Theory and Evidence…

Shifting of M&A in China

By

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An honors thesis submitted in partial fulfillment

of the requirements for the degree of

Bachelor of Science

Undergraduate College

Leonard N. Stern School of Business

New York University

May 2005

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EXECUTIVE SUMMARY

China’s fast growing economy and its influx of encouraging policies regarding FDI seems to be the perfect setting for foreign multinationals to enter the market through mergers and acquisitions. Contrary to popular belief, my theory is focused on shifting this enthusiasm to the domestic deals and to put off the surge of foreign cross border M&A until China has more experience in these deals and therefore make M&A more beneficial for both sides.

Economic Setting:

The Chinese Academy of International Trade and Economic Co-operation completed a report on overseas investment trends from 2005 to gain an insight into trends related to foreign direct investment as well as local investment policies. The tendancies for the next three years are: Scale economies in growing industries, limited R&D integration, favored sole ownership, more power for overseas headquarters, popular investment destinations, and the efficiency and transparency of investment policies.

China’s M&A Background:

According to PricewaterhouseCoopers' Transaction Services group, the rapid increase in activity is being fuelled by the ongoing restructuring and privatization of former State Owned Enterprises together with strong inbound investment across a range of industries, particularly those being deregulated where foreign participation was previously restricted to joint ventures and minority stakes such as financial services, retail and media.. Some of the surge in 2004 was the result of a resumption of deals that had been put on hold in 2003, when the outbreak of SARS interrupted business activity

Motivation and Impact of Cross Border M&A:

The most popular theory of FDI is Dunning's OLI or Eclectic Paradigm. Dunning identified three variables: Ownership (O), Location (L), and Internalization (I). Dunning has identified foreign-based multinational activities by four main types: market-seeking, resource-seeking, efficiency-seeking, and strategic-asset-seeking FDI. Regarding cross-border M&A, in particular, the World Investment Report (2001, 2002) has also summarized its motivations into eight main categories: new markets, greater size, personal motive, strategic assets, financial motive, speed, diversification, and synergy.

Ongoing and future Trend:

The restructuring of State Owned Enterprises have become more prevalent and often involves a merger or acquisition including big players in sectors that traditionally have been under State monopoly. The acquisition of Chinese companies by foreign companies accounts for 30% of the top ten deals in 2002. The presence of private equity is bringing greater competitiveness and sophistication to a market where domestic private companies are growing rapidly. Domestic companies are seeking outward expansion. Widespread consolidation seems necessary as Chinese industries try to remain competitive after WTO. SASAC is pushing for M&A among domestic firms to remove industry overcapacity and can better compete.

Cross Border M&A: The Process:

Acquisition contract negotiations tend to focus on three major issues: valuation, debt restructuring, and size of the workforce. All acquisitions of companies that are operating in China are subject to some level of official review or approval by local, provincial, and national government authorities. But the complexity, difficulty, and time required to complete the government review and approval process vary greatly by the type of acquisition target, the size of the acquisition transaction, and the impact on the industry and sector involved.

Drawbacks to Foreign Cross-Border M&A:

There are many drawbacks hindering foreign M&A capital flowing into China. Complicated Regulatory system, numerous policy uncertainties, poor transparency in policy decision-making, ambiguous valuations, complex due diligence, macro and microeconomic concerns, along with exit options are all reasons why China is currently not ideal for foreign cross border M&A.

Negative Impact on Host Economy

The biggest hidden issue is that foreign investors break through China's industrial protection line by manipulating domestic partners in M&A deals. Since current rules and regulations stipulate no specific punishment for such violations in M&A deals, local governments would, in pursuit of achievements, sacrifice the national, regional and employees' interests to attract more foreign investment. China should be clear-minded that foreign investors merging with or acquiring SOEs are not focusing on helping lift SOEs out of their dire straits, and many would bring certain negative impact. Chinese companies are seeking to gain technological and management knowledge, but foreign companies may not be so eager to share intellectual property.

Shifting Trend:

Domestic M&A will be beneficial in terms of integrating scattered industries and increasing competitiveness for the firms involved. They do not have to deal with the cultural hurdles such as foreigners. They are more familiar with the government, in terms of connections (guanxi) or flexibility in regulations. The potential for positive synergy is greater and it helps build a framework for future deals.

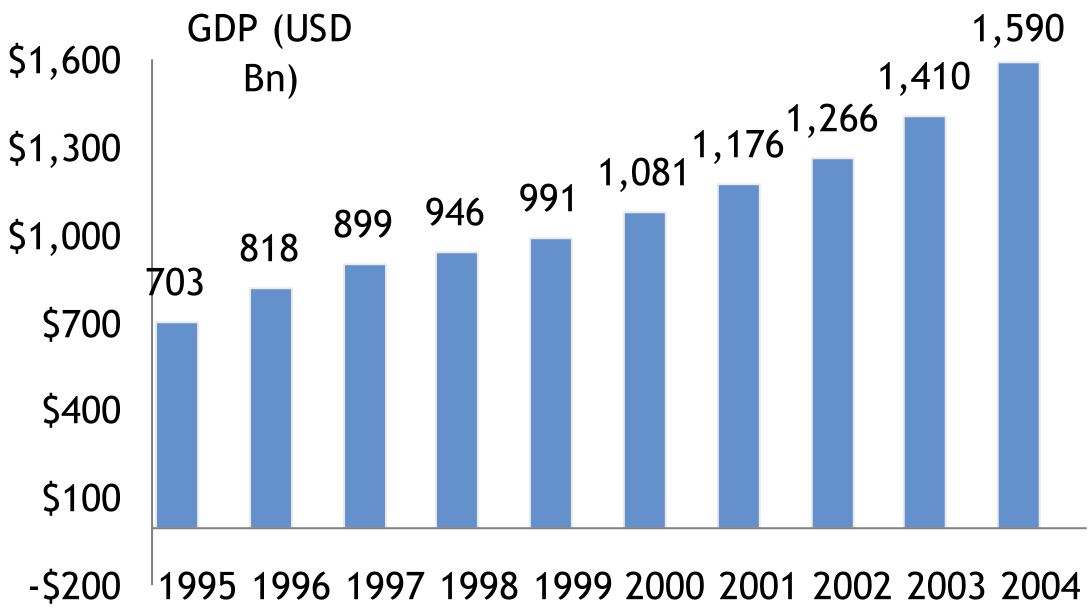
Recommendations for Domestic Deals:

Chinese companies would need on a more gradual, organic path to international expansion. Chinese companies should select a partner based on how it fits in with strategic objectives, rather than because it is first through the door. They should be aware of the “lemons problem and have a clear picture of how it intends to build upon the synergy. To ensure an acquisition will create value, Chinese companies need to avoid focusing solely on the best price.

The acquirer needs rigorous cash flow and synergy analysis rooted in a deep understanding of the target's business and industry. Valuing companies using market multiples, an approach favored by companies in developed markets, often fails to evaluate the unique value creation opportunities and potential synergies between an acquirer and its target. Multiples are an even poorer guide to valuing Sino-foreign deals given their relative newness.

Economic Forecast:

According to the National Bureau of Statistics, China's GDP grew by 9.5% year on year in the fourth quarter of 2004, bringing the average growth for the year to a higher than expected 9.5%. Industrial production figures for January-February 2005 showed a 17% year-on-year increase, a sign that the government needs to do more to keep investment spending down to a sustainable rate. With strong industrial production data for January and February 2005 and the surge in real-estate investment, the Economist Intelligence Unit raised its GDP growth forecast for 2005 and 2006 to 9% and 8% respectively. Gross fixed investment will remain very firm this year, and private consumption growth will pick up over the forecast period.[1]



China's FDI Outlook:

As China's economy continues to open and becomes increasingly market-oriented due to the government's fulfillment of its pledges made upon joining the World Trade Organization in 2002, overseas investment will be playing an increasingly pivotal role in determining the nation's economic progress. The Chinese Academy of International Trade and Economic Co-operation completed a report on overseas investment trends from 2005 to gain an insight into trends related to foreign direct investment as well as local investment policies.

The report mainly covers multinationals listed in the Business Week Top 1,000, from Europe, the Americas, Japan, South Korea and China's Hong Kong Special Administrative Region and Taiwan Province, representing the information technology, automobile, chemical, biology and pharmaceutical industries.

