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Improving the Odds for M&A Success in China

China's unique environment poses risks for dealmakers

By Raymond Tsang and Frank Leung

Merger and acquisition activity in China has been heating up in recent years, particularly since China's accession to the World Trade Organization. Despite the appeal of M&A to both foreign and domestic firms as a way to improve competitiveness or to grow, these deals often fail to deliver on their promise. To raise the odds of success, companies can implement a framework that addresses China's unique business and regulatory environment.

At one time, foreign companies looked to China primarily as a source of low-cost labor. M&A in these cases were not the most effective means of investment, as foreign firms had difficulty maintaining the low cost structures of the companies they had acquired. As Chinese manufacturers have grown more sophisticated and product quality has improved, however, foreign companies have glimpsed an opportunity to create greater value through exports and have stepped up the pace of acquisitions. The auto parts sector, for example, has been a hotbed of M&A activity. An example is Robert Bosch GmbH, which has invested \$600 million in China to date and expects to invest a further \$600 million by 2007, a portion of which will be reserved for M&A opportunities.

China's rapid growth has also led to the emergence of a middle class with considerable purchasing power and enormous potential. Foreign companies are eager to tap into this market, and are investing in R&D centers to better understand local customer preferences and develop targeted products. These firms can also leverage the availability of inexpensive talent to develop products for overseas markets.

Domestic companies, on the other hand, are being driven by market forces to consider M&A. Particularly for firms in fragmented

industries, increasing scale through M&A may be the only means of protecting their position in markets characterized by overcapacity and shrinking margins. Gome's recent acquisition of China Paradise (Yolo) in the electronics retail sector is just one of many deals where intensifying competition and industry consolidation are encouraging competing firms to merge or be acquired. High-technology, industrial goods, materials, and consumer staples were among the industries with the highest number of M&A transactions in 2005, according to Thomson ONE Banker and Mercer Management Consulting analysis.

The Near-Term Outlook

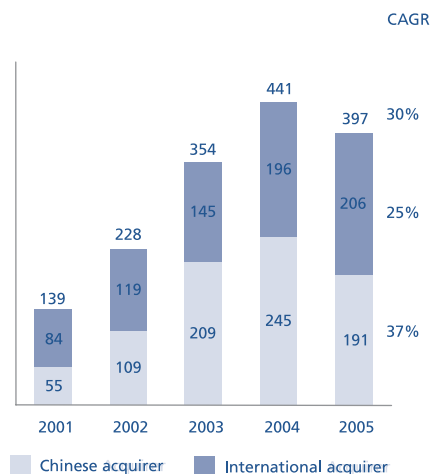
The results of this increasing interest in M&A on the part of foreign and domestic firms is that over the past five years, total M&A transactions in China have risen by an average 30% a year (Exhibit 1). In 2005, the total value of M&A amounted to \$33 billion, versus \$24 billion through July 2006. (For this article, we define M&A to include all investments that provide a controlling stake in an operating company in China, either by foreign or Chinese entities.)

Although M&A activity tends to be cyclical, it will likely continue to expand in China over the short- to medium-term based on several factors:

Raymond Tsang is a Shanghai-based director and Frank Leung is a Shanghai-based principal of Mercer Management Consulting. They can be reached at raymond.tsang@mercermc.com and frank.leung@mercermc.com. Paul Foo, a consultant in Shanghai, contributed to this article.

Exhibit 1 M&A activity is surging

Completed M&A deals in China



Source: Thomson ONE Banker

- **WTO obligations.** China is committed to reducing import tariffs, allowing 100% foreign ownership in most manufacturing industries and permitting significant market access to foreign investors in previously restricted service sectors, such as retail and distribution.
- **Consolidation of fragmented industries.** The government is motivated to “clean up” highly fragmented industries and sees foreign investment as critical to adding operational experience and capital to the sector, which facilitates more rapid consolidation.
- **Influx of capital into the private equity sector.** The growing economy and market potential of China have attracted large capital commitments to China-oriented private equity funds.
- **Increasing importance of private companies.** The number and size of privately owned enterprises (POE) have grown significantly in recent years, presenting a new and attractive pool of potential targets for foreign investors. The M&A process involving a POE is more straightforward than for a state-owned enterprise (SOE), requiring fewer government approvals.

