takeover Battle

Betting aggressively, Baoneng's Foresea Life Insurance was able to deliver high returns at high risk. As a result, its products became very attractive to Chinese investors looking for a better return on their money than might be found elsewhere. Besides raising its stake in Vanke, it has stakes ranging from 7% to 28% in eight other A-share listed companies. Its big bets nearly tripled Baoneng's investment income to 11.28 billion RMB (US $1.69 billion) in 2015.

Industry-wide, the asset growth rate of China's unlisted insurers was almost 60% in 2015 compared to 14% among large listed insurance companies, according to Reuters.[9] Some insurers sought to increase earnings through high-risk equity investments, further increasing the volatility of the Chinese stock market. The CIRC had warned these conglomerates against using their insurance subsidiaries as a funding source for these risky investments. In 2016, CIRC Chairman Liu Shiyu went so far as to describe the practice as a kind of industrial "banditry."

CIRC's decision to suspend Baoneng's unit Foresea Life Insurance from selling "universal life" products and the banning of Evergrande Life from trading in stocks, besides being punitive, also illustrated to observers that regulatory oversight had failed to keep pace with financial innovations in this growing sector. Ultimately, CIRC tightened rules by reducing the maximum total premiums the industry is allowed to invest in high-risk products.

Corporate Governance in China

Vanke was known for its decentralized ownership structure, which made it more vulnerable to a takeover bid. At the end of 2014, before the fight for control over Vanke ensued, about 60% of its shares were held by small shareholders. China Resources, being the largest shareholder of Vanke before the hostile bid, had a 15% stake. Wang Shi, founder of Vanke, and his executive team only held about 0.2% of the company when Baoneng launched its attack.[10]

Vanke did not have a 'poison pill' or shareholder plan to thwart unsolicited suitors, leaving the company — as well as other Chinese firms in the same plight — with little option but to suspend trading of shares to stop an aggressor from increasing its stake even more. Such a move, however, also hurts current shareholders who are then also prevented from selling off their shares to reduce risk and protect their interests. As a result, two patterns of "China-style" corporate governance persist: (a) limited separation of owners and managers, thus giving managers the power to direct corporate strategy and thwart hostile takeovers by virtue of shares held in a company; (b) reliance on government entities to play 'white knight' roles in response to market dynamics deemed disruptive to social and economic order.

8 "Shenzhen Metro to become biggest China Vanke shareholder as Evergrande cashes out". June 9. 2017. Accessed April 19, 2018. http://www.scmp.com/business/companies/article/2097697/shenzhen-metro-become-biggest-china-vanke-shareholder-evergrande

9 https://www.reuters.com/article/us-china-vanke-m-a-insurance/inside-china-vankes-power-struggle-an-unlisted-insurer-idUSKCN1080P4

10 https://www.businesslive.co.za/bd/world/asia/2017-01-13-new-twist-in-chinas-first-blue-chip-hostile-takeover-battle/

Appendix: A Timeline of the Vanke Takeover Battle

2015

- July: The Baoneng Group begins buying up shares in China Vanke.
- December 4: Baoneng becomes Vanke's largest shareholder after increasing its stake to 20%.
- December 18: Trading in Vanke's shares are suspended after Chairman Wang Shi says the firm does not welcome the involvement of Baoneng, which by then had a 24.26% stake.

2016

- January 6: Trading in Vanke shares resume in Hong Kong, but its Shenzhen-traded shares remain suspended, pending an asset restructuring plan meant to dilute Baoneng's stake.
- March 13: Vanke seeks state-backed Shenzhen Metro Group as a 'white knight' to fend off Baoneng's hostile takeover bid.
- June 17: Baoneng and China Resources Group, Vanke's two largest shareholders, reject its proposal to bring in Shenzhen Metro, during a board meeting.
- June 26: Baoneng files a motion to remove all of Vanke's board members, but it is vetoed by the board.
- July 4: Vanke's shares in Shenzhen resume trading after having been suspended for seven months.
- July 19: Vanke says Baoneng has further increased its stake to 25.4%.
- August 15: China Evergrande Group acquires 6.82% of Vanke's shares to become its third-largest shareholder.
- November 30: Evergrande further raises its stake to 14.07%.
- December 3: Chinese authorities begin to clamp down on leveraged buyouts and sends inspection teams to the insurance units of both Evergrande and Baoneng to check for any non-compliant activities.
- December 5: The China Insurance Regulatory Commission bans Baoneng's Foresea Life Insurance unit from selling 'universal life' insurance products.
- December 9: The commission bans Evergrande Life, the insurance arm of Evergrande, from trading in stocks.
- December 17: Evergrande says it has no intention of taking control of Vanke.

2017

- January 12: China Resources agrees to sell its entire 15.3% stake in Vanke to Shenzhen Metro.
- January 13: Evergrande says it has no intention of further increasing its Vanke holding and Baoneng says it welcomes Shenzhen Metro.
- March: Vanke is set to re-elect all its 11 board members after their three-year term expires.
- June: Shenzhen Metro becomes Vanke's largest shareholder, ending the takeover battle. Vanke Chairman Wang Shi announces he is stepping down.