Results:

[1] EIU Country Report

82 per cent of the multinationals surveyed indicated that they will boost their spending. Around 35 per cent of multinationals say they are at the stage of consolidating their investments in China by either taking a controlling stake or take absolute control of the venture.

Tendencies over the next three years:

While accelerating the shift of primary industries to the Chinese mainland, high-end products and technological development will be retained in their home countries, with investment in manufacturing continuing to rise. Multinationals will increase their investment in sales and after-sales services in order to sharpen their competitive edge. Some manufacturing giants will speed up their transfer of technology to China, after transferring assembly procedures to the nation to cultivate local technological and management skills.

Scale Economies in growing Industries:

The IT market accounted for 30.8 per cent of the Asian market (excluding Japan) in 2003, with this share expected to reach 38 per cent as the sector's growth rate continues to outstrip the global IT industry's average. Car production will hit 8.5 million units in 2005, up 30 per cent year-on-year. The size and growth rate of the two industries have become key factors influencing multinationals' investment strategies in the Chinese mainland.

Many multinationals say they will establish product retail terminals as the mainland frees up the commercial distribution sector, thereby stimulating growth of investment from distribution enterprises. Certain industry clusters are forming and has attracted more suppliers and manufacturers in the industry chain to enter the market.

R&D Expenditure:

Most multinationals will retain their core R&D functions in their home countries, although some will be transferred overseas. Many are reluctant to move basic R&D outside their home countries, probably wanting to maintain exclusive knowledge of core intelligence. Overseas companies had established 700 R&D centers in the Chinese mainland by the end of last year, according to statistics from the Ministry of Commerce. 46 per cent of the multinationals said they would like to set up independent research facilities, while 24 per cent say they will work with local partners to develop technologies.

Sole ownership favored:

The survey reveals that 57 per cent of multinationals prefer to establish solely-funded manufacturing facilities in the Chinese mainland, while 37 per cent say they are willing to co-operate with local enterprises, 28 per cent said mergers with and acquisitions of local companies cannot be ruled out.

The government revised its WFOE (wholly foreign-owned enterprise) Implementation Regulations in 2001 which provides that "the establishment of WFOEs must benefit the national economy" and that China "encourages the establishment of technologically advanced WFOEs."

More power for overseas Headquarters:

The mainland headquarters decide investment in local R&D and sales. The overseas headquarters will decide what kind of products should be manufactured in China according to the firm's global strategy. The local company will decide the production capacity, total investment, and is responsible for choosing investment destinations, government relations and human resources. The mainland operations of software and pharmaceutical companies, in which R&D has a more important role, generally have less power.

Investment Destinations:

The Yangtze River Delta will be the most popular investment destination for multinationals over the next three years, with 47 per cent indicating that they will invest in this region. It is followed by the Bohai Economic Rim, including Shandong, Shanxi, and Hebei provinces, and Beijing and Tianjin municipalities, with 22 per cent. The Pearl River Delta, which was previously the most popular investment destination, comes third, with 21 per cent. Northeast China and western and central China are still at the bottom of the list, with 9 per cent and 8 per cent respectively, despite the government's move to promote investment in the two regions. Meanwhile, 92 per cent of the multinationals say they will invest in development zones.

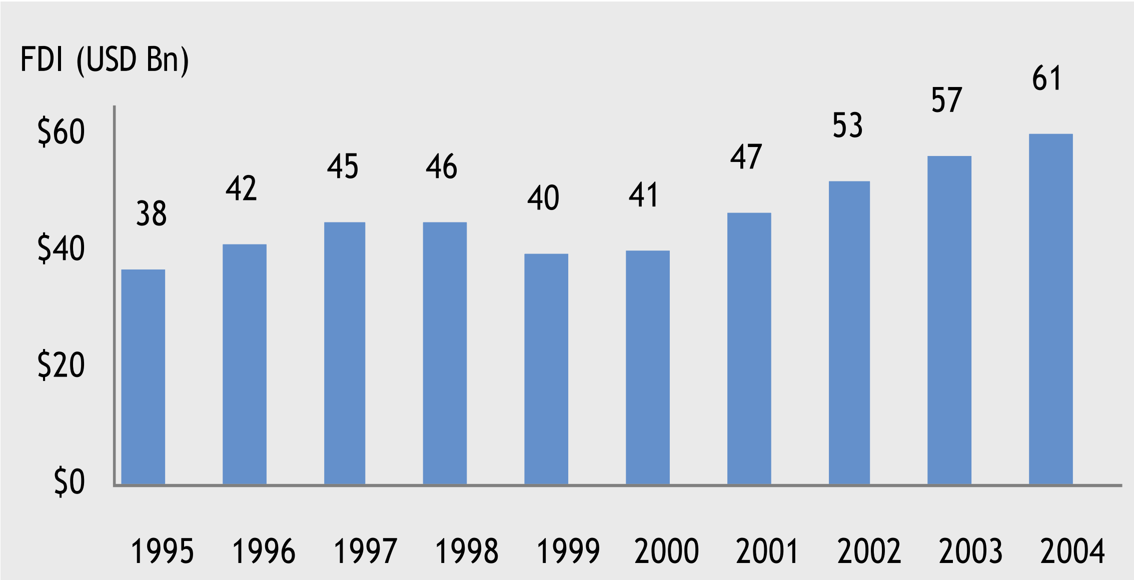
The efficiency and transparency of the investment policy:

Local governments have a major influence in the mainland's economic development. Local governments fiercely compete with each other in attracting foreign direct investment, offering all kinds of favorable policies in terms of land use and income tax which often don’t follow through due to sudden changes.

Most of the multinationals say they have little knowledge about regions outside eastern China and the cost of obtaining useful information regarding industry, markets, and human resources can be quite high. The survey indicates local governments do not achieve much from their publicity and promotions. Their departments responsible for attracting investment have no clear targets and have bad understanding about how an investment decision is made, which means that their promotions are generally ineffective.

Statistics:

Actual FDI in the Chinese mainland increased moderately by nearly 13 per cent to US$60.6 billion last year. Total contracted FDI reached US$153.5 billion in 2004, up 33.4 per cent year-on-year. By the end of last year, nearly 509,000 foreign-funded companies had been set up in China. The accumulated FDI reached US$562 billion and the contracted investment totaled US$1.1 trillion.



Source: CEIC, Xia Dynasty Fund

China's M&A Outlook:

An acquisition (shougou) is the purchase by one economic entity of all or part of the shares or assets of another economic entity while both survive. A "merger" (hebing or *jianbing) is the legal combination of two discrete economic entities in which only one entity survive and assume all the assets and liabilities of both entities.*[2]

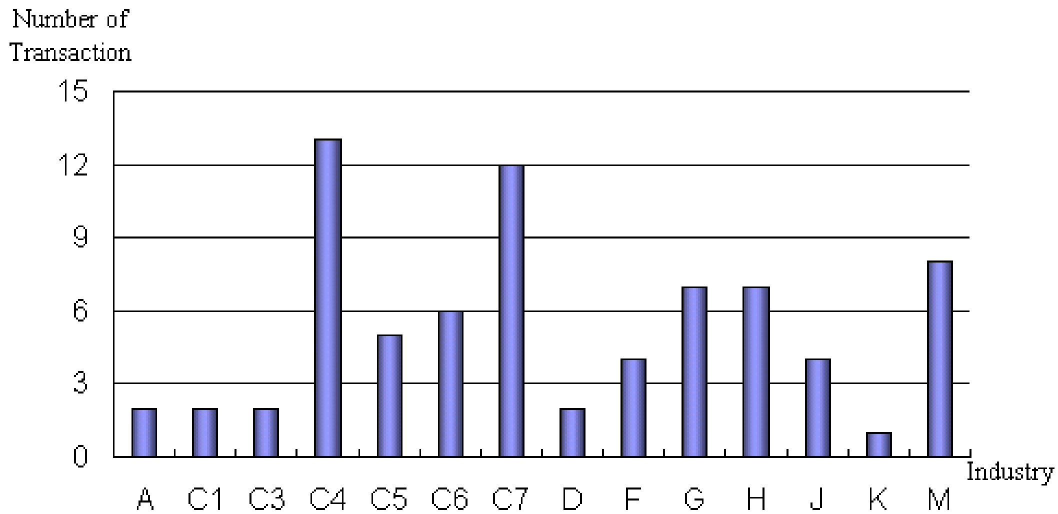
China M&A increased by 50% in 2004, compared to 2003, according to M&A Asia. The aggregate value of China deals (including Hong Kong) announced in 2004 was US$52 billion, compared with US$35 billion in the previous year. In terms of Asia-Pacific as a whole, aggregate deal values were 38% (US$69 billion) higher at US$250 billion, compared with US$181 billion in the prior period. China continues to be the number one location in Asia for deal activity (693 announced deals in 2004 versus 555 in 2003). China contributed 21% by value and 32% by number to the region as a whole. [3]