While it seems likely that the *pace* of M&A activity in China will not slow soon, the outlook for the *value* that these transactions should generate is less clear. Evidence from a wide range of industries suggests that reaping the benefits of M&A is proving to be more challenging than expected.

It could be argued that it is still too early to gauge whether past transactions have been successful in achieving an economic return on investment. Nevertheless, investments have not yet produced the kinds of returns and synergies that were originally envisaged. Global surveys by publications such as *Business Week* and *The Economist* have estimated that roughly 60-70% of M&A ventures have failed to increase shareholder value. Thus firms involved in future M&A transactions in China will need to carefully consider what can be done to maximize the value of these ventures.

A Best-Practice Framework

One reason for the mediocre record of M&A ventures thus far may be that companies often spend fewer resources justifying an M&A initiative in China, as the average deal size is relatively small compared to that of the U.S. or Europe. What is not taken into account, however, is that a failed M&A represents not only a loss of invested capital but also a lost opportunity to profit in the future from the rapidly expanding Chinese market.

It follows that companies seeking to make acquisitions in China need to devote greater time and effort to minimize the risk of failure. They must put the right process in place, given China’s distinctive regulatory and business environment. In our experience, there are specific best practices that substantially raise the odds of success. These apply whether the acquirer is a short-term financial investor looking to quickly build value and then exit, or a corporate investor focused on the longer term and with a portfolio strategy in mind. Although each type of investor has different considerations and metrics for gauging success in a transaction, the process involved shares many similarities. Let’s review each practice in turn.

The Planning Phase

1. Conduct extensive target screening to ensure strategic alignment. A company seeking an acquisition in China must design a rigorous process for screening and selecting acquisition candidates. Foreign companies under pressure to establish or rapidly grow their presence too often focus only on the largest or most prominent targets. Even seasoned executives have selected acquisition targets on the basis of simplistic factors such as “they understand Western culture.”

To be sure, market leadership, a strong reputation, or a Westernized management team can be desirable traits in a target, but this should not be the starting point of the process. First, the prospecting firm’s management needs to develop a strategy for achieving its vision in China, assess the capabilities required for that strategy’s success, and identify capability gaps.

With this information in place, the company can develop an initial list of candidates to fill these gaps and winnow it down to a relatively short list of targets. The company can then initiate discussions to identify firms that share the same strategic vision and would offer complementary strengths. Next, these high-priority candidates can be slated for more in-depth examination. It is important to be discreet and to limit exploratory discussions to a handful of individuals, in order to avoid market rumors that more often than not result in higher prices and expectations of a deal being done. While this approach may seem time-consuming, one need only look at the many acquisitions that have unraveled as a result of having chosen the wrong partner.

One example of successful target selection is the acquisition of JHJ International Transportation by YRC Worldwide (formerly known as Yellow Roadway Corporation). In 2005, YRC was undergoing an international expansion and saw China as part of its future growth plans, since many of its customers were moving there. JHJ International Transportation was at the time the second-

largest air freight forwarder in China and under severe competitive pressure because of its lack of sophisticated operational expertise. While YRC is an expert in global transportation, it lacked the domestic network and local know-how needed to operate in China, which JHJ could provide. In return, JHJ welcomed acquisition by a company that shared its vision and that could bring global best practices to bear on its operations. YRC thus identified a target that complemented its own capabilities, resulting in a stronger entity overall.

