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**A Practical Guide to
Successful M&A
in China**



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EXECUTIVE SUMMARY

Multinational companies are today turning increasingly to M&A as means to pursue their expansion plans for China. But finding a suitable candidate to acquire can be fraught with difficulty, and foreign managers are often tripped up by their unfamiliarity with China's often unique business, cultural, and regulatory environments.

Having helped dozens of foreign companies navigate the pitfalls of Chinese M&A, Booz & Company is well-placed to offer insights into the do's and don'ts of merging with a mainland company.

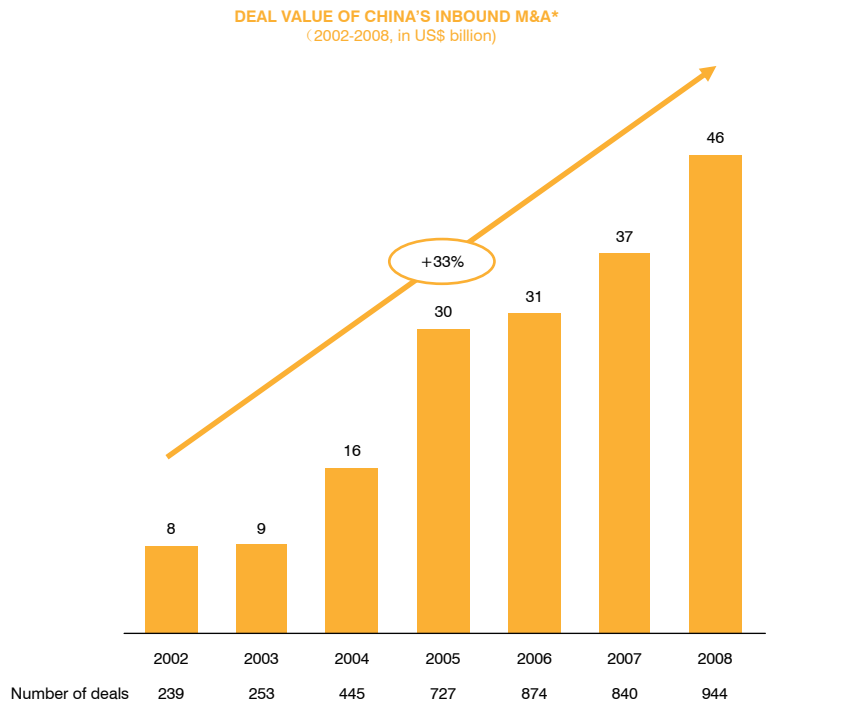
THE WHY AND HOW OF FOREIGN M&A IN CHINA

Multinational companies seeking to fulfill shareholders' endless appetite for income growth are turning increasingly to outbound expansion through cross-boarder M&A.

Unsurprisingly, China usually features high on their lists. Its strong economy and progressively deregulated markets have made it a magnet for expansion-

minded multinationals, and as more and more companies look to the East to replace lost growth opportunities at home, the Mainland is fast becoming a battlefield for multinational dealmakers. As a result, inbound M&A has ballooned in recent years, growing from US\$8 billion in 2002 to US\$46 billion in 2008, when a record 944 deals were completed (*see Exhibit 1*).

Exhibit 1
Deal Value of China's Inbound M&A



Note: Including acquirers from Hong Kong
Source: Booz & Company

As market entry thresholds come down and increasing amounts of capital become available in local markets many multinationals are today able to channel their foreign direct investment towards Chinese acquisition targets. As a result, M&A deals in China are becoming:

1. Progressively larger
2. Spread across a much wider range of industries ranging from energy to manufacturing to services (including retail, financial services, tourism and insurance)
3. Common in both state-owned and private sectors;
4. Targeted at both distressed companies and industry frontrunners, and

5. Increasingly focused on the ownership structures and operation of acquired companies.

MNCs' main focus is usually to work out how to tap into domestic markets by leveraging local knowledge and resources. Their goal is to gain control by cutting costs through localization and by investing in markets and companies with sound growth prospects, especially in mature industries with low organic growth.