According to PricewaterhouseCoopers' Transaction Services group, the rapid increase in activity is being fuelled by the ongoing restructuring and privatization of former State Owned Enterprises together with strong inbound investment across a range of industries, particularly those being deregulated where foreign participation was previously restricted to joint ventures and minority stakes such as financial services, retail and media.. Some of the surge in 2004 was the result of a resumption of deals that had been put on hold in 2003, when the outbreak of SARS interrupted business activity.[4]

It's always been assumed that the top sectors for M&A activity in China are Energy, Utilities and Mining, Financial Services, Transportation and Logistics, and Telecommunications, mostly because these industries relate to significant political/infrastructure type assets. But in terms of actual transaction activity levels, the deals are spread across a wide range of industries, including Manufacturing, Consumer and Industrial Products, Pharmaceuticals, Brewing and Automotive.

[2] ChinaBusinessReview- M&A in China Comes of Age 07/1998
[3] EIU Finance - News Analysis March 2, 2005
[4] EIU Finance - News Analysis March 2, 2005

Distribution Graph in Terms of Number of Transactions for Listed Companies



NOTES:

A for Agriculture, Forestry, Hunting and Fishing; C1 for Textile, Apparel and Leather; C3 for Paper Manufacturing and Printing; C4 for Petroleum, Chemical Manufacturing, Plastics and Rubber Product Manufacturing; C5 for Computer and Electronic Product Manufacturing; C6 for Metal and Nonmetallic Product Manufacturing; C7 for Machinery Manufacturing, Component Manufacturing and Instrument Manufacturing; D for Utilities; F for Transportation and Warehousing; G for Information; H for Wholesale Trade and Retail Trade; J for Real Estate; K for Services; M for Diversified Industry. [5]

Mr. Christopher Chan, Partner in Charge of PricewaterhouseCoopers' Corporate Finance team in Hong Kong and mainland China said: "We have seen a huge shift in confidence in the sense that, in the past, foreign investors were usually investing into an export orientated target. Today, there are many more deals that are based on a domestic market play." "On a regional basis, we have also seen an increasing upward trend in both the level of deal activity and deal valuations, reflecting perhaps an increased confidence in the fundamentals in Asia. A recent example was the Hong Kong port deal, where it was reported that the winning bid was more than twice the book value of the assets. Another case was the hostile bid by Anheuser-Busch for Harbin Brewery, which reportedly was priced at over 40 times forecast 2004 earnings".[6] "They feel the holy grail is closer," says Jim Woods, a partner at PricewaterhouseCoopers in Hong Kong. "Everybody is talking about China and there is always a bit of the herd mentality in M&A." Mr. Woods continued: "China is where all the action is, and no-one wants to miss the boat.[7]

Motivation and Impact of Cross Border M&A:

The most popular theory of FDI is Dunning's OLI or Eclectic Paradigm. Dunning identified three variables: Ownership (O), Location (L), and Internalization (I). According to Dunning locational decisions for foreign activities are made by multinational enterprises based on the purpose of augmenting or exploiting their already existing O specific advantages. Regarding the role of L, Dunning has identified foreign-

[5] Global M&A Research 2003
[6] PWC HK NEWS- Feb 2005
[7] PWC HK NEWS- Feb 2005

based multinational activities by four main types: market-seeking, resource-seeking, efficiency-seeking, and strategic-asset-seeking FDI.

Regarding cross-border M&A, in particular, the World Investment Report (2001, 2002) has also summarized its motivations into eight main categories: new markets, greater size, personal motive, strategic assets, financial motive, speed, diversification, and synergy.

In regard with the impacts of cross-border M&As, the World Investment Report (2000, 2001) acknowledges seven determinants: investment, financial resources, employment/skills, technology, export competitiveness, market structure, and competition.

Case Studies:

1. Emerson Electric acquires Avansys, a subsidiary of Huawei Technologies (2001).
The US-based Emerson has paid US$750 million in cash to buy 100 percent of Avansys Power, a unit of Shenzhen-based Huawei Technologies. This transaction was announced "Best cross-border M&A of the Year 2001" by Finance Asia. Emerson Electric, the biggest player in manufacturing telecom power equipment, was searching for a low cost production base for its products. Meanwhile, Huawei realized that Avansys, although being China's biggest manufacturer of power supplies for telephone networks, was a non-core business for the company. Also, Huawei needed cash to expand throughout China. "With the emerging trend of globalization, it's important that we focus resources on our core business - designing, producing and selling the highest quality telecommunications and data communications equipment," said Huawei's spokesman.[8]

2. Alcatel increased stake in Shanghai Bell (2001).
French telecommunications equipment firm Alcatel has taken a majority stake in Chinese telecoms firm Shanghai Bell, boosting its shareholding from the previous 31.65 percent. The firm paid 312 million Yuan (US$37.8 million) to buy a stake of 8.35 percent from the
Belgian government and 10 percent plus one share from Chinese shareholders. This would give Alcatel 50 percent plus one share in the firm, to be renamed Alcatel Shanghai Bell. Alcatel, building next generation networks and delivering voice and data solutions to carriers, wanted to expand activities in Asia. On the other hand, Shanghai Bell, a telecom technology leader with the most extensive sales and support network in China, wanted to attain state-of-the-art network technology from Alcatel.

3. HSBC Insurance Holdings Ltd. acquired share in Ping An Insurance Company of China, Ltd (2002).
The Hong Kong and Shanghai Bank (HSBC) Insurance Holdings Ltd. has taken a 10 percent stake in Ping An Insurance, China's second largest insurer for US$600 million. The wholly owned subsidiary of the HSBC Group was attracted to potential growth of the insurance and asset management sectors in China[9]. Meanwhile, Ping An was in the

[8] World IT Report, Apr. 9, 2003
[9] Hong Kong Bank, Oct. 8, 2002

process of restructuring and needed funds. Also, with the transaction HSBC could play the role of a strategic partner providing technical assistance and various service products.

4. AB (Anheuser-Busch) purchased Tsingtao Brewery share (2002).

The US-based AB (Anheuser-Busch) increased Tsingtao Brewery's share from 4.5 percent to 27 percent at US$182 million. AB, the world's largest brewer and maker of Budweiser, Bud Light, and Michelob, was searching for the opportunity to tap in China's growth. "To invest in the growth of China, you really need to do it through the mainstream companies," said Patrick Stokes, AB chief executive. As for Tsingtao Brewery, the largest Chinese brewer (12.8 percent market share, more than 50 percent of total beer export from China) was interested in the potential of increasing its sales in the US market. "We have been eyeing the U.S. beer market, but our sales there have been hampered by high transportation costs," said company secretary, Zhang Ruixiang.[10]

5. Ford increased stake in Jiangling Automobile Co., Ltd (2002).

Ford Automobile purchased additional shares of Jiangling Automobile from 20 percent to 30 percent at US$55 million. Ford wanted to expand its business in the Chinese automobile market and establish strategic ties with Jiangling in the long run. Jiangling Automobile Co., Ltd, which is part of one of China's major enterprises, Jiangling Automobile Group, started out as Ford's first auto joint venture in China. Jiangling Automobile Group, the parent company of Jiangling Automobile Co., Ltd., is one of China's 520 major enterprises and is capable of manufacturing 60,000 automobiles per year. From the transaction, the company prospects are attaining further technological support from Ford.[11]

