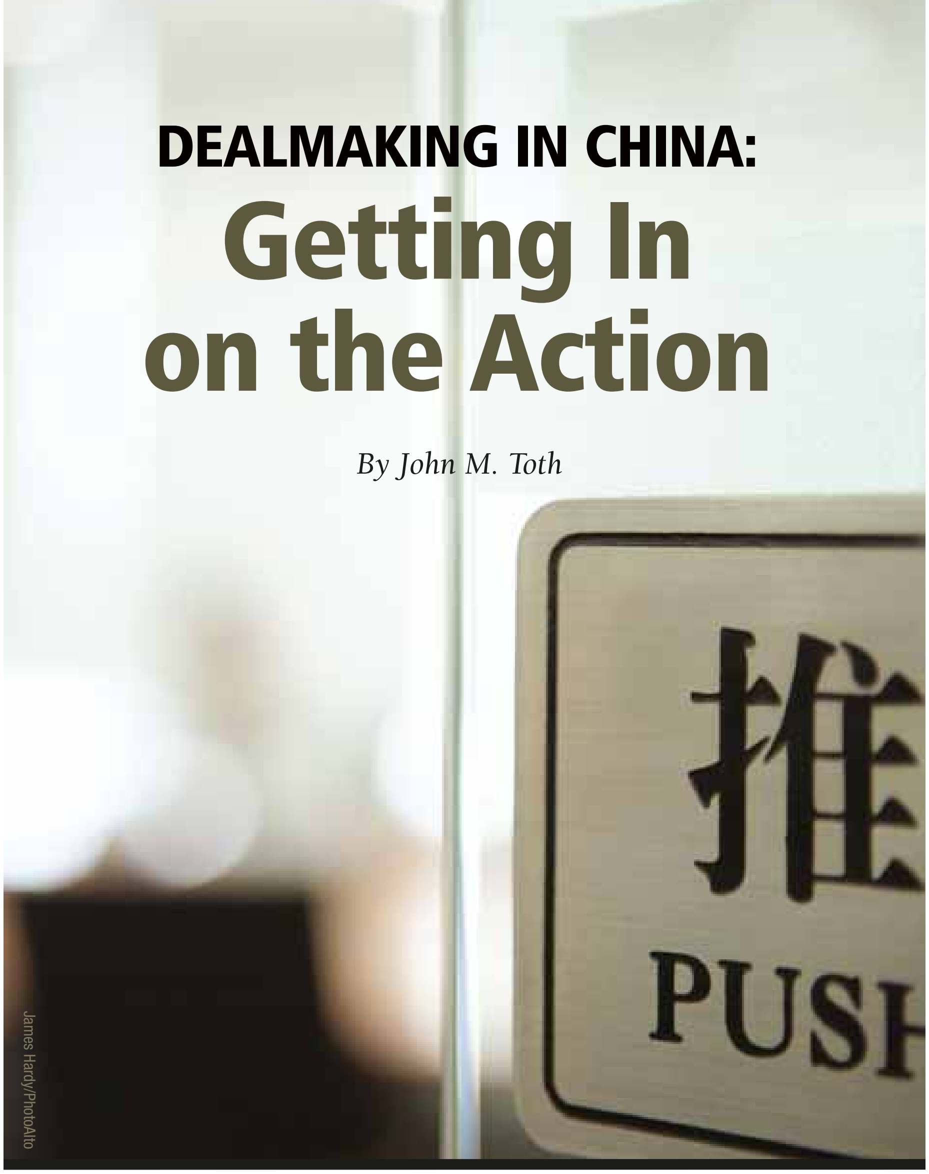
DEALMAKING IN CHINA: Getting In on the Action

By John M. Toth



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Having a meaningful footprint in China has become a strategic imperative for multinational companies from around the world. The attraction is China's seemingly insatiable demand for products, services, capital and technology. George D. Martin, partner and chair of the Faegre & Benson China Practice, sees the current acquisition boom in China as the logical culmination of foreign investment trends that he first observed when practicing in Shanghai in the mid-1990s. Martin expects this M&A trend to continue. But in the years to come, he advises, it won't be just foreign companies on the buy-side of cross-border M&A deals involving China.

China's accession to the World Trade Organization (WTO) in 2001 opened new sectors to foreign investment and eliminated many restrictions on structuring those investments. As a result, joint ventures that were in vogue among early China investors waned. Multinationals acknowledged the cross-cultural integration and operational problems with their partners. Initially, this realization, coupled with China's market liberalization, led to the establishment of more wholly foreign-owned enterprises as foreign businesses were convinced that such problems could be avoided with their own "greenfield" start-up operations. While this proved true, many companies found organic growth to be a frustrating—and unacceptably slow—process.

