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M&A IN CHINA

Some Introductory Remarks

WHY COME TO CHINA?

The 1990s was all about cost reduction. Whilst this theme still remains, today's story is about the opportunity presented by local demand.

China's economy is the world's number four and growing at over four times the rate of the US, Japan and Germany.

Over the last ten years, the question has moved on from "if" international companies should come to China to "how" they should come. As a consequence, it is now on the radar of almost every international company, and many smaller domestic companies.

EAT OR BE EATEN

China is coming. The commercial and strategic rationale for Chinese companies to expand overseas and capture more of the value chain is compelling. Once there are sufficient management grade staff that are capable of operating international businesses, Chinese companies will become a significant force in acquiring overseas. It has only just begun.

IT'S NOT ALL GLOOM AND DOOM

China's economy is one of the few bright spots in the world today. It has a very low level of national debt, providing the government with the flexibility to stimulate the economy and insulate it from any international downturn, just as it did during the Asian Crisis in the late 1990s.

Most commentators anticipate continuing strong growth, well ahead of all developed economies.

China presents good opportunities to the diligent. It is possible to do good deals that perform well and generate meaningful cost savings and growth.

4 THINGS YOU ALREADY KNOW ... BUT ARE ESPECIALLY IMPORTANT IN CHINA

1. Homework, homework, homework

China repays homework. The situation is often opaque and fluid and the "picture" can vary depending on personal experience. An acquisition team must therefore be thorough, well coordinated, have strong enough connections to get the inside track and gather as many "touchpoints" as possible to form an objective view.

2. Relationships and diplomacy (Guanxi/Face)

Relationships are important because there is a strong preference to trade with friends (largely born of a weak legal system). Getting the relationships right is critical and the channel of first contact with a potential target or partner will often have a significant bearing on how the approach is viewed. Equally, cold calls or unexpected introductory letters are seldom well received. Diplomatic skills are also important, especially when probing sensitive points.

Even if your counterparty is exiting the business, they have set the tone of the company for the last years, would you want to start a business with this man or woman?

For joint ventures, what does the future hold for your JV partner, especially if state controlled?

3. Marry in haste, repent at leisure

China moves so quickly that acquirers are still surprisingly often bounced into "once in a lifetime" deals they need to close tomorrow. Whilst it is important to be able to move quickly, do so only after completing your homework. In an economy that changes quickly, there will always be other "once in a lifetime" opportunities and, with your homework completed, you can move forwards quickly with confidence.

4. Hark the small voice

China is not so different. If some little thing niggles at the back of your mind or something just doesn't feel right, it probably belies a major issue. Trust your gut.

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3 MORE CHINA-SPECIFIC CONSIDERATIONS

1. The law

China's laws are broad and non-specific, providing latitude and power to the government official that is interpreting them. Almost everything requires approval or registration, and interpretation and enforcement varies widely throughout the country. Positioning your proposition correctly makes a difference and it is always advisable to seek, rather than avoid, government endorsement.

If you can't solve a problem using influence and well deployed relationships, then the chances are that the legal system won't help either.

2. The government: friend not foe

China has a large and fragmented government that exercises enormous power and influence.

Establishing your own independent relationship with the important parts of government/ the Party will pay dividends at some point. It is often the most effective investment protection weapon in your armoury.

This is particularly important in highly regulated sectors and inland from the more developed Eastern seaboard.

3. Reading the runes

Strong listening skills and an ability to read the signs is crucial for a deal leader in China.

Miscommunication is often deliberately used to avoid a tricky issue or point indirectly to a problem. Interpreting is a highly skilled role and should be performed by an experienced deal maker.

Be wary of those who claim to be well connected throughout China. This is most unlikely in a country that is similar in size to the whole of Europe or the US.

WHEN THE LAWYERS GO HOME

Most acquisitions fail because there is too much focus on the deal and not enough on the 90 day plan following closing/approval.

The relationships established during a transaction are critical to bedding down a new acquisition. An abrupt change of staff from deal team to the operational team is a lost opportunity to build on important relationships.

SOME COMMON DEAL ISSUES

The financial statements will be wrong, it is just a question of degree. This normally stems from the endemic practice of "mitigating" taxes. Particular attention should be paid to the balance sheet, income recognition, sales tax and staff welfare payments. Where there has been tax evasion, how will the historical issue and future operations be handled? Remember, you are trying to agree a deal with the vendor and the easiest route to resolving historical issues may place your vendor in an untenable position with the authorities.

Corruption. China is largely a cash economy and corruption is widespread in certain industries. A common practice is to pass kick-backs from suppliers direct to customers making it difficult to detect. For businesses with significant local sales understanding exactly how the distribution channel really works is crucial.

Land use rights. There is rarely an acquisition where this isn't an issue one way or another. Often an entrepreneur has bought the long leasehold from the local government at a discounted price on the basis that their company qualifies as "high-tech" (which is encouraged by the government), but rarely do they live up to the high-tech billing. On a transfer of control this issue often crystallises and because there has been very significant appreciation in land values over the last decade this is often a big issue.

Licences. Ensuring that one can obtain and maintain the licences one needs requires upfront planning and effort. This is particularly important when one chooses to structure the transaction as an asset deal to avoid possible hidden liabilities or taking on known tax issues.

Where's the chop? A company's chop (seal) binds the company come what may. Rogue employees agreeing deals outside the scope of their authority can be very difficult to due diligence. This has been a major issue in financial services and many other industries.

Contact Details

Beijing

C-405 Lufthansa Centre
50 Liangmaqiao Road
Beijing 100125
People's Republic of China

T +86 10 6467 5673
F +86 10 6467 5693

Shanghai

Platinum, unit 2208
No. 233 Taicang Road
Luwan District
Shanghai 200020
People's Republic of China

T +86 21 6141 0929
F +86 21 6141 0919

Shenzhen

Rm 1401-02 Tower B
International Chamber of Commerce Building
Fuhua Yi Lu, Futian District
Shenzhen 518048
People's Republic of China

T +86 755 8287 6100
F +86 755 8287 6178

Hong Kong

19/F Ruttonjee House, Ruttonjee Centre
11 Duddell Street, Central
Hong Kong SAR
People's Republic of China

T +852 9350 1916
F +852 2136 4221

London

53 Davies Street
London W1K 5JH
United Kingdom

T +44 203 178 7320
F +44 207 629 6551

If you would like more information about Vermilion Partners, please contact **Marcus Shadbolt** at m.shadbolt@vermillion-partners.com