General Impacts on China

	Emerson &	Alcatel &	HSBC &	Anheuser-Busch	Ford &

10 International Herald Tribune, Oct. 22, 2002

11 People's Daily, Oct. 31, 2001

	Avansys	Shanghai Mobile	Ping An Insurance	& Tsingtao	Jiangling Auto
Value, share	$750 mil., 100%	$37.8 mil., 50% + 1 share	$600 mil., 10%	$182 mil., 27%	$55 mil., 30% (20%? 30%)
Factor Conditions	1. Financing 2. Know-how and technology	1. Improve China's infrastructure 2. Providing industry-leading solutions 3. 3,500 R&D engineers to be hired in three years	1. More funds from HSBC 2. Provide technical assistance and services	1. More funds to finance affiliates 2. Technical resources 3. Buying breweries in the U.S.	1. Financing funds into Jiangling 2. Technical innovation 3. Improving fundamental credit
Demand Conditions	1. Continued and increased sales to Emerson 2. Avansys' export of its patented technology	1. Increasing capacity to approximately 10 million subscribers 2. Improvement of the quality of demand, after providing high-quality networks	1. China's insurance and wealth management market to grow rapidly by cross border M&As	1. Helping export increase 2. New markets opened from the help of AB 3. A variety of choices of beer introduced by AB for Chinese consumers	1. Advanced demand quality with new product lines from Ford 2. Consumers' concept change of debt with the introduction of vehicle loan systems
Related & Supporting Sectors		1. Alcatel in cooperation with China's aerospace departments		1. Developing related sectors	1. Improvement of vehicle loan system 2. Formation of automobile clusters
Strategy, Structure& Rivalry	1. Able to resume number one in the market share 2. Continuing relationship with Emerson	1. Strategic cooperation with Alcatel	1. Influencing more competitors to enter the market	1. Improving corporate governance	1. Increased competition on marketing

China shows a more variety of impacts and is concentrated not only in the area of Factor Conditions, but Demand Conditions as well. These case studies shows that even though there are initial intended motivations of the cross-border M&As by the transacting entities, there are unexpected results that affect the host-economy as well and many could have negative implications.

Ongoing and future Trend:

Restructuring of SOEs

The restructuring of State Owned Enterprises often involves a merger or acquisition including big players in sectors that traditionally have been under State monopoly such as telecommunications, power generation, aviation and financial services. Such market reforms have resulted in some of the largest M&A deals in China in 2002. Some small to medium-sized SOEs are opting to exit their markets and simultaneously create potential M&A opportunities for private enterprises.

In the past, the M&A activities of SOEs were mainly carried out to fulfill political rather than commercial objectives, but this that is quickly changing. In a few industrial sectors, the State is encouraging state-owned enterprises to consolidate into large integrated conglomerates, which are intended to be global leaders in their fields. For example, the government mandated consolidation, Air China, China Southern, and China Eastern Airlines took over 6 smaller airlines in October 2002.[12] Impact of jet purchases and service upgrades aimed at making them more competitive, stem major losses in industry. The marginally profitable big 3 embraced smaller companies some which would have been chronic money losers. Raising combined share of growing domestic market to 80% from 50%, and freeing up their resources for aggressive expansion at home and abroad. China's carriers want to position themselves to compete head on with airline abroad. Merger was designed to make the big three stronger in a market where intense price competition has badly hurt airline finances in recent years.

As another example, following the principle of segregating "power generation" and "power supply, the State are in the process of selling power generation assets. This brings in cash flow and allows the reshuffling of human resources in an effort to further develop the country's power network. In one of 2002's top 10 deals, Shenzhen Shajiao B Power Co. auctioned off 35% of its equity to Guangzhou Holdings for Rmb1.4 billion.

"I think the mainstream will be SOEs buying private companies. A lot of private companies have made great progress in the past 20 years, but now a lot of those big companies have hit the ceiling of their growth. Some of them have made a placement to a state-owned company, to raise capital". James Chen founder of HollyHigh.
SOEs have the financial resources, the ability to get licenses and government support. Private company may have marketing advantages and market strength but they may have difficulty getting economic resources.

Growing Inward Investment From Multinationals

China's socialist market economy has been under development for many years and a number of enterprises have established well-known brand names and strong distribution networks in China and has become attractive targets to multinational corporations looking to establish a firm foothold in the Chinese market through direct investment. The

[12] WSJ: Consolidation of Airlines –Dec 2002

acquisition of Chinese companies by foreign companies accounts for 30% of the top ten deals in 2002.

In sectors that are not yet fully opened to foreign investors, minority share participation in such restricted enterprises is an important strategy to participate in the China market. The main deals in the financial sector include equity deals between HSBC and Ping An Insurance, AIA Insurance and Hua Tai Insurance and the current proposed transaction between Newbridge Capital and Shenzhen Development Bank. Despite these foreign investors only holding minority stakes, this represents a major step in their strategy to enter the China market. In all of these deals, the Chinese enterprises will benefit by gaining access to overseas management techniques and technology as well as additional capital.

Growing Private Equity Activity

The serious intent demonstrated in recent months by global private equity funds is also having a major impact on the China deal market. There were 70 China related private equity deals announced in 2004 (2003:53) with an aggregate deal value of US$2 billion (2003: US$1.7 billion)[13]. Mr. Woods explained "Many of the problems that stifled activity by financial investors in the past still exist, including exit structuring issues, perceived difficulties in raising debt financing, concerns over the quality of management, and valuation issues. Notwithstanding this, a number of blue chip funds are already well established and are active in the market, and several other major US/European houses are likely to set up offices in the months ahead. The deals included Morgan Stanley's US$50m private-equity investment in China Yongle Appliance Company, a household-appliance retailer.[14]

The presence of private equity is bringing greater competitiveness and sophistication to a market where domestic private companies are growing rapidly. The equal-treatment principle inherent in WTO membership will eventually give these companies the same benefits as state-owned enterprises, but they will need to adapt to take advantage of or even to survive the competition that comes with this.

Growing Chinese Outbound Investment

For some domestic companies, there is a stream of outward overseas M&A, facilitated by government's new and simplified approval procedures. Traditionally in sectors like oil and gas, utilities and energy 59%, the trend is going into other sectors. The number of Chinese acquisitions overseas accounted for half of the top 10 China deals in 2002.

China's Commerce Ministry figures the country's corporations spent $2.85 billion buying foreign companies and other assets in 2003[15]. The Chinese need to go abroad for resources to feed their industrial machines and to get talent and research they can't get at home. Beijing wants to create global champions. Allowing further overseas investment

[13] M&A Asia
[14] EIU Finance- China M&A On the Rise Feb 2005
[15] BusinessWeek: China Goes Shopping Dec 2004

could eventually help relieve pressure on China’s over valued currency. When China lets the yuan appreciate, the buying power of these companies will increase.

China National Petroleum Corp, parent of PetroChina, Sinopec, and CNOOC, each invested billions in oil and gas projects in Africa, Southeast Asia, and Latin America. CNOOC's three deals totaled US$1.2 billion, including the acquisition of Repsol YPE's five oilfields in Indonesia for US$600 million, a 5% interest in Northwest Shelf Venture's oilfields for US$320 million and BP's oil interests in Indonesia for US$280 million.

China will buy into industries in which it already competes heavily, particularly electronics, auto parts, appliances, textiles, and apparel where acquiring global supply chains can confer big advantages, even for low cost players like China, the global scale will give them lower cost components and R&D and branding are now done globally.

These included BOE's acquisition of Hynix's LCD division in Korea, SAIC's equity participation in the GM-Daewoo joint venture and TCL's Euro8.2 million acquisition of Schneider Electronics AG. Last June, BaoSteel Group acquired a 46% interest in Rio Tino's (Australia) mining company for US$30 million. Lenovo, China’s largest personal computer (PC) firm, is in the process of buying IBM’s PC-making business for US$1.25bn.

David Norman, an M&A specialist with Richards Butler, a law firm, believes the real trend is of smaller Chinese companies buying overseas listed companies is to inject assets into them, or buying assets with the ultimate aim of an initial public offering. But despite the growing interest in such deals, outward M&A by Chinese firms remains an untested phenomenon.

