On the Way to the New Height: Walmart's Acquisition of Yihaodian Cleared on Conditions in China

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The global retailing giant Walmart announced in February that it would further acquire 33.6% interest in Yihaodian, a leading B2C e-commerce company in China. Before the investment, Walmart already held 17.7% interest in Yihaodian. The new deal is subject to government regulatory approvals, including antitrust approval from the Chinese anti-monopoly regulator, the Ministry of Commerce ("MOFCOM"). On 13 August 2012, Walmart announced that it has received conditional approval from MOFCOM.

The Deal

According to MOFCOM, the deal includes two key parts, i.e. (i) Walmart acquires 33.6% equity interest of New Heights Holding Ltd. ("New Heights Holding") through its wholly-owned subsidiary GEC 2 Pte. Ltd. ("GEC"); (ii) New Heights Holding, acquires control through its two wholly-owned subsidiaries, Hong Kong New Heights Corporation Ltd. and New Heights Information Technology (Shanghai) Co Ltd.("New Heights Shanghai"), over Shanghai Yishiduo Electronic Commerce Co. Ltd. ("Yishiduo") which owns Yihaodian's online direct sale business. The deal is among nine parties, including Walmart, GEC, China Ping An Insurance (Overseas) Ltd., Mr. Yu Gang, Mr. Liu Junling, Shanghai Yishiduo Electronic Commerce Co. Ltd. ("Yishiduo"), Shenzhen Ping An Innovation Co Ltd., etc. After the transaction, Walmart will own 51.3% of New Heights Holding, by which it gains control on the online direct sale business of Yihaodian in China.

Telecommunication Issues

Walmart will gain a foot hole in China's vast yet fast-growing e-commerce market, a market that foreign investment is highly regulated. Under the Chinese regulations, online direct sale of third-party goods is referred to as e-commerce, in which foreign investors are permitted to hold controlling interest ("E-commerce"). Offering online platform and services to independent third parties to sell their products, however, is a highly regulated sector in China. It is referred to as “value-added telecommunications services” (“VATS”) under the Chinese regulations, which is categorized as “restricted” under China’s current foreign investment catalogue. Foreign equity ownership in the VATS sector is capped at 50% under the telecommunication regulations. Yihaodian operates in both of these business sectors. Now that, Walmart being a foreign entity cannot own controlling interest in an entity that operates in both the sectors. This is an interesting case in the short history of MOFCOM antitrust review. MOFCOM faces a situation where foreign investment in the deal is in part subject to regulatory restrictions.

Due to the restrictions, the deal would remain subject to the examination and approval of China’s telecommunication regulator, the Ministry of Industry and Information Technology, if Walmart wishes to exercise the same control on Yihaodian’s VATS business. The approval from the telecommunication regulator will enable Walmart to lawfully hold the VATS business through Yihaodian. Otherwise, Walmart will need to set up an acceptable fire wall between the two businesses

MOFCOM’s approval cleared a significant regulatory hurdle towards the completion of the deal. This is the 14th deals that have been approved by MOFCOM on conditions since China’s Anti-monopoly Law took effect in August 2008. During the past 4 years, China’s regulatory system for merger-related anti-monopoly review has developed rapidly. MOFCOM has reviewed over 500 cases and has established itself as one of the most important anti-trust regulators in the world.

Antitrust Issues

MOFCOM was notified of the deal for antitrust clearance on 16 December 2011. It did not, however, accept the notification until two months later. During the two months, the parties were required to supplement and complete their filing materials. MOFCOM’s review went through the three phases that are permitted by China’s Anti-Monopoly Law and used 177 days from the date of acceptance (180 days are the maximum time).

