

Breaking into the Chinese Less-Than-Truckload Market

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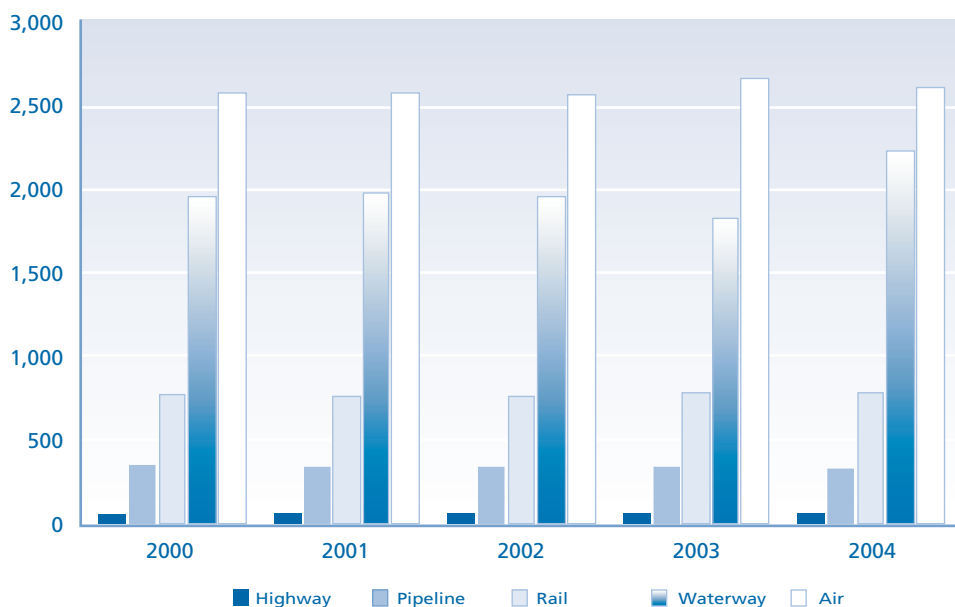
There is plenty of evidence at present of massive unmet and growing demand for efficient and reliable trucking in China, particularly in the less-than-truckload (LTL) sector. Since China has opened up road transportation to 100 percent foreign investment as part of the WTO accession agreement, jumping in to such an enormous and in-need market may seem very attractive to foreign trucking firms.

The opportunities in this market are primarily for cross-regional transport, particularly between economic hubs, as shorthaul markets are highly competitive. Even so, foreign players must do their homework, or risk spending time and effort pursuing seemingly attractive transactions which falter before closing or shortly thereafter because of poor due diligence or the fact that the objectives of the parties were misaligned.

Opportunities in Chinese LTL

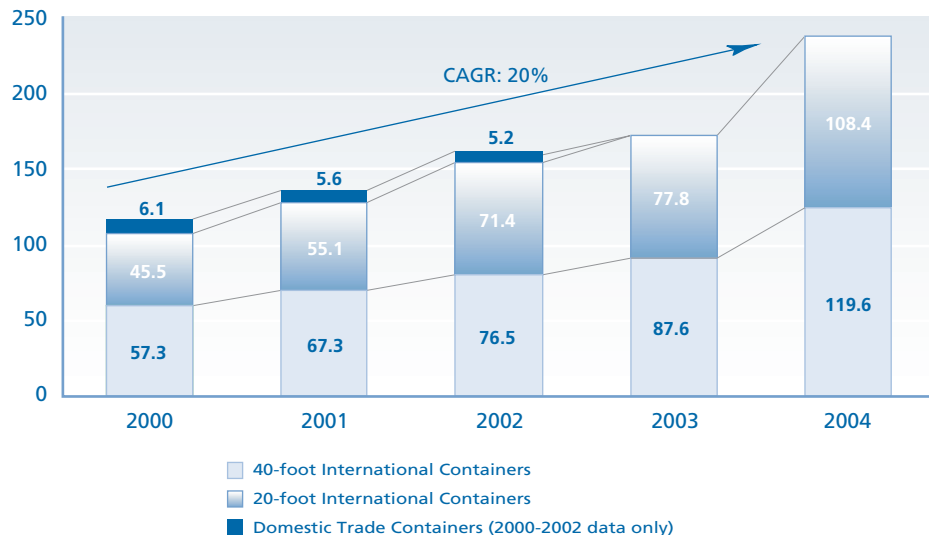
China's trucking market is extremely fragmented and intensely price competitive. Barriers to entry are low and Chinese trucking companies have on average around one truck and fewer than two employees—even large operators typically have less than 200 trucks. This fragmented market results in low utilization, with a long haul loading rate of around 50 percent. Trucking hauls are generally short, averaging 60 kilometers (35 miles), and the containerization rate for domestic goods is less than 2 percent (Exhibits 1 and 2).