Domestic Chinese Market is Consolidating

The level of industry concentration in China is unusually low, and widespread consolidation seems necessary as Chinese industries try to remain competitive after WTO. That is why Beijing is pushing mergers and consolidation and these domestic deals have become commonplace. There are also the attempts to rescue failing SOEs by combining them with healthy enterprises and create conglomerates. SASAC is pushing for M&A among domestic firms to remove industry overcapacity and can better compete.[16]

In the auto industry alone there are more than 90 Chinese car and truck companies. Although the market is dominated by about 10 major corporations, smaller companies continue to survive by selling substandard cars and trucks below market prices which often hurts sales at more successful car firms. Therefore, mergers and acquisitions would serve well. Geely Group plans to buy all stake in its HK listed arm- Geely Automotive Holdings Co. Ltd. The group has 20% stake right now. The deal will raise Geely to channel all of its auto assets into the HK listed firm, helping it raise more funds from the stock market to assist its ambitious expansion plans.

[16] WSJ:Beijing Push on Mergers Ratchets Up- Aug 2000

In the telecommunications sector, there were several small to medium sized deals in 2002 with smaller companies looking to increase economies of scale, some combining resources to step into the telecom services business. Deals include CITIC Guoan's Rmb600 million acquisition of Great Wall Broadband, AsiaInfo's Rmb380 million acquisition of Bonson Tech and Purple Communications' acquisition of 21ViaNet China and Abovenet (US). Under WTO, China needs to open up its telecommunications sector to foreign investment within five years so there will be more activity amongst small and medium sized enterprises and an increase in investment from private enterprises, thus driving more domestic M&A activity.

China's highly fragmented software-outsourcing industry would prevent it from matching neighboring India's success in the global info tech services market for many years. They must consolidate to gain size and expertise needed to capture large international projects. The Top 10 IT services companies in China have just 20% share of domestic market compared with India's 45%. Only 12% of these providers saw mergers, acquisitions, and alliances as a priority.[17]

Internet is jammed with thousands of underfinanced money losing web sites that have been surviving largely on foreign investment capital since they began in 1998. Venture capitalists say consolidation is healthy because few of China's internet companies have innovative technology or original business plans that would give them a competitive edge in the global industry. China's internet industry is all about size: with so little differentiation between companies, only a few big players are likely to attract enough traffic to survive.[18]

China's pharmaceutical industry is on the forefront of consolidation and acquisition. "They're looking to back-integrate into critical intermediates for their own production, Ms. Capie of Pharmavantage consulting. "They're looking for acquisitions in terms of forward integration, specifically finished dosage form facilities and chain stores to gain retail outlets for their finished dosage form"[19]. She expects these companies to make aggressive investment overseas. Domestic investment will move deeper into the interior, where labor remains cheap.

Through mergers and acquisitions in the manufacturing industry, small producers will be pushed out of the market, which will help improve market order. "Establishing a co-operative, mutually beneficial relationship is the only way to improve the overall competitiveness of China's home appliance industry," Huang Guangyu, chairman of Gome Appliances, told the summit on strategic co-operation hosted by the firm on March 20 in Shanghai. "Effective co-operation between manufacturers and retailers will contribute to the healthy development of the entire industry."

One good example from the retail sector is Wumart, one of China's leading chain retailers, who plans to expand its business nationwide through mergers and acquisitions

[17] Anbound-China Market: Feb 2005
[18] New York Times: Sept 2000
[19] Chemical Market Reporter- Mar 2004

(M&A) in the coming years. The Beijing-based retailing giant currently operates more than 400 hypermarkets, supermarkets and convenience stores in Beijing, neighboring Hebei Province and Tianjin Municipality, as well as East China's Shanghai. "We are to open another 100 outlets in Beijing and 10 hypermarkets in eastern and northern China this year, while our network will be ultimately extended across China," said Wu Jianzhong, deputy president of Wumart. Instead of establishing new stores, Wumart's development strategy is based on M&As of local small and medium-sized retail companies, especially in regions outside Beijing. Meanwhile, the company is considering buying stakes in companies engaged in businesses complementary to Wumart's retail operation, including logistics, real estate development, food processing and daily necessities manufacturing. The firm has been following its M&A plotline closely with the acquisition last year of 12 supermarkets from Daiei - Japan's third largest retailing enterprise - in Tianjin, as well as a 33.74 per cent stake in local rival Chaoshifa, to become the largest share holder in the company. "Wumart's M&A expansion strategy seems practical and efficient, and provides a shortcut for its penetration into unfamiliar markets," said Fan Yanru, deputy secretary-general with the retail enterprises committee of the China Commerce Association for General Merchandise. Huang Hai, assistant minister of commerce, said in January at a high-level forum for Chinese and foreign retailers that the most urgent task for domestic retailers were consolidation in order to enhance their competitiveness.[20]

[20] CBnet - Industry Updates- 3/9/05

Cross Border M&A: The Process

When Acquisition is a Good Option:

-Products or services are in a traditional sector with well established domestic competitors;

-The acquisition would cause a quantum jump in domestic market share for a strategic product or service type;

-Domestic competitors are beginning to export to core markets;

-Technology and intellectual property rights are not major concerns;

-There are state-mandated regulatory barriers to market access;

-There is an attractive field of available and willing mid-sized acquisition targets.

Equity or an Asset Acquisition?

In an equity acquisition, the foreign company takes part or full ownership of the target company's assets and liabilities. In an asset acquisition, the acquirer takes only the core business, leaving peripheral and nonperforming assets and liabilities to be restructured by the previous owner.

Many equity acquisitions are converted to asset acquisitions during the due diligence phase, when hidden operating weaknesses and liabilities are revealed. There are both financial and operating advantages in leaving unwanted assets, redundant employees, bad loans, and contingent liabilities behind. However, asset acquisitions are more complex and take longer to complete. Most acquisitions of more than $50 million are in fact equity or stock acquisitions, while small and mid-sized acquisitions tend to be converted to asset acquisitions. [21]

An equity acquisition may be appropriate when

- The target company is listed;

- The foreign company can acquire the target company offshore or through acquisition of an offshore holding company;

- The foreign company wants a minority equity position in the acquired business;

- The government has mandated limits on foreign equity ownership, which would allow only partial acquisition;

- The local government and existing management refuse to consider an asset acquisition;

[21] Closing the Deal: Acquisitions in China

- Local and national approval authorities refuse to allow the company to be broken up;

- The acquirer is a financial investor, such as a foreign private equity fund.

Acquisition financing in China is limited. Banks typically are not prepared to lend without parent corporate guaranties. The Equity Change Regulations address the prospect of a pledge of the equity investment to a lender under the Security Law of the PRC, provided all the other equity holders consent. The pledge is limited to paid-up capital only and must receive government approval. Notwithstanding the availability of financing methods, including the possibility of listing on a PRC or foreign stock exchange or issuing bonds, financing for the operating needs of the target typically still takes the form of foreign shareholder loans or bank loans secured by foreign investor guaranties.

Companies must decide whether to finance the acquisition internally or seek an external investment partner. Large multinationals often have enough access to internal capital and bank loans to finance investment projects in China. But external investment partners may bring mergers and acquisitions (M&A) expertise to the table, including skills in selecting, negotiating, and restructuring the target company. Domestic Chinese investment partners may also be needed if there are mandated equity limits on foreign investment in the target sector.

What to Expect:

An average-sized acquisition (roughly $20 to $50 million) will take about nine to twelve months from start to finish. Typical external acquisition costs (excluding internal management time and travel) will run from $500,000 to $2 million and can be significantly higher for larger or more complex acquisitions that involve an investment bank.[22] The time, cost, and risk analysis required for acquisition may decrease the relative value of smaller acquisitions.

Once an appropriate acquisition target has been identified and selected, willingness to be acquired must be established at several levels. In the case of privately owned target companies, the owners and key managers are identical and local government involvement is minimal. In the case of SOEs, the provincial SASAC is now the equity owner and will make the final decision to divest the asset. Many local SOEs are now also part of a larger state-owned group company, in which case the group company will always be present at the negotiating table and may become the main negotiating partner. The local government industry bureau will also likely be involved, although it no longer formally "owns" the target company. Willingness to be acquired often depends upon the intensity of resistance from the existing SOE management. More aggressive SASACs in some provinces will sometimes push enterprise management into a deal that it would otherwise reject.

