


booz&co.

China in Search of The
Perfect Deal
*Opportunity, Motive
And Means?*



Contact Information

Greater China

Andrew Cainey

Partner

+86-21-2327-9800

andrew.cainey@booz.com

EXECUTIVE SUMMARY

On the hunt for the killer in American crime thrillers, detectives are said to consider three questions: Who has the means? Who has the motive? And who has the opportunity? As Chinese institutions and companies consider how to “go out” through acquisitions and partnership investments, they would do well to ask themselves the same three questions. Only by looking at the three questions together, can they be confident of success. Of course, there are many different players in China, each looking at overseas investments from their own perspective. These include both governmental entities such as CIC (China Investment Corporation) and SAFE (State Administration of Foreign Exchange), major corporations with differing shareholder and stakeholder structures such as Bank of China, Lenovo and Haier and smaller emerging businesses such as Beijing’s LinkGlobal Logistics that acquired Germany’s Schwerin-Parchim airport. Each will have their own answer to the three questions, but some key considerations stand out—starting with the opportunity itself.

OPPORTUNITY

In the wake of the global financial crisis, the opportunities for overseas acquisition are greater than ever before. Asset prices in the US and Europe are down both in absolute terms and relative to China, where the stock market has already recovered strongly in 2009. Many western companies also face the need to raise new capital—especially in the financial sector, but also in sectors such as automotive and natural resources. These same companies also often find that access to credit is heavily restricted—especially where they have historically raised financing through credit markets.

As the need to attract capital has increased in still difficult market conditions, the reception accorded to potential Chinese investors has become warmer. At the Boao Forum in April, Lou Jiwei, Chairman and CEO of CIC, recounted the swift change in atmosphere in Europe from 2008. At that time, investment opportunities were only offered with many strings attached. Now in 2009, CIC is seen as a “lovable force” and there is little talk of investment restrictions.

Chinese companies are not short of opportunities for overseas expansion. The real challenges lie elsewhere.

MOTIVE

China’s economy continues to develop apace. Despite the sharp slowdown in growth, China retains its growth advantage versus more developed economies such as the US, Japan and Europe. With such strong growth opportunities at home, why look overseas at all? In fact, there are many possible reasons—but clarity on which ones are relevant for each company is critical to success.

When CIC and SAFE invest portions of China’s foreign exchange reserves in minority stakes of overseas companies, the decision is essentially one of portfolio asset allocation. Like major institutional investors everywhere, they seek to diversify across asset classes (in other words, not just US Treasury bills) to improve their risk-adjusted returns on the portfolio. Alongside this, certain investments suggest a desire to gain complementary synergies in addition to these financial returns. For example, CIC’s substantial, though minority and non-voting, stakes in Blackstone and Morgan Stanley, enable access to a range

of skilled investment professionals and perspectives on other potential investment opportunities. Mooted investments in natural resources provide an additional benefit of supporting China’s desire to improve access to much-needed raw materials alongside financial benefits.

For business enterprises—be they state-owned or private sector—overseas acquisitions can support corporate strategy in a number of ways. There are six potential strategic motives for an overseas deal, each with varying relevance for Chinese enterprises today:

1. Access new growth opportunities
Around the world, many companies look overseas to capture growth when they face slower growth in their home market. Alternatively, they may face anti-trust constraints on increasing their market share at home. Indeed, it is just for this reason that many Western companies look to China. Similarly, this means that this rationale has less relevance for Chinese companies looking out. There can, however, still be value in establishing early positions in newly developing markets (such as Africa, the Middle East) in order to gain a foothold or play a role in shaping market development.

2. Gain scale

Again, overseas acquirers may seek to gain positions in major markets to gain scale economies of operation. This is of particular relevance to companies from relatively small home markets: Nokia could not compete in mobile phones based on its home market of Finland alone. Nor could Samsung rely primarily on the South Korean market. With China's rise and position as the world's largest or second-largest market in products ranging from automotive to computers, this is less relevant for Chinese companies. Nonetheless, in time, Chinese companies will wish to gain additional scale in the US, Japanese and increasingly integrated European markets.