Exhibit 1 **Average Transport Distance in China (km)**



Source: Year Book of China Transportation & Communications, 2001-2005.

Exhibit 2 **Container Traffic Moved by Truck in China** (million tons)



Source: Year Book of China Transportation & Communications, 2001-2005.

Beyond the chaotic environment in the various regions, however, strong and often unmet demand exists for cross-regional and trunk services between major economic hubs, such as Beijing, Qingdao, Shanghai, Guangzhou, and Shenzhen in the coastal areas, and into major pockets of rapid development and investment in the interior, such as Chengdu and Chongqing.

The emerging domestic market for LTL presents an opportunity for growth many times larger than cross-border export/import flows. Growth in this market should benefit from a variety of factors:

- China's now completed superhighway network, which is driving national economic integration. China's once poorly linked regional manufacturing centers, which had to rely on local resources, are now modifying their supply chains for national reach, with growing emphasis on trucking services.
- Manufacturers are increasingly adopting integrated national approaches and requiring time-definite delivery of smaller shipment sizes, especially in sectors such as auto components and high tech. Multi-national corporations (MNC's) that are invested in China in particular seek more sophisticated road transportation solutions.
- As global express firms respond to fast-growing demand within China, they are looking to LTL as an economic and practical alternative to air transport.
- The Chinese government is finally addressing China's very high logistics costs (at least double those of the United States) and sees a well run series of LTL networks as a positive way to optimize the use of transportation assets and provide better service to shippers.

The demand for LTL in China has not escaped the attention of Chinese trucking firms, which see a chance to escape from their current "no-profit zone" by providing new and differentiated services. Chinese express delivery and air

freight providers are also showing strong interest in extending their offering to include LTL services.

In particular, larger specialized trucking firms are emerging in key regional markets where the economy and LTL demand are growing fastest. TNT for example recently announced that it is in discussions to acquire Hoau, China's leading LTL company, with operations concentrated in East China's Lower Yangtze. This wealthy region, comprising Shanghai, Jiangsu, and Zhejiang, accounts for 10 percent of China's population but 25 percent of the nation's GDP.

The Rationale for Foreign Investment in LTL

In the broader logistics market, Chinese and foreign players are increasingly eschewing joint ventures. Large Chinese players do not want to give up operating control, while foreign firms no longer face regulatory constraints on ownership. LTL services, however, appear to be a different game: the logic behind the Hoau/TNT deal in part has to do with the highly technical nature of LTL and the high standards required to persuade major customers—many of them MNC's—to sign up.

Chinese logistics providers and truckers recognize that there are barriers to success in the LTL market that foreign partners can help them overcome, by providing needed management skills and processes (including network management), technology/IT systems for planning and operating LTL services, sales and marketing skills, and relationships with major MNC's operating in China.

For their part, foreign firms see working with a Chinese LTL company as a speedy and effective way to enter an attractive market still in its earliest stages of growth. Partnering with or acquiring a Chinese LTL firm can provide:

- Lower initial capital cost by acquiring an existing trucking fleet
- A Chinese partner that can manage the truck fleet and the drivers
- A readymade network of offices and yards to support truck operations
- Existing local truck licenses or the ability to arrange them at the local level

This joint realization by both Chinese and foreign firms of the benefits to be gained through partnership is a critical first step. But it takes more than just goodwill to make such a win-win deal work: it requires a thorough, structured process for defining and negotiating a partnership/acquisition that takes into account the particular challenges of doing business in China.

Navigating a Successful Chinese LTL Transaction

A critical issue going into the process is developing a clear strategic vision that defines what customers will be served, what their needs will be, and what it will take to address those needs in terms of assets, skills, technology, and government relations. That vision can then be used to develop an "ideal" partner/acquisition profile and a set of criteria against which potential targets can be assessed.