The national regulations on acquisition of listed SOEs also require a formal bidding process, and some localities, such as Beijing, have established "equity exchange centers"

[22] Closing the Deal: Acquisitions in China

for this purpose. There is sometimes intense competition among domestic and foreign suitors, and the provincial SASAC usually has enough buyers to pick on the basis of pricing, technological prowess, management capabilities, and other criteria.

Key Negotiating Issues

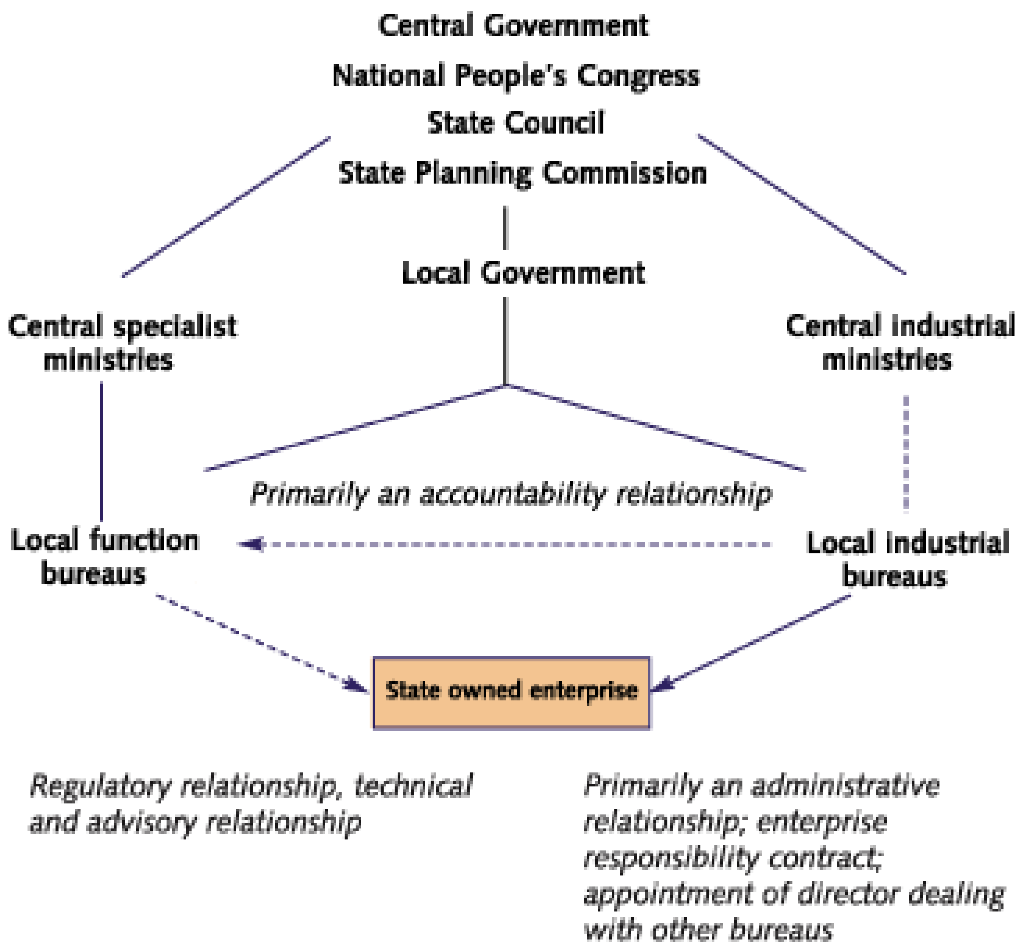
Acquisition contract negotiations tend to focus on three major issues: valuation, debt restructuring, and size of the workforce. Heavy working capital debt, unrecoverable receivables, tax liabilities, and other current and contingent liabilities bring the NAV down significantly. This means that many equity acquisitions are made at a relatively low price compared to the value of the business as reflected by discounted cash flow or prevailing stock market multiples for comparable businesses. Beijing is extremely sensitive to charges that state assets are being sold too cheaply, especially in MBOs so such acquisitions must be done at prices above net asset value, which must be set by a state-approved assets-valuation accountant.

Liabilities are probably the leading cause of negotiation failure and are also the main reason that deals that begin as equity acquisitions often end as asset acquisitions. The more aggressive provincial SASAC bureaus increasingly recognize that they cannot expect acquiring companies to shoulder decades of liability accumulation and will sometimes offer to restructure debt prior to the acquisition. The large state banks, however, must protect their books and will often resist SASAC's attempts to let the acquiring party off the hook.

Government Approvals and Closing the Deal

All acquisitions of companies that are operating in China are subject to some level of official review or approval by local, provincial, and national government authorities. But the complexity, difficulty, and time required to complete the government review and approval process vary greatly by the type of acquisition target, the size of the acquisition transaction, and the impact on the industry and sector involved.

An acquisition deal in China cannot formally "close" until all relevant government approvals and licenses have been issued. This not only creates a lag of a few months to a year or more in the closing and restructuring, but also causes timing problems with capital injection and enterprise restructuring. There is no effective escrow mechanism available under PRC commercial law that allows the buyer and seller to fully commit resources when the deal is finalized and signed, before required government approvals are complete. Milestone payments or restructuring and refinancing commitments on either side are therefore difficult to execute until government approvals are complete.



Source: Child, J (1996), Management in China during the Age of Reform, Cambridge University Press.

The Regulatory Environment

Acquisition of a domestic Chinese company, whether private, foreign-invested, state-owned, or listed, is subject to a growing body of legal and tax regulations. While specific rules may be restrictive, the new regulations, as a whole, help legitimize and extend the options available to foreign corporations and investment funds seeking acquisition opportunities in China.

Changes in China's merger laws and takeover codes over the past few years, is part of government push to sell down state owned enterprises it doesn't want. Until recently foreign investors couldn't buy the Legal person shares of SOE, now there is change to domestic takeover law allowing this. Legal person shares in listed and unlisted companies are mostly held by central and local governments, and state companies. The listed companies LP shares can't be traded on Shanghai or Shenzhen stock exchanges. For many listed SOEs only 30% is tradable. Some of these nontradeable shares are increasingly being bought and sold in large chunks, off exchange, in private transactions.

The nontradability of state-owned and legal person shares also limits exits for foreign private equity funds or domestic Chinese investment groups doing buyouts in China, since investors usually gain control of listed SOEs via acquisition of these shares. Part of the failure of D'Long International Strategic Investment Co. was due to its inability to sell legal person shares in any of its six listed subsidiaries to raise cash and reduce debt. Foreign private equity has been slow to develop in China primarily because of this low liquidity in public stock markets and low price-to-earnings multiples in private trade sales The China securities Regulatory Commission, fearing a flood of legal person share sales on domestic stock markets should this restriction be removed, shows no sign of moving on this key issue.

Paying Taxes:

Taxes that have not been paid by the closing date are likely to be assessed to the new enterprise. In addition, there is no statute of limitations on unpaid tax liabilities, exposing the new enterprise to contingent liability for income tax and VAT obligations that the acquired enterprise has underpaid for years or even decades. [23] This is especially relevant because most domestic enterprises keep separate sets of "management accounts" and "tax accounts." The local tax bureaus routinely negotiate tax settlements with SOEs that are financially weak. In virtually every acquisition, contingent tax liabilities must therefore be addressed in the valuation of the business and in contractual warranties.

[23] China Tax Advisor Oct. 2001

Drawbacks of Cross-Border M&A:

Despite the best-laid plans, the majority of large-scale mergers and acquisitions fell well short of financial projections. According to one study, of 150 recent deals valued at $500 million or more, about half actually destroyed shareholder wealth, and another third contributed only marginally to it. A recently-completed 10-year study of 340 major acquisitions found that total shareholder returns for 57% of the merged concerns fell behind industry averages for three years after the merger.[24]

Developing foreign owned companies is not easy. The policy in China is mainly determined by the headquarter and localization is one of their biggest challenges. Even though M&A is growing, cross border deals pale in comparison to domestic ones. From August 1999- May 2003 foreign cases numbered 50 while domestic ones exceeded 2100.[25]

These are the many drawbacks hindering foreign M&A capital flowing into China. Complicated Regulatory system, numerous policy uncertainties, poor transparency in policy decision-making, ambiguous valuations, complex due diligence, macro and microeconomic concerns, along with exit options are all reasons why China is currently not ideal for foreign cross border M&A.