3. Turnaround and add value

Cross-border acquisitions may come about when a relatively strong company sees an underperforming competitor and believes it can acquire and integrate this business, turning around performance. Daimler-Benz applied this logic at the time of its acquisition of Chrysler. Fiat is now in discussions for a similar restructuring of parts of the Fiat, GM and Chrysler businesses. On paper, the relative strength and profitability of Chinese companies makes this an attractive opportunity. In practice, however,

it looks much less attractive when the question of "means" to make it a success is addressed. Indeed, it looks, for the most part, highly risky. For example, SAIC has encountered many challenges in its acquisition of Ssangyong Motor in Korea. The exception is where the opportunity is based on buying natural resource assets now in the belief that long-run demand trends in China, India and elsewhere will drive commodity prices higher again before too long. This would be then a "turnaround" in value, but with little need for operational and management experience to bring about the benefits. Essentially it is an investment based on market timing, applying China's capital strength to take advantage of a deeply-held conviction on long-term asset price trends.

4. Gain access to scarce resources

In fact, rather than focusing on growth, scale and turnarounds, much of the interest in overseas M&A focuses currently on supporting China's strategic goals of securing stable supply of commodities ranging from energy sources to basic and rare metals. Ownership and minority shareholdings in companies such as Rio-Tinto are seen to provide both an opportunity for profit, as and when commodity prices recover, and

an additional dimension to securing much-needed raw materials above and beyond purchasing in the spot market. While recognizing the commodities continue to be bought and sold in the market, these investments create options and flexibility for future co-operation and development as conditions evolve. They increase familiarity and cement relationships with different stakeholders and market participants. They also bring additional information and insight into the dynamics of strategically critical markets.

5. Access capabilities and market knowledge

One of the most relevant motives for acquisition currently is to access capabilities and market knowledge. For example, Geely has recently acquired Australia's Drivetrain Systems International for US\$40M in order to strengthen its gearbox production in China. In the same way, Bank of China acquired Singapore Aircraft Leasing in order to build expertise in aircraft leasing. More broadly, buying a foreign company provides a foothold in a different market, with an opportunity to learn about different customer needs and different ways of operating. This has many similarities to the way in which Western companies established their

MEANS

At a time of falling global credit flows and capital losses caused by stock market declines, China continues to enjoy the financial means to take advantage of overseas acquisition opportunities. China's foreign exchange reserves continue to rise, reaching US\$ 1,950 billion by the end of March 2009. State-owned enterprises, in particular, are well-positioned to benefit from the renewed growth in Chinese bank lending and new regulations enabling lending to finance M&A transactions. In addition, many of the largest Chinese companies continue to earn substantial profits. SASAC (State-Owned Asset Supervision and Administration Commission) announced that the aggregate profits of Chinese state-owned enterprises as of March 2009 were 26 per cent up on the previous year.

But Vice-Premier Wang Qishan has spoken clearly on the critical issues: That cross-border acquisition is not a matter of money and that Chinese companies need to consider if they could integrate and manage acquired foreign companies successfully. With particular reference to the question of whether Geely should make a large-scale overseas acquisition, Vice-Premier Wang observed: "The success of a company depends on personal connections and the environment.

You are successful in Hunan and China but not necessarily so in a foreign country".

In fact, it is in the area of non-financial means that Chinese companies face the greatest challenges. The twin concepts of "hard" and "soft" power are useful here. Chinese companies today enjoy 'hard' power—through sheer financial muscle, scale and relative strength. They often lack "soft power" to make acquisitions successfully—in other words, they lack capabilities in attracting, inspiring and persuading all the different stakeholders required to make the deal a success. One key challenge is to have a few key people who are in a position to assess the true context of an opportunity and then to manage and integrate the new enterprise effectively. It is also critically important to have the capability to engage effectively with all of a company's stakeholders in a foreign and usually unfamiliar environment: for example, how to inspire and enthruse different consumer segments; how to attract and motivate employee talent and how to navigate the regulatory and social context, for example in the area of employment law. Li Rongrong, Head of SASAC has reinforced his view that many Chinese companies do not understand the legal risks of foreign acquisitions.