It is likely that the handful of Chinese trucking/logistics firms with the scale and quality to be candidates will stand out very clearly, and the market has no end of brokers and investment bankers keen to make introductions. But even if a strong candidate is already on a company's radar screen, there are good reasons to step back temporarily and conduct a thorough search process. Rigorously evaluating a spectrum of choices against the previously defined strategic vision and partner criteria will likely throw up a few candidates beyond the obvious ones. Most importantly, such a process provides fact-based validation and is valuable both in building internal consensus around the choice and in providing a transparent due process which respects shareholder interests.

After the initial screening, the search process will move on to significant evaluation of a shortlist of candidates. In particular, it is worth making sure at this stage that the Chinese side shares the vision of the foreign party, to avoid wasting time later in the process on unproductive discussions. Thus the search cannot confine itself to data available in the public domain, but should include initial contacts with candidates at a senior level. (To avoid premature negotiations and market confusion, those contacts may initially be handled by an external advisor.)

Once the best target is identified, due diligence is required, as would be the case anywhere in the world. But in China, due to inadequate transparency, poor corporate ethics standards, and cultural barriers, the foreign company will face added complexity and risk around the due diligence process, as shown in Exhibit 3.

Exhibit 3 Risks and Challenges of Due Diligence in China

Issue	Risks/Challenges
Financial Due Diligence	Chinese corporate accounting is acknowledged to often be inaccurate or misleading, beyond even the shaky levels that are sometimes found internationally
Network	In assessing Chinese transportation and logistics companies, great effort needs to be made to validate the scale and quality of the network that is claimed to exist. This should include visits to multiple sites to test and verify claims
Transportation Assets	Balance sheets may overstate the number and value of the vehicles owned or misrepresent their true ownership. The true depreciation status or actual condition may also be inaccurate and should be verified
Employees	In an acquisition, great care needs to be taken to fully understand pension and other obligations. This is particularly critical if the target is a state-owned enterprise with legacy liabilities With regard to existing staff, a company must ensure it is not taking on an inflated work force. There is local government pressure to maintain jobs and once the deal is struck, it can be difficult to reduce the work force later on
Land Ownership	Underlying land use rights in China are often unclear and can require large cash payments to rectify
Truck Operating Licenses (at the local level)	The foreign firm should not assume that existing operating licenses will be grandfathered. It may have to rely on its new Chinese partner/acquisition to use its government relationships to apply for operating licenses

If due diligence is satisfactory, a final issue that must be addressed is the choice of investment structure. The traditional joint venture involves establishing a new entity into which both sides inject assets and/or cash. The M&A transaction can be done through an equity acquisition (assets and liabilities) or an asset acquisition (just selected assets, which are usually purchased by a new Chinese entity established by the foreign party). The foreign investor will need to be cautious about an equity approach since, as mentioned, Chinese balance sheets are often murky at best. The asset approach can also be challenging, due to the difficulty of agreeing on a valuation, an issue that also surfaces with traditional joint ventures that involve asset contributions rather than just cash.

Though a potential investor may find the issues listed above daunting, a strong, persistent, but collaborative negotiating style which uncovers vital issues up front—rather than shortly before the signing ceremony—can help ensure a successful transaction. There is one other absolutely critical area, however, that needs to be addressed and focused on at all stages in the process: ethical standards and shared vision. These can be deal-breakers anywhere in the world, but the complexity involved in uncovering and addressing these are magnified in the Chinese context:

- Is the target company's corporate culture, business style, and ethical standards compatible? Is the vision of the target aligned with the foreign investor's, both in the short and longer term?
- Is the target prepared to give a foreign investor equity control and if so, can that be converted into effective operating control?
- Is the target sincere in wanting to build the company under foreign management control, or will the staff, network, or government relationships that they bring to the table melt away, thus vitiating the whole purpose of the partnership/acquisition?

If the answers to any of the above are “no” or “uncertain,” then any agreements reached through negotiations may not pass the test of time. In China, foreign parties are reluctant to test legal undertakings in court, given the poor rule of law. Though well crafted legal documents are essential, in the final analysis, compatibility and communication will most likely determine the level of long-term success that can be achieved by the venture.