So far, there have been both successes and failures. Dutch express giant TNT, for example, successfully acquired local freight and parcels delivery firm Hoau in early 2007. But similar high-profile bids by U.S.

private equity firm the Carlyle Group (for construction machinery maker Xugong), and Coca-Cola (for juice maker Huiyuan), both came to nothing following long and costly negotiations.

After a comprehensive program of research, Booz & Company has distilled the fundamental lessons of recent M&A activity in China into three key themes, which should also provide useful reading for Chinese companies preparing to 'go global' in an outbound M&A campaign.

THREE KEY STEPS TO SUCCESS

1. Be Prepared

Know What You're Looking for

Companies need to work out in advance what they want to achieve from merging with a Chinese company. For some, M&A is a means of penetrating new markets rather than just boosting profits. For others, corporate acquisitions are calculated to bring new customers and marketing opportunities, or to boost growth rates by eliminating competitors.

Whatever the motivation, a company should never rush into a merger without knowing its real goals. The blind pursuit of higher revenue is a typical mistake in poorly-executed mergers. Managers should instead think carefully of how to define the target to acquire. Nestle's practice, for example, when scouting for merger opportunities in China, has been to focus on the relative strengths of the acquisition target, such as its unique expertise, or access to specific markets or marketing networks. By seeing the proposed acquisition in the context of the broader goals of its globalization strategy, each company can prioritize its objectives from a wide range of themes. These might include seeking out new markets, technologies, branding, or resources. Once this is done, sifting out particular targets becomes more straightforward.

Do Your Homework

Successful M&A deals are invariably the result of comprehensive research and data collection rather than opportunistic impulse. Buyers need to look beyond the obvious. The capital strength of the acquisition target and the costs of the M&A are certainly important issues, but there are also a host of other factors to consider, ranging from future capital required to the expected future revenue of the merged company. Randomly choosing "cheap" targets will not result in successful mergers. Companies should therefore constantly review and validate their research into prospective targets to ensure it complies with their strategic

objectives and ultimately brings value to the company as well as a good return on the purchase price. Generally speaking, 60%–70% of the time spent on a successful acquisition is devoted to this type of preparatory strategic planning by MNC with strong acquisition track.

Since good M&A strategy is based primarily on extensive research and validation, buying companies must first become experts on their target's business and track record. After that, they should analyze its financial position, technological sophistication, and market share (for both themselves and the target company). Finally, buyers should take a wider view, looking at conditions in the respective economies of both companies' home countries, together with corresponding political, legal and cultural conditions. Once this is done, the information can be collectively analyzed and validated, providing a better understanding of prospective difficulties in consolidating the two companies.

Does the Reality Match the Ambition?

Before a merger is consummated, senior management should create a set of guidelines laying out the way forward for the merged company. This should be more than just a standard "long-term strategy"—it should also define important corporate objectives such as integration-based M&A, organic growth alternative, and the nature and scope of future business alliances. The guidelines should provide a common-sense roadmap for the two companies to follow as they complete the merger, ensuring that each step is backed by sound business reasoning. CFO and M&A teams in particular should benefit from this process because it will allow them to make objective assessments of trading prospects. If the reality of the merger aligns with the ambitions set out in the guidelines then it will be a value-added exercise. If not, or if it sets alarm bells ringing loudly enough, an exit can be mapped out that will allow a swift exit from the deal.

Deploy Adequate Internal Resources

Once the strategy has been successfully developed and tested, a team comprising management and related leaders from each unit will be created to decide on the next steps in each relevant area, (legal, accounting, finance, etc). This should ensure that policies are flexible and responsive, with clear communications channels to the rest of the company.