A realistic assessment of whether the means for success are in place—and a plan to address and mitigate any gaps—is critical to success.

initial presence in China. When the motive to build capabilities—rather than scale—is clear, this sets an important guideline on the size of the acquisition. This type of deal tends to be smaller—and so easier to control and integrate, an important consideration, when we look at "means" below.

6. Follow your customer

As some Chinese companies strengthen their presence overseas—with or without acquisitions—there is an opportunity and need for the suppliers to those companies to establish a similar footprint. Acquisitions and investments can help by bringing the capability and presence required. For example, ICBC's 20 per cent stake in Standard Bank of South Africa provides a platform for supporting China-Africa trade and business expansion. Success here requires understanding which locations and activities are critical to making an important customer in China and a valued customer worldwide.

All in all, there are many possible motives for an overseas move. Important is to be cool-headed and pragmatic about what the relevant motives really are—and then to be systematic about making sure the means are in place to deliver.

About the Authors

Andrew Caine is a partner and the head of financial services for Booz & Company in Greater China, and Director of Booz China Strategy Foresight Institute. He has over twenty 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.

THE PERFECT DEAL: LINK MEANS, MOTIVE AND OPPORTUNITY TOGETHER

As always, for Chinese companies, opportunities abound: and in the current environment, this is just as true overseas as at home. And for companies accustomed to focusing on the “hard power” elements of financial resources, it may often seem that the means are in place, too. This would mean that once the motive is clear, a company is ready to act.

This is not the case. Would-be Chinese acquirers need to focus on two sets of questions that relate means and motive to individual, specific opportunities:

- What truly are my motives in “going out”? How do they align with my overall objectives for developing my business? How do they fit with the specific opportunities? What trade-offs and choices will this involve? What are the implications for target selection, goal-setting and management approach?
- What means are really needed for success in each opportunity—beyond the financial resources? In particular, do I have the people, the senior management mindset and the understanding of the overseas market and regulatory context in order to succeed? If not, how can I fill the gaps—and how long will this take?

Chinese multinationals are on the rise and acquisitions can play an important role in accelerating their growth and capability development. Those who succeed will look for the perfect deal by linking opportunity, means and motive closely together.

The most recent list of our office addresses and telephone numbers can be found on our website, www.booz.com

Worldwide
Offices

Asia

Beijing
Delhi
Hong Kong
Mumbai
Seoul
Shanghai
Taipei
Tokyo

**Australia,
New Zealand &
Southeast Asia**

Adelaide
Auckland
Bangkok
Brisbane
Canberra
Jakarta
Kuala Lumpur
Melbourne
Sydney

Europe

Amsterdam
Berlin
Copenhagen

Dublin
Düsseldorf
Frankfurt
Helsinki
London
Madrid
Milan
Moscow
Munich
Oslo
Paris
Rome
Stockholm
Stuttgart
Vienna
Warsaw
Zurich

Middle East

Abu Dhabi
Beirut
Cairo
Dubai
Riyadh

North America

Atlanta
Chicago
Cleveland
Dallas
Detroit
Florham Park
Houston
Los Angeles
McLean

Mexico City
New York City
Parsippany
San Francisco

South America

Buenos Aires
Rio de Janeiro
Santiago
São Paulo

Booz & Company is a leading global management consulting firm, helping the world's top businesses, governments, and organizations.

Our founder, Edwin Booz, defined the profession when he established the first management consulting firm in 1914.

Today, with more than 3,300 people in 59 offices around the world, we bring foresight and knowledge, deep functional expertise, and a practical approach to building capabilities and delivering real impact. We work closely with our clients to create and deliver essential advantage.

For our management magazine *strategy+business*, visit www.strategy-business.com.

Visit www.booz.com to learn more about Booz & Company.
