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Mergers and Acquisitions in China:

Current Trends and Challenges in the Middle Kingdom

By: James C. Chapman, Partner, Foley & Lardner
Linlin Li, Attorney

INTRODUCTION

2010 was a very strong year for mergers and acquisitions in the Middle Kingdom. Statistics provided by Thomson Reuters show that over 3,000 M&A transactions involving Chinese enterprises with a combined US$131.1 billion were reported in 2010. Among these deals, cross border transactions amounted to US$80.7 billion, a 21.2 percent increase compared with US$63.6 billion recorded in 2009. In terms of the number of M&A deals, the materials sector saw the most activity M&A transactions accounting for 24 percent of the total; followed by the energy and power sector with making up 20 percent. The financial sector came in third place with 17 percent of all the deals. These deals were driven by a number of factors including the reorganization of State-owned enterprises, acceleration of the pace of Chinese government's "zou chu guo men" or "going out policy," and desire of foreign companies to enter into new markets by seeking acquisitions in China.

However, notwithstanding the increase in M&A activity and the growing Chinese economy, China remains a challenging environment for foreign investors. Cultural, regulatory, due diligence and legal obstacles make acquisitions in China risky and difficult. Foreign companies seeking acquisitions in China are usually aware of well-known risks such as questionable business practices, environmental exposure and the lack of intellectual property protection. Unfortunately, they are often unprepared to handle a wide range of cultural, legal and organizational differences presented in China. Successful acquirors in China are those that commit the required resources and efforts, and use best-practice strategies to minimize the inherent risks. This article identifies the current trends in mergers and acquisitions in China, discusses the key challenges and the common mistakes that are made in connection with acquisitions in the Middle Kingdom.

M&A TRENDS IN CHINA

In China, M&A activity is closely aligned with the government policy priorities. In 2010, Chinese government showed its determination to continue to restructure its industries and economy by publishing a series of regulations with regard to creation of a friendlier regulatory environment for M&A activities, strengthening environmental protection, restructuring state-owned enterprises to encourage them to grow into global companies, and encouraging the development of high-tech companies. As a result of these policy objectives and other factors, we may expect to see the following M&A trends in China:

<u>Friendlier Regulatory Environment for M&A</u>. On April 6, 2010, Chinese State Council issued a notice with regard to improving the use of foreign investment. The notice encourages foreign investors to participate in the re-organization and restructuring of domestic enterprises through equity investments and mergers and acquisitions. According to the notice, the Chinese government will amend the Catalogue for the Guidance of Foreign Investment Industries to encourage foreign investments in high-end manufacturing, high-tech, new energy, energy

efficiency and environmental protection sectors. As a result, these sectors will be hot areas for M&A activity.

Sale of Obsolete Production Capacity. The new published "Notice of the State Council on Further Strengthening the Elimination of Backward Production Capacities" sets ambitious environmental targets and requires certain energy-consuming sectors such as coal, coke, ferroalloy, iron and steel, buildings, lighting and transportation industries to phase out enterprises with obsolete production capacity by the end of 2012. With targets to ensure achievement of these objectives, the governmental authorities will encourage the sale or restructure of such enterprises with obsolete production capacity. Therefore in the following two years, China is likely to see a high volume of M&A deals in these industries.

Restructure of the State-Owned Enterprises. In accordance with the opinion of State-Owned Assets Supervision and Administration Council ("**SASAC**"), the number of state-owned enterprises ("**SOEs**") owned by SASAC shall be reduced to 100 by the end of 2010 and further reduce the number of SOEs to 80 by 2020. At the end of 2010, the number of state-owned enterprises is still over 120, far from the objective of SASAC. These SOE's tend to be complex organizations with many business units. The split up and reorganization of these companies will lead to a surge of M&A activities in the coming years.

Encouragement of High-tech Company Development. The Chinese government has published numerous laws and regulations encouraging the development of high-tech companies. High-tech companies enjoy 15 percent preferential tax treatment in addition to favorable financing and employee recruiting policies. Large high tech companies tend to boost the growth of smaller, local high-tech companies. As these local high-tech companies tend to develop their narrowly focused but value-added products often fill in gaps in product lines of many multinationals and other large companies. As more and more large enterprises fill out their product offerings in China and elsewhere, these smaller high tech companies will be attractive targets for acquisition by larger companies looking to increase their market share in China.