Changing Regulations or National Sentiment Can Sink Your Deal

Foreign investors are unable to operate in all sectors in China because domestic political or industrial policies sometimes bar non-Chinese participants from certain industries. Moreover, government policy is subject to constant change, so foreign players must be constantly aware of how new laws, regulations, or policies might impact the prospects of any given deal. Failure to do so may result in the waste of enormous effort and expense if regulators refuse to give the go-ahead. Another factor to consider is the recently-introduced market competition review, which amounts at this point to an anti-monopoly investigation Coca-Cola's unsuccessful 2009 attempt to acquire Huiyuan, China's largest juice maker, for example, was a direct result of its failure to navigate an anti-monopoly investigation conducted by the Ministry of Commerce.

Finally, MNCs must be careful also to comply with local regulations (which may differ from province to province) and also to recognize that national sentiment (which often comes out against high-profile mergers) today plays an increasingly important role in determining the outcome of the approvals process.

Chinese M&A Is Not for Everyone

Some companies jump into deals for the wrong reasons. They may buy on impulse, for example, or simply because the target appears cheap, completely ignoring fundamental issues such as actual asset value, operational capabilities, or the deal's

strategic coherence with their other businesses. Potential buyers should first review their own organizational competencies by analyzing their capabilities in the realms of teaming, strategy planning, operations, and finance. Only after further analysis of development trends, business opportunities, best practices and risks for both the company and the industry will managers be in a position to determine whether any potential deal really brings added value for the company.

2. Five Real-World Solutions

Find the Right Leader

Deals negotiated solely or mainly by external advisers rarely lead to successful mergers, so companies need to find a strong, experienced leader to identify and pursue merger targets. The right candidate should have uncompromised integrity, excellent communication skills, and be offered appropriate incentives. Companies will then have access to effective deployment, leadership and troubleshooting skills, boosting the prospects for success.

Weigh up Pros and Cons

After creating a target shortlist, management should focus on identifying their individual strengths and weakness in a deliberate and systematic manner. This process should include getting inputs and assessment from all stake holders of acquiring company so nothing is missed. The clear shortlist also creates alternative option should primary target acquisition fails.

Conduct Due Diligence

Due diligence is a highly important part of the M&A process. Best overseen by the potential CEO or CFO to be assigned to acquired entity. Besides normal DD items, the DD should focus on troubles, such as levels of debt and receivables, potential corruption issues, tax and labor liabilities, non-competition violations by previous owners or management. As part of DD exercise,

companies should also prepare mitigation plans for risks discovered, so there is a plan ready to go for correcting problems identified.

Play Fair and Square

The buyer needs to calculate the value of the target company fairly and objectively. Over valued transaction should be dealt with care while under-bid will cause seller to seek alternative buyer and may cause deal to derail quickly.

Introduce a Parallel "Shadow Management Team"

During the M&A process, the focus is on deal transaction while not much attention is paid to deep understanding of acquired company's daily operation, leading to many integration risks. Therefore, companies are advised to send in a "shadow management team" to monitor and learn all aspects of acquired company's operation so day 1 becomes a smooth event, instead of risky steep learning.

3. Dodging the bullets of integration

Keep Your Goals Realistic

Foreign companies may have high expectations for their post-merger businesses, but lack a practical and holistic strategy that will work in China's often singular business climate. In our experience, typical missteps include:

- Not having a clear role and performance expectation for old owner if retained in new entity to gain best leverage of know how and relationship
- Not taking strong control on finance as early as possible, which may cause unexpected cash flow and other problems
- Synergy expected stays on paper while no one is tasked to ensure synergy is fostered and achieved, defeating the purpose for acquisition
- Financial projections unrealistic

before acquisition and corrections not made quick enough with rescue and remedy actions

- Not giving enough trainings and communications time with acquired management team, resulting in misunderstanding between new and old management team
- Unwilling to invest enough new capital to fix problems or generate growth, and reply too long on “old system” in place, which is not adequate for growth needs