Another example is the acquisition by Anheuser-Busch of Harbin Brewery. Prior to 2004, Anheuser-Busch had made various investments in the domestic Chinese beer market, including taking a passive stake in Tsingtao Brewery, the market leader. In 2004, it successfully wrested Harbin Brewery, the fourth largest brewer in China, from the clutches of SAB Miller, giving it access to a 30% market share in the Northeast region. Anheuser-Busch now has a household brand and distribution channel in one region that it can use as a platform to further expand its presence in China, and that complements its already well-established position in central China (the result of an investment in Wuhan International Brewing Company). In this case, a targeted investment in a highly strategic candidate created greater value for Anheuser-Busch than its previous investments in a larger brand-name company. Although Anheuser-Busch had to outbid SAB Miller in this deal, the strategic value that it was able to derive from this acquisition was also significantly higher.

2. Choose the right deal structure. A wide range of deal structures can be considered in an M&A situation, including share deals, asset deals, contractual joint ventures, and majority equity joint ventures with either more or less than a two-thirds stake (the minority joint venture is another option not discussed here). Exhibit 2 provides a brief description of each of these deal structures, including their pros and cons.

Depending on the nature of the industry and the acquisition candidate in question, it is important to identify the structure that will be most advantageous to the acquirer. Key considerations include:

- *Regulatory requirements.* In some sectors, such as automotive manufacturing, foreign investors still face equity restrictions, so a 100% acquisition is not possible.
- *Degree of control.* Except for highly regulated industries, where a strong Chinese partner can be beneficial, most foreign investors in China prefer a deal structure that ensures they retain a high degree of control.
- *Importance of intellectual property.* A general lack of recourse for infringement of intellectual property rights means that foreign investors may be more likely to transfer their technology and know-how only if they have a clear controlling stake and operating control.
- *Importance of access to customers.* In sectors where direct customer access is critical to success, the acquiring company must choose a structure that will ensure it has sustained access to distribution channels and customers.
- *Management model and problem resolution.* Different deal structures will allow the

Exhibit 2 M&A deal structure tradeoffs

Deal structure	Description	Benefits	Drawbacks
Share deal (more than 50%)	<ul style="list-style-type: none"> • Direct acquisition of part or all of the equity interest, including full assets and liabilities of an existing company 	<ul style="list-style-type: none"> • Less risk of minority party continuing in business as a competitor • Speedier access to market through acquired business 	<ul style="list-style-type: none"> • Difficult to determine true picture or extent of financial liabilities (e.g., environmental) • Earn-out not permitted beyond one year (hard to retain key existing management)
Asset deal	<ul style="list-style-type: none"> • Acquisition of some or all of the business assets, typically excluding liabilities of an existing company 	<ul style="list-style-type: none"> • Only selected assets are injected into new company (excludes those not required) • Greatly reduces the risk of legal liabilities tracing back to the new company 	<ul style="list-style-type: none"> • Earn-out not permitted beyond one year (hard to retain key existing management) • Longer approval process if SOE assets are involved
Contractual joint venture	<ul style="list-style-type: none"> • New joint venture with a pre-determined timeframe • Profit split not based on equity 	<ul style="list-style-type: none"> • Return can be based on other contributions, not just assets • Speedier negotiation compared to equity joint venture; less haggling over value of assets contributed 	<ul style="list-style-type: none"> • More potential for conflict if return not based on equity split • Counter-party less inclined to agree to this if terms deemed unfavorable
Equity joint venture (less than 2/3)	<ul style="list-style-type: none"> • Controlling stake in a new joint venture • Profit split based on equity contribution 	<ul style="list-style-type: none"> • Possess operating control and better protection of intellectual property • Can be consolidated into parent financials • Minority partner plays important role and has high degree of motivation 	<ul style="list-style-type: none"> • Minority partner may not cede full operating control to majority partner • Future expansion may be hampered if capital injections not matched by minority party • Major part of profits shared, even though the partner becomes less useful over time
Equity joint venture (more than 2/3)	<ul style="list-style-type: none"> • Dominant controlling stake in new joint venture • Profit split based on equity contribution 	<ul style="list-style-type: none"> • High degree of operating control and reduced risk (intellectual property, business ethics, financial) • Majority party has greater freedom to determine strategy and growth path 	<ul style="list-style-type: none"> • May encourage minority party to engage in other competing ventures due to reduced motivation

acquiring company differing degrees of management control over the operations of the organization. The complexity of business operations will be a factor in determining the optimal deal structure.

