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Feature performance



Leaping into the

spotlight

Over two billion people are expected to watch the Winter Olympics in Turin, Italy, next month. It's a chance for some of the world's biggest brand-name firms – companies that Olympic organisers rely on for financial and logistical support – to get their message across. One company will supply IT infrastructure to the Turin Games, and that company is Lenovo, a mainland Chinese company that grabbed international headlines a year ago with its acquisition of IBM's PC business. Lenovo will use the Games to unveil a revamped brand identity and a range of new products. For a Chinese firm, it's an unprecedented leap into the global spotlight; it's likely to spur similar ambitions among other PRC firms.

China's overseas forays stretch back to the mid-1970s, when a few large state-owned enterprises made tentative investments. By the mid-1980s, 143 Chinese enterprises had invested US\$170 million overseas. By the early-1990s, Chinese companies had established a foothold in more than 90 countries, largely in natural resources, assembly and transport industries.

Today, mainland China is one of the largest outbound investors in Asia. But while many PRC companies, particularly

in technology and engineering sectors, have found success in markets such as Russia, Latin America and the Middle East, they have to date fared less well in the bigger and more brand-conscious markets of Europe and the United States. One way around this may come through mergers and acquisitions.

There are several leading examples of Chinese companies' involvement in overseas M&A. Along with Lenovo there is Haier, which bid US\$1.3 billion for American white goods manufacturer Maytag, and the China National Offshore Oil Co. (CNOOC), whose unsuccessful US\$18.5 billion cash bid for Unocal stirred up a frenzy of protectionist rhetoric in the U.S. In the past year TCL, PetroChina, Ningbo Bird, SAIC, Nanjing Autos, ChinaChem and Air China were also rumoured to be considering overseas acquisitions.

The government started talking up this trend two years ago. And the eleventh Five Year Plan, to be unveiled next month, could see more government initiatives to encourage outbound investment. It's fair to say many companies will feel more comfortable tapping the potential of their domestic market, but if even a fraction of mainland Chinese companies start pursuing global strategies, then we'll all need to sit up and take notice. **A+**

The view from »»hong kong



▶ **Clement Chan**
Managing director,
Horwath CPA Hong Kong



▶ **Shaoming Huang**
Senior economist,
Bank of China (Hong Kong)

▶▶▶ **How much growth is there in outbound investment?**

Until a few years ago, our work was solely about advising foreign investors in China. Now, we are getting a steady flow of enquiries from PRC companies. Many are looking to set up trading companies as a window into markets like Malaysia, Singapore and Australia. We have also handled some cases where PRC companies have looked to set up production facilities in countries like Vietnam and Indonesia.

What approaches are PRC companies taking and how do their approaches differ from those of international firms?

You can over-generalise, but some PRC companies certainly appear to act quite spontaneously and overall the level of due diligence carried out is not as extensive as that of their Western counterparts. Investment decisions have tended to be made according to clear strategic reasons, rather than dictated by the current financial state of the target company.

How important are China's Five Year Plans?

All companies, whether private or state owned, will consider the Five Year Plan closely, and try whenever possible to work in the same direction. The financial services and insurance sectors are sure to be opened up over the coming years, so the Five Year Plan is a chance for the government to announce policies in these areas to support reform.

▶▶▶ **What is driving PRC companies' outbound investment?**

A common rationale is stability – in terms of access to resources and diversifying into new markets. Outbound investment is still a small proportion of overall capital flows, but we are seeing the start of a new trend that will grow in tandem with China's economic development.

What are the challenges for PRC companies in building management experience and expertise?

This is the real challenge. PRC companies are learning fast and it's clear that the big companies are competing for the most skilled management for this very reason.

What is the Bank of China's role in supporting outbound investment?

Bank of China (Hong Kong) has close ties to its parent company in Beijing, so we get entrusted to handle many financing activities for their big corporate clients. A PRC company needs to get domestic approval for a foreign exchange quota – once that happens the bank can provide any kind of financing solution.

Is the government lightening its grip?

The government policy is, in principle, to encourage outbound investment. The capital controls still provide some natural constraints. Investments are still approved based on their compatibility with state development and industry policies.

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Feature performance





A taste for acquisitions

By Gary Bowerman

Will mergers and acquisitions be the next leap forward for PRC companies? Merging with or buying overseas companies can bring many benefits, such as access to brands and management expertise, and circumventing certain market barriers.

Many successful Chinese companies are starting to eye overseas expansion, in part because competition in their domestic market is becoming so intense. So far, outbound merger and acquisition (M&A) activity is in its infancy, but it's already possible to see two clear strategies. The first involves largely state-owned companies purchasing raw materials and energy interests, typically in Asia, Latin America and Africa, for resources to sustain China's domestic economic growth. The second trend is privately managed companies targeting commercial markets, particularly the United States and Western Europe.

"Chinese companies can see that the strongest markets and highest prices for certain goods are in the West," says Ruggero Jenna, partner of Value Partners management consultancy in Shanghai. "China

has the most efficient manufacturing facilities and best-value research and development, so it makes sense to combine this technology and efficiency with branding and access to markets."

It's early days. Figures released in December by KPMG show Chinese firms completed 37 overseas deals in 2005, totalling US\$8.2 billion. This was up from US\$1.8 billion in 2004 and made China Asia's third largest acquirer, behind Hong Kong and Japan. Yet over half this figure came from China National Petroleum's Corp's acquisition of PetroKazakhstan. Inbound M&A investment into China remains far higher, totalling US\$43.8 billion in the first 11 months of 2005.