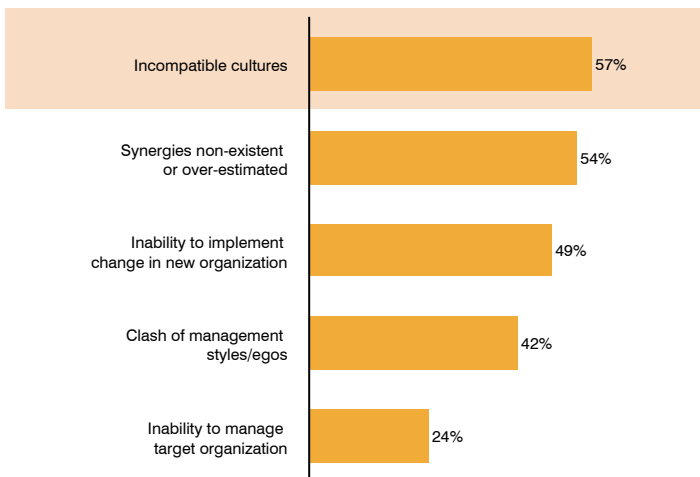
Understand Your New Shareholders
Your new Chinese partners are likely to have much more influence in the running of the business than would usually be the case in the West. Shareholder structures tend to be more intricate in China. They often involve tight-knit relationships with local and central governments, and a widely-cast social network that might involve family members, distant relatives, and business partners of the company. Moreover, shareholders who may seem at first peripheral figures may turn out to

be surprisingly influential in the final phase of M&A. Failure to cater to their interests can result in heavy losses or even legal disputes.

Be Aware of the Culture Gulf
Given the often wide cultural differences between East and West, it is unsurprising that failures of foreign/Chinese business mergers often boil down to the inability to integrate successfully two distinct corporate cultures (see Exhibit 2). Despite this, cultural integration is often not a priority for foreign

Exhibit 2
Observed M&A Causes of Failure

OBSERVED M&A CAUSES OF FAILURE*



Note: Global survey of 132 senior executives (2002) - 45% from Europe, 24% Asia Pacific, 17% USA, 13% rest of world
Source: Harvard Business Review, Literature research, Booz & Company

executives. Even those who try to address the issue rarely understand how to approach it effectively. The following chart should provide some insight (see Exhibit 3).

One Size Does Not Fit All
Multinationals focused on standardizing business models and processes across different regions will often try to apply their current

models to the newly-integrated company. Very few of them make the effort to retain local norms and practices in the merged entity (see Exhibit 4).

Exhibit 3
Lessons learnt from cultural integration

Activity	Key learning
Understand the culture you are acquiring	<ul style="list-style-type: none"> Understand existing cultures and acknowledge sub-cultures and key drivers: people, organization and rhetoric
Define the desired cultural vision	<ul style="list-style-type: none"> Ensure the strategic intent drives the cultural vision of the new identity Recognize the desired culture will be significantly influenced by the existing people, organization and rhetoric Strategic intent and leadership behaviors are supporting drivers to shape the desired culture Engage leadership to agree, own and drive the cultural vision
Embed the desired culture through practical action	<ul style="list-style-type: none"> Secure strong ongoing sponsorship and involvement to influence, shape and enable the cultural change Implement practical initiatives to drive change and embed new ways of working Track and intervene to influence culture shifts

Source: Booz & Company

Exhibit 4
Differences Between Chinese and Western Culture

Selected Business Practice	Western Company Norm	Chinese Company Norm
Sourcing and purchasing	<ul style="list-style-type: none"> Transparency & open bidding process 	<ul style="list-style-type: none"> "Guan Xi" is important
Authority delegation	<ul style="list-style-type: none"> Prefer decentralized 	<ul style="list-style-type: none"> Prefer central control - approval authority is normally centralized in 1 or 2 key people
Data integrity and reporting	<ul style="list-style-type: none"> Prefer facts and data with standard reporting 	<ul style="list-style-type: none"> Inadequate management reporting system
HR	<ul style="list-style-type: none"> Appropriate span of control 	<ul style="list-style-type: none"> Hierarchical
Performance evaluation	<ul style="list-style-type: none"> Performance-driven based on clear JD 	<ul style="list-style-type: none"> Seniority-driven Relationship-based
Communication	<ul style="list-style-type: none"> Open and two-way communication 	<ul style="list-style-type: none"> Instruction oriented

Source: Booz & Company

Local Workers Have Different Mindsets
 Western companies often try to ensure smooth integration by requiring that local staff adopt Western management systems and processes. In reality, however, most local Chinese are poorly informed about the West. The new mindset and methodologies will be alien to them without an extensive coaching and training system (see Exhibit 5).