- *Portfolio strategy.* The acquiring company must determine the ideal structure based on its long-term strategic vision and the degree of operational integration it desires.

Based on these and other considerations, the acquiring company will need to determine what would be the most suitable deal structure and then work with the acquisition candidate to gain consensus early on in the negotiation process.

3. Understand the regulatory environment; create competitive advantage by anticipating shifts. China is still heavily regulated, and one of the challenges foreign companies face is navigating this regulatory maze. Successful companies typically have a finger on the pulse of the regulatory environment and a knack for anticipating shifts before they happen.

An example of a company that has taken advantage of shifts in regulation to create strategic advantage is Carrefour SA. When the retailer first entered China in 1995, foreign retailers were barred from forming their own chains and could only operate through individual joint ventures on a local basis with majority Chinese partners. Instead of seeing this as an obstacle, Carrefour decided to be an early mover and carefully selected local partners who were willing to give Carrefour relatively free rein in terms of management, allowing it to gain a head start in understanding local market conditions and customer needs. By the time the regulation was lifted in December 2004, Carrefour had already opened 49 stores. The retailer then embarked on an aggressive acquisition campaign, quickly buying back control of some of its joint ventures. Carrefour now boasts of being the largest international food retailer in China, with 79 stores, and plans to acquire up

to ten domestic retail chains in its drive toward second- and third-tier cities.

Carrefour's experience also illustrates that a company often has to take risks to benefit from regulatory shifts; the company made some missteps early on with respect to ownership structures and government approvals, but was ultimately able to benefit from adopting a bold strategy.

M&A activities in China's restricted industries or those requiring large capital investments also typically require approval from both local and central government authorities. Many high-profile deals have progressed to an advanced stage, only to stall during the approval process. In addition to recent provisions by the Ministry of Commerce and National Development and Reform Commission to protect national economic security, the China Securities Regulatory Commission also published a set of updated measures that gives the Commission greatly expanded powers to rule on takeover activity. This will provide the Commission with more discretionary control, which may in turn prove more challenging for companies seeking to acquire leading players in China. Companies conducting M&A transactions must assess the potential obstacles in the approval process and be fully aware of the various regulations and authorities that could come into play. It may take aggressive lobbying to obtain regulatory approval.

The Deal-Making Phase

4. Conduct extensive strategic and operational due diligence. In developed markets, due diligence usually consists of a legal team to verify the legal status of the acquisition candidate and identify potential legal liabilities, and an accounting team to conduct financial due diligence. In China, one must take a much broader and more detailed approach to verify the strategic and operational value of an acquisition candidate and expose potential deal breakers. In addition to financial and legal due diligence, some problematic areas for in-depth investigation include:

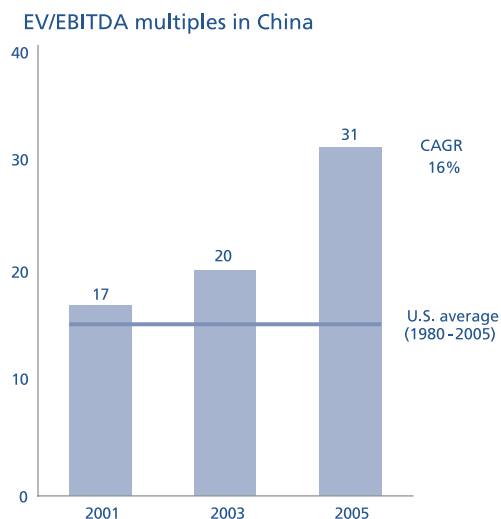
- *The overall business and market* to further confirm market potential and the competitive situation, as well as the candidate's capability to execute the strategy
- *Operations* to ensure overall operational effectiveness, as well as compliance with regulatory requirements
- *Sales and distribution* to gauge efficiency and control of the network. Additionally, soliciting customer and distributor feedback on the product or service offering can help highlight satisfaction levels as well as any questionable business practices
- *Suppliers* to confirm the sustainability of procurement contracts and supplier relationships after the acquisition
- *Human resources* to identify potential staff issues and ensure compliance with regulations and desired business practices
- *Key management* who will have a major role in the future operations of the acquired entity, to ensure integrity and identify potential "fit" issues