More comfortable with market risk, facing aggressive plans for business in China by their competitors and determined to make this market a more significant component of their global operations, U.S. multinationals embraced M&A in China. While not free of risk, M&A has proved to be the best means by which to achieve strategic growth in China. Martin cites statistics indicating nearly 300 cross-border acquisitions of Chinese companies in 2006, up 16 percent from the year before; and M&A volume is up even more in 2007. Yet, achieving critical mass is not simple. Most acquisitions are small by developed market standards—a systemic challenge in China resulting from local companies operating in highly segmented and regional markets. Because of this, "foreign investors need to complete more deals for significant market penetration," Martin says. "That means having a greater deal flow. The challenge is that buyers are largely on their own in finding targets. Investment bankers in Greater China tend to be focused on capital markets and only the very largest M&A deals."

Thinking Holistically

"Acquisition targets in any emerging market usually have poor financial controls, inadequate record keeping, spotty regulatory compliance and a history of questionable business practices," Martin cautions. "Buyers can also face very real cultural hurdles in obtaining full disclosure during diligence and in getting local managers to accept the ways of their new owners."

Martin believes, however, that thorough and realistic integration planning makes it possible for U.S. companies to achieve success with their new businesses in China.

Dave Sampsell, associate general counsel for Minneapolis, Minn.-based ADC Telecommunications, Inc., agrees. Sampsell has worked on acquisition and joint venture transactions around the world for ADC, a global provider of network infrastructure equipment and related services. He found that analyzing and negotiating an acquisition in China involves a range of issues either unique to China or more sensitive than they might be elsewhere.

"Above all, you need to think holistically about how to structure the purchase and how you will address diligence issues you uncover relative to the impact on future operations, including any ongoing relationship with the sellers of the business," he says. "Obviously this is important in any deal, but the legal, cultural and language differences between the United States and China really heighten the importance of thinking not only about legal solutions to issues but the business impact of those solutions." This involves deliberate fact checking during diligence, heightened attention to relationship-building and careful consideration as to how acquired operations will be overseen and integrated.

Love It or Leave It

The good news is that the number of viable targets in China is increasing. State-owned enterprises are being privatized and early investors in Asia are divesting to realize the rewards of their early market entry. But, "expect intense negotiations over price," Martin warns. "The strategic imperative driving interest in China drives up valuation. In addition, local management is often pressured by their shareholders to explore an IPO on one of the booming Chinese stock markets. And, there are financial investors emerging on the scene." As a result, Martin has seen instances where acquiring companies paid multiples of 12 to 18 times EBITDA—significantly higher than current valuations in the United States in comparable industries.

Martin recommends that buyers emphasize their strategic value. "Chinese companies are highly motivated by the prospect of absorbing international best practices, worldwide branding and distribution, and accessing the deeper pockets of a strategic foreign buyer to help with expansion," he says. At the same time, Martin cautions that Chinese owners take great pride in the companies they have built and may be reluctant to change their ways post-closing. "If the management of an acquired company does not embrace the new ownership culture within six to nine months of closing, it never will. The best solution is to part ways, cut losses and move on," he asserts.

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Look Before Leaping

The challenges associated with buying and operating a business in China make exhaustive legal and financial due diligence essential. Sampsell recalls, "It was impossible for us to do all the diligence ourselves. First, we don't have many people who read and speak Mandarin, much less in areas of needed expertise." He says that ADC invested more than a year negotiating and structuring a recently announced acquisition, relying on a multilingual team in China that included Faegre & Benson as outside counsel and a global accounting firm. ADC also retained a market research firm to verify the target's market assessments and business plans.

Even so, risks can't be avoided entirely. Martin says that a buyer can mitigate those risks, however, by positioning its own managers to at least initially control finances, protect intellectual property and oversee operations. He also adds, "Being prepared to make a quick change is imperative." For example, under PRC law, the chairperson is the company's "legal representative"—a role with significant power. Martin recommends installing your own designee as the new chairperson to allow for swift action if problems occur. Still, reliance on expatriates is not a long-term solution. Martin recommends a transition period of no longer than three years, during which expatriates train local successors.

The Payoff

The frenzy surrounding China can be intoxicating. This is an exciting market, with many competitors hunting for the same targets. Committing to the market and engaging with a fully dedicated team is important. But, Martin notes, "the most successful buyers look at many deals, carefully choose which to pursue, undertake exhaustive diligence, make realistic valuation and risk decisions, and instill strong governance, with ongoing training and oversight of local management."

Those who do so will find ample rewards in China for many years to come. And, they will be better positioned to fend off their rapidly emerging Chinese competitors, whose commitment to globalization—with increasing means to achieve it—will soon add additional buy-side pressures to this dynamic market.

George D. Martin *is a partner and chair of the China Practice at Faegre & Benson LLP, which maintains a foreign law office in Shanghai. He may be reached at* gmartin@faegre.com.

Dave Sampsell *is associate general counsel of ADC Telecommunications, Inc. He may be reached at* david.sampsell@adc.com.