At this stage, more specific trends are hard to discern. A recent survey of 176 large Chinese companies by the Economist Intelligence Unit revealed that 91 percent intend to focus on the domestic market for the next three

“Chinese companies can see that the strongest markets and highest prices for certain goods are in the West.”

years. Only 17 percent have pinpointed either Southeast or Northeast Asia as a target market, with 12 percent selecting Europe and Russia, and only 11 percent North America. In September, a jointly released survey of 196 Chinese enterprises by the Asia Pacific Foundation of Canada and the China Council for the Promotion of International Trade in Beijing showed 23 percent intend to increase their overseas investment within the next 12 months, and more than 40 percent will invest overseas within five years – although only 16 percent were considering the M&A route. Companies most likely to invest overseas reside in the automotive, food and beverage, mechanical and electrical industries.

Ready-made branding

For a big Chinese company mapping out its global strategy, M&A is a tempting route into established markets; preferable to setting up a company from scratch in a new country with inexact growth potential. Unaccustomed to overseas management techniques, market structures, brand

strategies and regulatory frameworks, M&A offers Chinese companies access to ready-made brands, enhanced supply and distribution channels, infrastructure, raw materials and management expertise.

Higher-priced consumer markets are also part of the attraction. “Chinese firms in some areas are seeing the domestic market getting very crowded,” says Hubert Tse, counsel for Shanghai law firm Chen & Co. “Mobile handsets are an example. A number of Chinese mobile handset manufacturers have started to sell their products overseas to maintain growth in the face of fierce competition at home.”

In 2003-04, Tse represented a leading PRC conglomerate in the proposed acquisition of Alcatel’s global handset business. “This transaction demonstrates that leading PRC companies have the self-belief, global vision and ability to undertake major acquisitions abroad to expand their business internationally,” notes Tse. “Besides, they have the top global investment banks by their side advising them on overseas expansion.”

High value markets

Chinese companies are especially keen to buy United States companies,

opening a bridge into the world’s largest consumer market – and an opportunity to circumnavigate issues like dumping and import tariffs.

Take Zhongren Jing, director of International Development for Shanghai Fosun Pharmaceutical. At a recent forum in Shanghai, he claimed, “We are currently looking at overseas acquisitions because 48 percent of the pharmaceutical industry is in the U.S. and 30 percent is in Europe. We are one of the largest pharmaceutical companies in China, but globally we are very small.”

Market access is the goal. “The regulatory barriers for registering our products in the United States and Europe are very high,” Jing says. “We need to find the right way to speed up our globalisation process.” Shanghai Fosun is closing in on “two acquisition deals, for a total of less than US\$100 million,” which will help meet the company’s objective to compete in the mainstream global market. “Buying a brand name, regulatory expertise and management competence. These are the reasons we want to buy a U.S. company,” Jing adds.

Post-merger pragmatism is essential. “Western companies are more regulated



Maytag

and transparent and we would need to keep that expertise in place for the day-to-day running of the [U.S.] business,” Jing says. But the cost advantages China offers will be maximised, and not just in manufacturing. “We will look to bring some of the research to China,” Jing adds.

Europe is another new frontier. Last year analysts admitted surprise at the open competition between two Chinese companies, Nanjing Autos and SAIC, to acquire the remains of failed British carmaker MG Rover. The fact that SAIC had already purchased the rights to some of Rover’s intellectual property and engine transmission technology before the British company collapsed complicated the negotiations.

The floodgates start to open

The financing of M&A is unlikely to prove burdensome for Chinese companies of a sufficient size. Cash rich, with huge currency reserves, China is encouraging its local champions’ global aspirations. Banks also view overseas M&A as offering greater long-term returns, particularly for clients able to deposit substantial renminbi profits as

IBM Unocal
MG (Rover)
PetroKazakhstan IBM
Maytag
MG (Rover)
Unocal
Unocal IBM
PetroKazakhstan

collateral against foreign exchange loans. Private share placements are another option: Shanghai Fosun Pharmaceutical raised US\$500 million through this method. And, of course, there is the option of raising funds through an initial public offering (IPO).

Regulatory restrictions are a bigger consideration. In early 2005 the State Administration of Foreign Exchange (SAFE) restricted the holding of offshore assets by PRC citizens. This method had been used frequently by Chinese entrepreneurs to obtain foreign private equity and venture capital. While the aim was to avoid large capital outflows from China, it stifled the exit route for venture capital from companies

purchased offshore by Chinese enterprises.

This bottleneck may be clearing. On 5 January 2006, SAFE announced that sometime in 2006 it would remove the foreign exchange limit for PRC companies seeking overseas acquisitions. "This latest move, according to SAFE, is to lend further policy support to PRC enterprises undertaking investments overseas," says Chen & Co.'s Tse. "As a result, we could see cashed-up PRC companies buying large amounts of foreign currency in readiness for outbound M&A in 2006."

This policy reversal shows that while rapid economic growth has created enterprises with global ambitions, the relevant laws have struggled to keep pace. Legal inconsistencies and ambiguities

regarding foreign-funded M&A will take time to iron out, but a more developed and standardised set of regulations are gradually being put in place.

As greater legal transparency emerges, Chinese companies are likely to increase the volume of experimental overseas acquisitions. And they are receiving plenty of encouragement. Scores of national inward investment agencies are swarming into cities such as Shanghai, intent on persuading local businesses to invest in their country or region – and offering acquisition opportunities. **A+**

Gary Bowerman is editor of *Shanghai Business Review*.

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