Extensive due diligence should uncover problems early enough in the M&A process for the acquirer to determine whether they are worth the time and effort to resolve, or if they are insurmountable and will kill the deal. Due diligence serves as a "sanity check" for the acquiring company, enabling it to re-assess and back up its initial interest in the target. Due diligence findings should then be incorporated into the business case and reflected in the expected return on investment.

5. Avoid paying an unreasonable premium.

The premiums being paid for acquisitions in China have been increasing at an astonishing rate over the past few years, as shown in Exhibit 3. The multiple of enterprise value (EV) to earnings before interest, taxes, depreciation, and amortization (EBITDA) rose from roughly 17 in 2001 to over 31 by 2005. This rep-

Exhibit 3 Soaring multiples



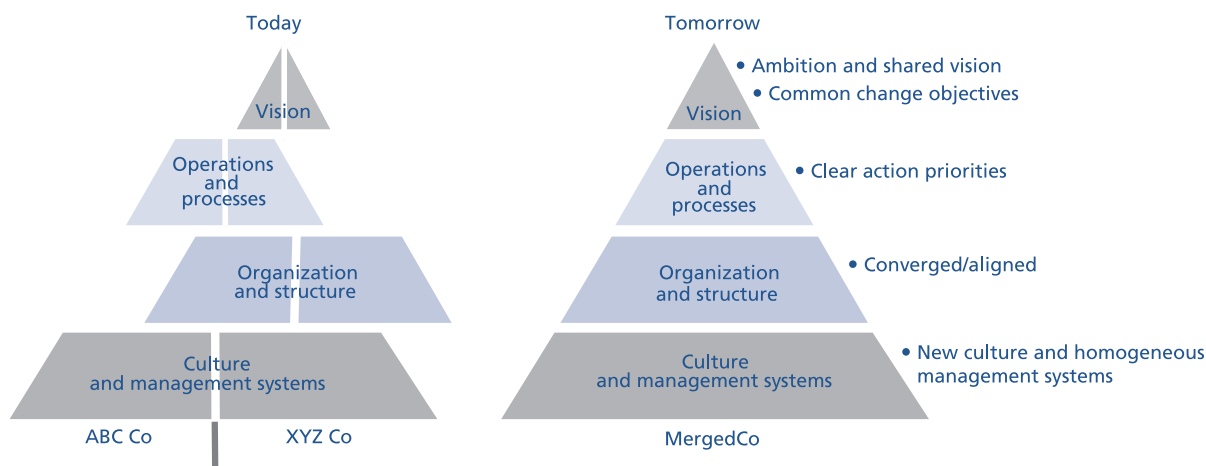
Source: Thomson ONE Banker, Stanford University Economics Department.

resents a 16% yearly increase in average valuations. Contrast this with a historical average ratio for acquisitions in the U.S. of around 15, or the ratio of the Shanghai Stock Exchange, which is trading at a multiple of 11 to 15.

This dramatic rise in valuations can be attributed to growing investor confidence in prospects for the Chinese market, combined with the increasing scarcity of suitable investment opportunities in some sectors. While some of the increase in premiums paid might be explained by a shift in the industry composition of companies being acquired (toward those with presumably greater prospects for future profitable growth), the overall industry composition has not changed dramatically. The downside of high premiums is that they drastically reduce the potential return from an acquisition. But if foreign capital inflows and liquidity continue to rise while the pool of attractive and available acquisition candidates declines, it is likely that valuations will become even dearer in the future.