Regulatory Hurdles

New regulations leave much to be desired and in typical Chinese regulatory fashion are vague and ambiguous to give authorities as much wiggle room as possible when it comes to implementation. They are essentially works in progress to test how market reacts before coming up with final versions. Quite a few M&A rules and regulations released by different government departments, exist alongside contradictory provisions, leaving investors unclear of what to do. Some “interim provisions” are not recognized by all departments, causing a lot of time and effort wasted in the process of ownership transaction. Furthermore, random “amendments” to these rules and regulations, such as rushing through relaxing and tightening policies, discourage many foreign investors.

Jin said reasons for these factors are rooted in a lack of overall knowledge about using foreign capital. “China still takes great pride in being the most popular destination for foreign direct investment. Not yet realizing the risks lying in poor M&A capital, China hasn’t come up with a strategy that could appeal to a great deal of international M&A capital. Enterprises just cannot follow the random and obscure law-makings in China,” said Jin.

Lack of Transparency

The report noted that industry insiders, as well as experts on law and economics, are basically excluded from China’s M&A market during the policy decision and law

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[24] Kendall Consulting Group- Organizational Due Diligence M&A Report 2002
[25] Asia Pulse: Pace of Foreign M&A Slows in China Mar 2004

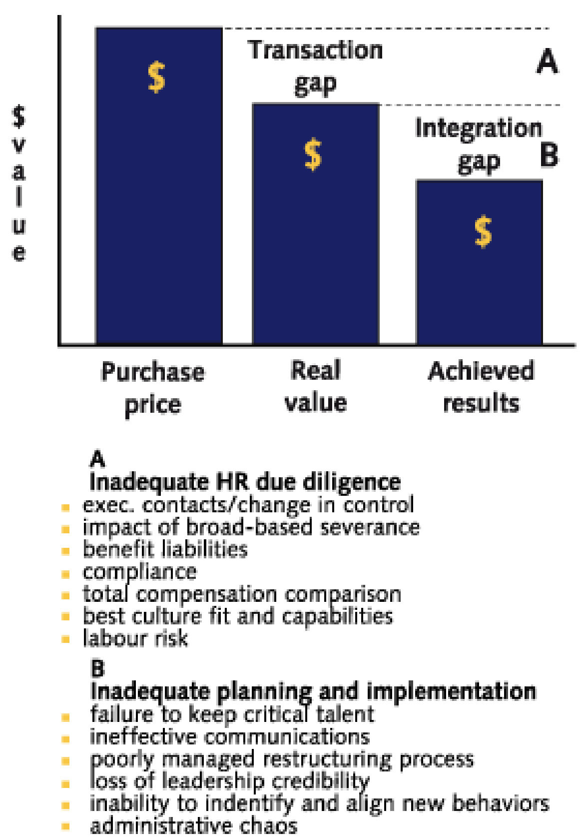
making, although transparency in the process demands broad participation and supervision.

Many M&A rules have been unveiled over the past three years, but most policy-makers still operate from the government's perspective and what they consider most is how to maintain their right to command. As a result, rules and regulations unveiled against this background are difficult to comprehend and implement.

Complex Deal Evaluation and Due Diligence

With the increasing size of the deals being undertaken and the continuous privatization of large SOEs, transactions are becoming considerably more complex and can take many months to complete. The quality of information available to prospective acquirers is invariably very poor, and the due diligence process requires a large team comprising a variety of different skill sets to analyze and interpret trends in the business. Identifying potential risks and exposures is another area that is time-consuming and problematic.

Together with due diligence, valuation is a critical component in the M&A process. The price paid for assets or shares in China may not be determined solely by the parties, unlike in other jurisdictions. PRC law requires appraisals where a transaction involves either State-owned assets or the interest in an FIE held by an SOE. In a direct-share purchase, Chinese law also imposes certain restrictions on the price the parties may negotiate.



Due diligence in China should include assessing and selecting the leadership team: researching the leaders' backgrounds and reputations, managerial capabilities, culture, current organizational structure and an understanding of their motivation for making the deal. These will be important in relation to the team's ability and willingness to change in the future.

Macroeconomic concern:

Traditional mindsets in different parts of China are an issue that must be tackled. From the production of television sets to the manufacture of heavy machinery, every province has its own enterprises. In every industry, there may be anywhere from ten to a hundred different companies competing in the marketplace. Even the biggest players in the market may not hold any more than 20% to 30% of the total market share. Following on from the experience of developed economies, pooling of resources amongst small to medium sized enterprises is an effective strategy to enhance competitiveness. However, currently price wars amongst domestic manufacturers have become the most prevalent competitive "strategy".

Microeconomic Concern:

Many Chinese enterprises do not have a long-term business development or growth strategy. Without such direction, the likelihood of having an effective strategic plan for M&A investments is limited.

Other factors:

As elsewhere, representations and warranties play a critical part in M&A documentation in China, particularly because foreign lawyers often do not have access to government records that confirm title to real estate or existence of liens, and because of dubious tax avoidance structures and questionable accounting practices.

In addition to facing restrictions imposed by the Catalogue on obtaining a controlling interest, foreign investors must deal with Chinese statutes that confer important powers on minority equity holders in FIEs. Unanimous consent of the board of directors is necessary for all major actions of a company, such as increasing capital, amending the articles of association, assigning registered capital, merging with another firm, or dissolving the firm. (Joint stock limited companies are not subject to the same unanimity requirements.) The foreign shareholder should therefore be aware that a Chinese partner is able to exert influence far beyond that which its minority shareholding would suggest.

Parties in an M&A transaction may be concerned that the shareholders from which they are purchasing shares, or other shareholders of the target company, intend to compete with the target company. In such a case, parties can formulate covenants not to compete, and not to solicit employees. These covenants are generally enforceable under PRC law if reasonably limited in time and scope. Restrictive covenants with individual employees may not exceed three years and require separate consideration. And when a foreign investor buys into an existing PRC entity, or when an FIE acquires all of the assets of an

SOE careful consideration must be given to the pre-existing legal obligations owed to such employees.

Exit option:

Another strategic issue is that of exit options for investors. The objectives of financial investors usually differ from those of operating companies making strategic investments in China. Financial investors envision a shorter term of involvement and seek some type of exit strategy exercisable within three to five years of making the investment. Financial investors will want to include exit provisions in the acquisition documents. This may take the form of a put option allowing the investor to sell its equity back to the seller, or an obligation to cause the holding vehicle to undertake a public offering so the financial seller can dispose of its shares. In an indirect structure, a financial investor buying shares in an offshore holding company should be free to incorporate such obligations. In direct structures not involving joint stock limited companies, the statutory preemptive and veto rights of each equity holder and the non-share issuing nature of the enterprises pose potential obstacles for an exit strategy. Such transactions might be restructured to allow the financial investor to hold its interest in a single-purpose, offshore holding company, to facilitate both the exercise of a put option (relating to the shares of the offshore company rather than the PRC-based company) without being subject to preemptive or veto rights as well as a possible future listing. If a listing is not contemplated, the financial investor may want to try to arrange waivers of preemptive rights and consents in advance (although enforceability is uncertain under PRC law).

Lack of True Synergy:

In many cases, the synergies that sounded good in theory did not represent true synergy at all. Even deals that may represent true synergy in some areas sometimes fall apart when synergy is lacking in other areas. "Unless you understand the long-run strategic value of intent (of mergers and acquisitions), you will grow frustrated when it proves-as it must-not to be a cheap and easy way of responding to the uncertainties of globalization."[26]

Repeatedly, companies learn that despite the best-developed financial plans, it is the people who make the alliance succeed or fail.

The real deal-killer is the failure to effectively integrate the two merging organizations. Sometimes a transition leader or team is appointed, however, most times the leader and team members are inexperienced or unschooled in many of the skills so critical for an effective and efficient integration.

Clashes of Culture Can Unravel the Whole

The most important factor of success to M&A deals is the harmonious merging of the two companies' cultures. Cultural clashes are frequently at the root of many misguided mergers and acquisitions. Differences between corporate cultures are difficult enough to overcome, but when differences between national cultures also come into play, the

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[26]" Harvard Business Review, March/April 1989

challenges increase exponentially. When you have two companies coming from completely different management styles or organizational traditions, smooth transitions will be almost impossible.