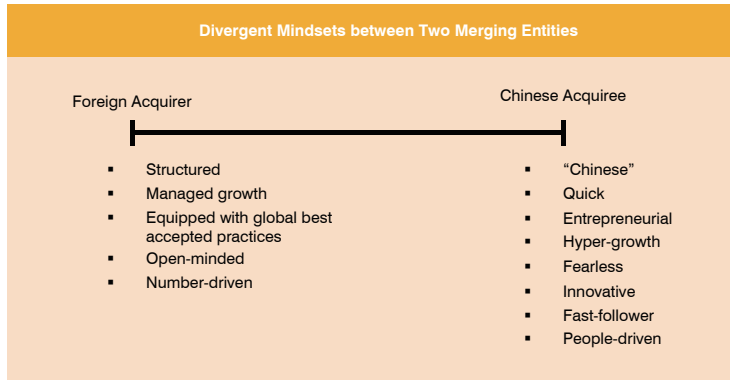
Without this, confusion, frustration and conflict invariably follow. Worse,

business may suffer as a result of ambiguous strategies. Foreign companies must therefore understand that successful businesses in China are not built in a day. They require great patience, systematic training, and both formal and informal coaching.

Retaining Key Staff Is Vital
 The typical reaction of perplexed local staff faced with different communication styles, working methods, or language barriers is shown in Exhibit 6.

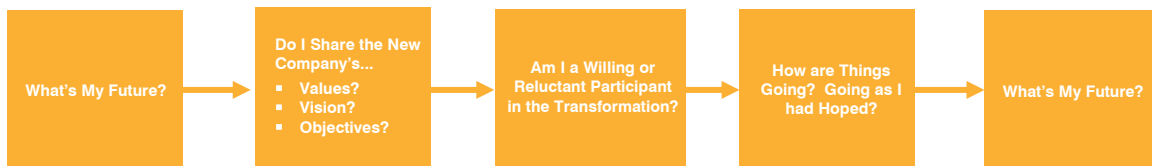
Exhibit 5
Mindset Divergence between Two Merging Entities

CLIENT EXAMPLE



Source: Booz & Company

Exhibit 6
Typical Employee Reaction to Merger



Source: Booz & Company

About the Authors

Andrew Caine is a Booz & Company partner and also the firm's managing director for Greater China. He has over 20 years of management consulting experience in Asia and Europe, and has been working in Asia since 1997. He advises local and multinational financial institutions on all aspects of strategy, organization, and capability building in China, Korea, and the rest of Asia.

Fushing Pang is an executive advisor of Booz & Company Greater China. He has over 25 years of senior management experience in large MNC, in high tech, healthcare, and logistics industries in China and Asia, with hands-on experiences in general management as well as M&A and post merger integration. Since joining Booz, he has consulted extensively with many industries in China on wider ranging topics.

CONCLUSION

The best way to deal with mounting workplace confusion is by introducing, as quickly as possible, a robust human resource management program. Retaining the right people is crucial for mergers of Chinese businesses because the hierarchical nature of most local corporate structures tends to foster strong leaders at the top of the pyramid, but leave relatively little scope for middle management to attain the same levels of experience and ability. In addition, these key senior management figures are usually the ones with close relationships with government contacts and suppliers, as well as access to under-the-radar corporate information. They thus remain essential to the stability and coordination of the new company, especially during the transitional period following the merger.

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