In light of this development, executives must avoid getting caught up in the thrill of the chase, establishing a ceiling price based on the lowest acceptable return on investment and then sticking with this position. They should be prepared to walk away from the negotiating table if prices soar, consider other options, and resist the fear of missing

Exhibit 4 Post-merger integration objectives



a “great deal,” focusing instead on getting a price that is justified by the likely return on investment. It is also important to tentatively agree to a general set of terms with the acquisition candidate prior to investing time and resources in the due diligence process.

The Integration Phase

6. Develop post-merger integration planning in detail. As Exhibit 4 shows, the post-merger integration process should focus on combining two different organizations into one organization with a shared vision, operations and processes, a single organizational structure, and a unified culture and management system. The change processes involved are complex, so planning should take place as early as possible. Such planning will compel senior executives to rationalize the investment and acknowledge potential challenges.

Several principles are helpful here:

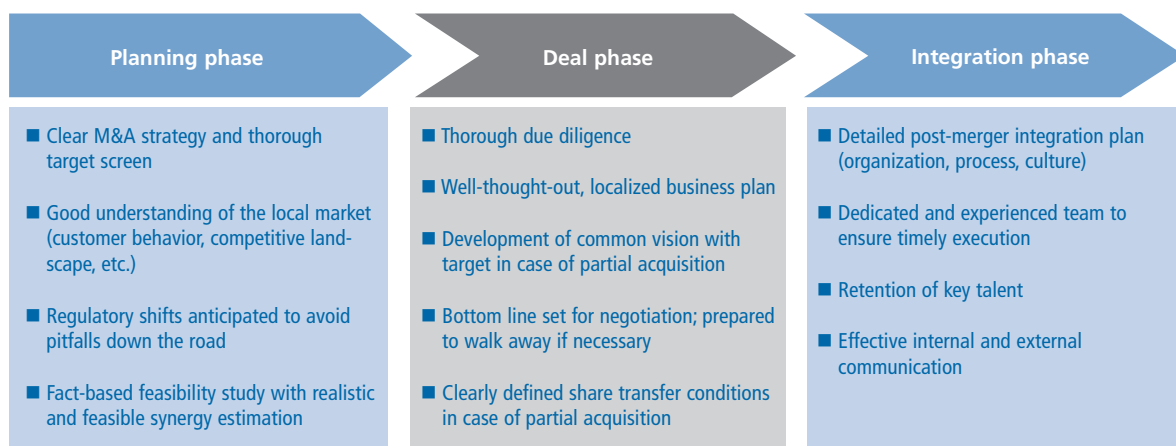
- Balance a focus on cost synergies with a focus on growing the newly combined company.
- Create a plan to retain key employees early in the process to ensure that employees do not leave en masse, especially for deal structures with one-year earn-out periods.

- Build a formal management structure to develop and execute the integration plan, which will ensure focused and efficient efforts.
- Make sure the integration plan takes advantage of the best initiatives and practices of both companies.
- Address employee issues in addition to structuring the formal organization, with an emphasis on effective and timely communication.
- Integrate the two companies quickly to ensure the effective transition of daily operations.

The stakes involved in successfully executing M&A transactions in China are only likely to rise in the future, as more and more companies enter the fray, shrinking the pool of desirable targets, pushing up valuations, and making it more difficult to get the level of return on investment needed to justify an acquisition. The companies that stand to win at this game are those that commit the resources and effort the M&A process requires and that minimize the inherent risks (Exhibit 5).

An M&A initiative is a complex undertaking at the best of times, requiring flawless execu-

Exhibit 5 Key success factors



tion from the initial planning and deal making through to implementation and integration. China's unique regulatory and business environment only adds to these

challenges. But the rewards for succeeding can be large, given China's potential as a top exporter and the world's largest domestic market.❖