Negative Impact on Host Economy

Employment

Workforce redundancy is another deal-breaking issue. For example, the effort by LaFarge SA, a leading French cement maker, to acquire the two largest cement producers in Yunnan foundered on the status of several thousand redundant workers. Resolution of the workforce issue depends almost entirely on cooperation from the local government. In some cases, the local government will work with SASAC and the buyer to shrink employment at the target company prior to the acquisition. In other cases, the local government will accept a per capita payment from the buyer as part of the acquisition deal and will then make the layoffs and subsequent social benefit payments. Neither solution will change the local workforce's perception that the foreign investor "caused" the layoffs and/or the reduction or termination of pension and medical benefits.

Alerting System Needed

The biggest hidden issue is that foreign investors break through China’s industrial protection line by manipulating domestic partners in M&A deals. As a developing country, China still has certain sectors forbidden to foreign investors. But some fake domestic enterprises (funded by foreign capital but registered as domestic enterprises) and M&A deals involving fake domestic enterprises (funded or aided by foreign investors but implemented by domestic enterprises) are consistently breaking through the forbidden sectors.

Since current rules and regulations stipulate no specific punishment for such violations in M&A deals, local governments would, in pursuit of achievements, sacrifice the national, regional and employees’ interests to attract more foreign investment.

There should be a pre-warning system in foreign-funded M&A which includes anti-unfair competition and anti-monopoly legal systems, as well as a national economic security permit certificate system.

Sound Development

China should be clear-minded that foreign investors merging with or acquiring SOEs are not focusing on helping lift SOEs out of their dire straits, and many would bring certain negative impact. Chinese companies are seeking to gain technological and management knowledge, but foreign companies may not be so eager to share intellectual property.

After M&A, some SOEs shifted to cooperate with affiliated enterprises of multinationals. The changes in their supply chain produced a negative impact on their own affiliated companies. Moreover, as SOEs merged with and acquired by foreign investors occupy certain market shares in their industry, M&A deals inevitably spark an industry monopoly.

In addition, some policy loopholes in M&A rules and regulations might cause loss of state-owned assets, such as transfer of profits, slow technology innovation, and costly transfer payment for low technology.

Beijing is particularly concerned about undervaluation of State-owned assets sold or contributed to FIEs. A recurring problem with these asset evaluations is that the Chinese appraisers, who typically base their valuation on replacement value less depreciation, often grossly overvalue the assets to be acquired. Typically, once the appraisal has been confirmed, the parties may only agree to a price that differs no more than 10 percent from the appraised price.

Discretion to determine the price in the sale and purchase of shares in a joint stock limited company is also subject to certain limitations. New shares must be issued at or above par. The issue of shares above par is subject to approval by the China Securities Regulatory Commission. Under the Company Law, the same price should be paid for each of the shares subscribed for by any unit or individual. But the government has exercised its right to grant waivers under this rule. If the seller is a holder of State-owned shares, the State-owned Shares Opinion stipulates that the price not be lower than net asset value per share and should also take into account such factors as net asset yield ratio, actual price of investment, reasonable price/earnings ratio, and market price, if any.

Finally, most Chinese enterprises embarking on deals stop at the asset valuation level and have not realized the importance of future cash flows in valuing the enterprise. This usually results in overpaying for an acquisition target which will ultimately result in poor returns for the buyer. In a November 2002 edition of Business Weekly, an industry analyst made the following comment about Chinese enterprises embarking on M&A deals abroad: "I feel that Chinese enterprises are over paying, similar to Japanese enterprises in the 1980s when they were buying real estate abroad".

Implicit Monopolies by Multinationals

The Chinese government and media have become increasingly sensitive to concentration and potential domination by foreign investors of some domestic markets, such as mobile phones, photographic film, and soft drinks. Antitrust concerns will slow the government approval process, but will not necessarily result in government rejection of the deal. For example, in October 2003 Eastman Kodak, which had already acquired three of four domestic photographic film producers and a dominant position in the photographic film market, was allowed to acquire 20 percent of Lucky Film, the remaining domestic film company.

For a long time, being not fully aware of the importance of the commercial distribution industry, China did not formulate explicit restriction policy. As a result, foreign enterprises got into the main channels of commercial distribution in China. A survey shows that ninety percent of the more than 300 large-scale foreign retail enterprises in China were set up in an unlawful manner. Now foreign retailers have shifted from the entry period to a full-scale fast expansion period. By the end of 2003, more than forty of the world's largest 50 retail enterprises had come to China. The most competitive sector is large-sale supermarkets, which represent the development direction of the modern commercial circulation industry. Foreign enterprises take up more than 80% in this market.[27]

In fact, the negative impact of the inflow of excessive foreign capital on the retail industry has been very obvious, take for example the Nanjing incidences. Several large-scale foreign supermarkets more or less "speculate in goods". They collect costly admission, exploit suppliers, and some even misuse their ascendancy to engage in unfair competition, like dumping goods at a low price, setting an excessively high price and committing price discrimination. Without relevant laws or regulations in place, China's industry and commerce authorities are not in a position to directly investigate into foreign supermarkets' monopolistic behavior of constraining fair completion and impairing market order.

[27] China Economic Net-Nov.18, 2004

Focusing on Domestic Deals:

Chief executives at multinational companies have the Chinese market at the top of their agenda, creating intense competition on Chinese companies' home turf. As a result, thinning profit margins are eroding the cash pools and time cushion that Chinese companies would need on a more gradual, organic path to international expansion (i.e. Japan and Korea). With constantly shrinking product cycles and rapidly advancing technologies, it is difficult for some Chinese companies to catch or surpass their rivals - without a quantum leap. That is where mergers and acquisitions can pay off but not without a considerable amount of risk, and in China a lack of experience in such deals compounds the risk. That's why sound partner selection, rigorous valuation, and well-planned post-merger integration can boost the odds of making these deals work.

Chinese companies should select a partner based on how it fits in with strategic objectives, rather than because it is first through the door. They should be aware of the "lemons problem and have a clear picture of how it intends to build upon the synergy. To ensure an acquisition will create value, Chinese companies need to avoid focusing solely on the best price.

The acquirer needs rigorous cash flow and synergy analysis rooted in a deep understanding of the target's business and industry. Valuing companies using market multiples, an approach favored by companies in developed markets, often fails to evaluate the unique value creation opportunities and potential synergies between an acquirer and its target. Multiples are an even poorer guide to valuing Sino-foreign deals given their relative newness.[28]

Learning how to run a business with global reach and how to integrate different organizations are among the biggest challenges. Instead of pursuing an outright acquisition, Chinese companies might - like Lenovo and TCL - consider a global joint venture as an interim step.

Instead of forcing a complete and sudden takeover of operations on day one of the merger, an interim joint venture helps to secure the commitment of the foreign partner to the integration while ensuring a more gradual transition. Such an arrangement does not, however, replace a detailed integration plan outlining what management must do to realize the value promised by the deal. Also, it does not mitigate risks, such as the loss of customers, or guarantee that the business will not stall immediately after the merger.

[28] The Financial Times -4/12/05

Conclusion:

After studying many reports regarding the trend of M&A in China, I believe that cross border mergers and acquisitions would not achieve the type of synergy expected of these eager multinationals from developed countries. Based on the many drawbacks of such deals such as regulatory obstacles, cultural issues, and the lack of concrete success cases, the focus shift to making successful domestic mergers and acquisitions, which seems to be a growing trend not only out of necessity but also due to the unfamiliarity of China to foreign M&A. The best way to pave the road of successful foreign M&A deals would be to let China's domestic companies continue their integration and work out all the regulatory uncertainties and gain more expertise in this area. I am not ruling out cross border M&A's and am fully aware of the positive aspects of such deals, but the current conditions in China is not ideal for foreigners to make such optimistic projections. I also would recommend a slower process in the outbound M&A from Chinese companies due to their inexperience in such deals and the fear that they would be buying when asset prices are at their peak and overpaying like the Japanese did back in the 90's. In conclusion, gradual and moderate steps in M&A will yield the most optimal results.

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