KEY CHALLENGES AND POTENTIAL "DEAL BRAKERS"

In evaluating potential Chinese targets, there are many challenges. The first challenge is the lack of integrity on the part of the target's management. Many managers have been known to employ questionable practices and to personally profit from the Company's business. In addition, there are disagreements over management control. Owners are often reluctant to give up control especially to "waiguoren" or "foreigners." The second challenge is the inability to establish clear title to assets or improper licensing of those assets. Tracking the ownership and chain of title to assets is very difficult in China. Similarly it is also almost impossible to discover liens and other encumbrances. The third challenge is the high expectations of value of Chinese sellers attributable to the booming Chinese stock markets. Unlike foreign companies, the Chinese do not use price-earnings ratios, return on investment, discounted cash flow or similar valuation methods in setting the purchase price. The fourth challenge is the unreliability of financial statements, lax regulatory compliance and ambiguity with respect to tax payments that create significant contingent liabilities. As a result, there tends to be a large gap between what a buyer is willing to pay and a seller is willing to accept. Another challenge foreign investors may encounter is the practice of many Chinese of holding ownership in the names of other people, usually family members or friends. As a result, there are often verbal agreements as to the ownership of the enterprise. In addition, documents filed with the regulatory authorities may conflict with company records. Therefore an acquiror must spend a significant amount of time and effort to conduct financial and legal due diligence to sort these issues out before jumping into a deal.

AVOID COMMON MISTAKES

Many post-acquisition problems can be traced back to a common mistake that could have been avoided. Common mistakes include: 1) the failure to define a clear objective and acquisition criteria; 2) the failure to conduct broad and thorough business and legal due diligence or research on the target; 3) the failure to fully understand the cultural differences and directly copy western business practices in China; 4) the over-reliance on personal relationships; 5) following “common” local business practices without understanding their legal basis; 6) the failure to recognize inconsistent regulatory interpretations and regimes between local, provincial and central governments and their officials; 7) the failure to uncover improper related-party transactions and payments; and 8) the failure to understand the limitations on transferring critical licenses. These mistakes continually frustrate foreign buyers in China. Committing these mistakes leaves the buyer vulnerable to the seller and government officials who are content to take advantage of “foreigners.” Moreover, these mistakes absorb a tremendous amount of time, energy and money that would be better spent on productive activities necessary for success in China’s competitive and fast moving environment. By utilizing a well-conceived acquisition strategy, these common mistakes can be avoided.

CONCLUSION

Although acquisitions in China are still difficult to complete by Western standards, the amount of M&A activity in China is high. With the Chinese government’s approach to creating a friendlier investment environment, the increased desirability of China as a market for high-end goods and services and the increase in experience by foreign companies in making acquisitions in China, M&A activity can be expected to further accelerate.

Mr. James Chapman is a Partner in Foley & Lardner's Silicon Valley office. His practice focuses on Mergers and Acquisitions, Venture Capital and Securities law. Mr. Chapman has been involved in over 200 Mergers, Acquisitions and financing transactions. He also has extensive experience in international business transactions. Mr. Chapman assists U.S. companies acquire China-based companies, structure investments in China and represents Chinese companies in public and private securities offerings in the U.S. Mr. Chapman is a frequent speaker at China-focused events.

jchapman@foley.com

Ms. Linlin Li is an attorney practicing corporate law in China. She holds law degrees from Chinese and U.S. universities and is a licensed attorney in China and the State of New York. Ms. Li has significant experience on advising international and Chinese companies on complex commercial transactions, including cross border mergers and acquisitions, foreign direct investments and strategic alliances, and State-owned enterprises' restructuring. In addition, Ms. Li advises China-based clients on their overseas mergers and acquisitions, listings and investments. Ms. Li is fluent in Mandarin and English.

linlin.li.ucla@gmail.com