As usual, MOFCOM first endeavoured to define the scope of the markets relevant to its review of the merger. It considered Walmart as one of the primary supermarket competitors in both China and the world. With its main business focused on superstore retail, Walmart enjoys competitive advantages in supply, storage, product lines, store network management and related services, logistics and brands. According to MOFCOM, Yihaodian is China’s largest online supermarket, operating not only the business of online direct sale (e-commerce) but also VATS business. The goods that Yihaodian sells through its e-commerce business cover a broad range, which include food, beverage, personal care, kitchen and toilet products, home electrical appliances, etc, supplied by over one thousand suppliers. Yihaodian's VATS business mainly is the provision of platform for sales online by a large number of independent third party merchants. MOFCOM stated that it considered the B2C online retailing market in China relevant to its review. MOFCOM took into account not only the scope of business of the Walmart and Yihaodian, but also the factors such as the models, suppliers and buyers and purchasers customs when defining the relevant market.

MOFCOM noted that the e-commerce business involves various key elements, such as online payment, goods storage and logistics, online sales service, web platform, etc. Among them, logistics and services play key part in deciding the development of the e-commerce business. MOFCOM further noted that Walmart has, through its widespread store networks in China, has built a matured and developed logistics and service system and broad supply channels. Walmart also enjoys well-established brand recognition in the market. These constitute Walmart's competitive advantages in China's retailing market. Although the advantages exist mostly in Walmart's store network, they could, however, be transferred to the online business of Yihaodian by the transaction. Further, MOFCOM holds that these advantages combined with the strengths Yihaodian already gained in the e-commerce sector could substantially increase the competitive power of the latter in such business.

MOFCOM went on to examine the possible impact of the deal on the VATS business of Yihaodian. It is clear that MOFCOM has been well noted that Walmart is forbidden by the Chinese telecommunication regulations to control any domestic VATS business. However, since it is not within its duty as an antitrust regulator to deal with this conflict, MOFCOM decided to follow its antitrust methodology and avoid commenting on the regulatory restrictions. It anticipated that Walmart could enter into the VATS market through Yihaodian after the transaction, which would enable it to expand fast in the market by taking advantage of the notable synergized strengths of both online and store-based retailing business to be realized by the transaction. As such, the parties would stand on an advantageous position in the VATS market, by which Yihaodian could gain excessive pricing power in the market against other merchants who use its platform, and therefore would reduce or eliminate competition in the market.

Remedies

As conditions to the approval of the deal, MOFCOM required Walmart to perform the following obligations:

1. it must limit the acquisition to the effect that it only include the sector of direct online retail through Yihaodian platform;
2. it must not offer its online platform to a third party of any online transactional services before obtaining relevant VATS permits; and
3. it must not be engaged in the VATS business operated by Yishiduo after the completion of the transaction through a variable interest entity ("VIE").

Apparently, all these conditions focus on one issue only, i.e. the access Walmart may gain after by the acquisition to the VATS business operated by Yihaodian. MOFCOM is determined to take the chance to prohibit Walmart from circumventing the regulatory restrictions in the VATS market for antitrust reasons. These conditions require Walmart and other parties to effectively separate the business of E-commerce from the VATS of Yihaodian or effort to gain telecommunication approval.

Conclusions

MOFCOM's approach in dealing with a transaction that may in part contradict with the current regulations is the highlight of this case. It firstly indicated that MOFCOM would like to take a relatively flexible position when reviewing a case involving regulatory restrictions. MOFCOM is willing to accept restrictive remedies that can filter out the effect of the element conflicting regulations, depending on the agreement of the merger parties.

Secondly, in this case, MOFCOM, for the first time, expressly denied using the so-called VIE structure for the purpose of penetrating the regulatory restrictions in China. The VIE structure has been a contradictory issue. It has been commonly used by foreign investors in investing in restricted or prohibited industrial sectors in China and arranging offshore financing transactions for China-based companies. This investment structure has been tolerated by the Chinese authorities. Recently, it was reported that the VIE structure is under attack from China Security Regulatory Commission and some local governments. MOFCOM has not yet made its view clear as to the VIE structure. MOFCOM's denial of the VIE structure seems to enforce its decision that Walmart must not enter into the VATS market without permission.

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