

10Minutes

on doing deals in China



May 2011

New rules to succeed in China's new economy

Highlights

Inbound and outbound M&A in China is booming, as Chinese industries consolidate domestically and expand globally.

Foreign investors are entering or expanding in *China for the China market* instead of just manufacturing in China for export markets.

As a result, they are reassessing what Chinese partners bring to the table and cautiously exploring alternatives to wholly foreign-owned enterprises.

Private equity has emerged as an important provider of growth capital.

Some investors recognize that new regulations affecting M&A may be creating short-term concern, but the long-term trend is toward greater clarity in a maturing system.

Merger and acquisition (M&A) activity in China is scaling new heights, but the rules for acquiring a stake in the world's fastest-growing economy have changed. Valuations are booming amid intense competition. Chinese domestic acquirers, with deep pockets and deeper relationships, are snatching up the deals—sometimes with just a handshake.

Many Western-headquartered businesses fear that new Chinese tax and regulatory measures reflect growing protectionism. Some companies, however, are paying close attention to investment opportunities signaled by the 12th Five-Year Plan. It envisions a new economy that is more urban, equitable, consumption-driven, and environmentally efficient. These companies recognize that a changing China calls for a fundamental shift in deal-making strategy. Their new approaches will pay off—not only in China but beyond—as Chinese companies become influential players in the global deals market.

Investors must work harder to make their case in a changing China.

1. Analyze the new give and take: Mature Chinese companies no longer want cash, but rather technologies, managerial expertise, and new markets. In return, they offer resources, relationships, and knowledge to succeed in a lucrative domestic market characterized by bureaucratic complexity, diverse regulations, and varied consumer preferences.
2. Structure win-win arrangements with potential competitors: There is intense competition for quality targets. Consider alternatives to outright acquisitions and traditional joint ventures, such as cooperative or contractual relationships that allow flexibility in profit-sharing, management structures, and capital investments.
3. Persevere with an evolving system: In some respects, China is aligning with global standards, for example; it has committed to converging with the International Financial Reporting Standards (IFRS). In other ways, China seems intent on carving its own path. But ultimately, it knows that M&A is necessary for its economic restructuring.

At a glance

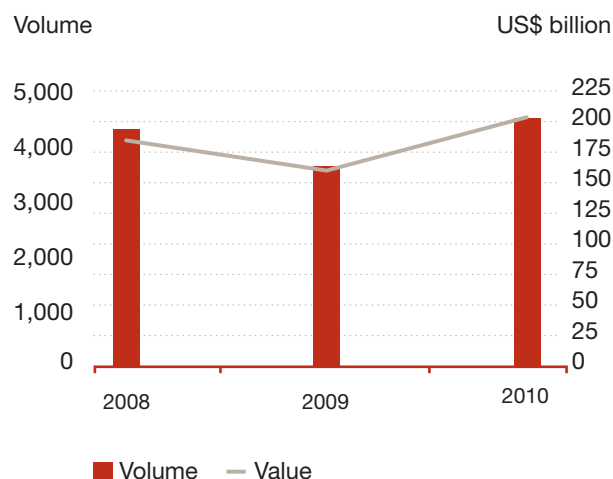
Western and Chinese deal environments are very different. Understanding and reconciling both perspectives is key to success.

	In the West	In China
Politics	<ul style="list-style-type: none"> Market forces largely determine deal-making activity. 	<ul style="list-style-type: none"> Government policy and approvals help to align the deal environment with economic objectives.
Growth	<ul style="list-style-type: none"> As focus shifts from recovery to growth, there is renewed interest in transactions, with particular emphasis on high-growth markets like China. 	<ul style="list-style-type: none"> Rapid growth is creating optimism, raising expectations, and putting pressure on an evolving regulatory system.
Culture	<ul style="list-style-type: none"> There is a strong emphasis on systems and processes at each stage—from signing confidentiality agreements and performing due diligence to securing internal and external approvals. 	<ul style="list-style-type: none"> Deal negotiation, execution, and integration are influenced by the nature and personality of the seller. Expect vastly different processes and outcomes when dealing with state-owned enterprises (SOEs) compared with privately owned ones.
Regulation	<ul style="list-style-type: none"> There is a tradition of reliance on the rule of law. Regulatory interpretation and enforcement are relatively clear and consistent. 	<ul style="list-style-type: none"> Regulatory enforcement is becoming more rigorous, but interpretations vary across provinces.
Valuations	<ul style="list-style-type: none"> Western acquirers are cash-flow driven and require a reliable set of projections based on long-term growth prospects. 	<ul style="list-style-type: none"> Chinese sellers have high valuation expectations as they are accustomed to relatively closed capital markets with P/E multiples of up to 50, or even higher.

China is reshaping the M&A business

Figure 1. Transaction volume in China returns close to pre-crisis levels

Total deal volume and value, 2008-10



Note: Deal volume refers to the number of deals announced. It encompasses domestic Chinese transactions, including those in Hong Kong and Macau; inbound M&A from foreign corporates and private equity; and outbound M&A by mainland Chinese companies pursuing acquisitions abroad.

Deal value refers to those deals where a value has been disclosed.

Source: ThomsonReuters and PwC analysis

China is a hot market for deals. In 2010, more than 4,000 inbound and outbound transactions, valued in aggregate at over US\$200 billion, were recorded in China. This represents a 16% increase in deal volume and a 27% increase in deal value over the previous year, as shown in Figure 1.¹ Compare that with the US, where deal volume remained flat and deal value increased 9% in the 12 months ending November 2010 (compared to the previous year).²

What's behind the numbers?

China is not simply in the midst of an M&A boom but rather, it is changing domestic and global M&A business landscape. Inbound and domestic corporate deals are driving the consolidation of key industries—e.g., auto parts, cement, and metals—that comprise a large number of small enterprises. Foreign investment is particularly welcome in high-tech enterprises, green technologies,³ and sectors oriented toward Chinese consumer spending, e.g., healthcare and consumer goods.

Western businesses are concerned that this shift in China's priorities—from acquiring capital to accelerating structural reforms—may be changing attitudes towards foreign investment. With China seeking technologies and know-how, some companies point out that R&D and IP transfer have become conditions for market access. A leading survey of US companies in China shows the country remains a top investment destination but almost two-thirds of respondents characterize the regulatory environment as either “not changing” or “deteriorating” over the past year.⁴

1 PwC, M&A Market 2010 Review and Outlook for 2011, January 17, 2010.

Shaking up the global order

And that's not all. China is also redefining the global deal landscape. Chinese companies are not only securing resources through megadeals in Africa and South America. They are also expanding worldwide into sectors such as automotive and chemicals. Some believe it's only a matter of time before outbound Chinese investors start acquiring significant stakes in Europe and North America. But that's proving to be harder as Chinese companies strive to align with Western practices and processes.

Is the US a difficult market to penetrate?

Chinese telecom equipment maker Huawei, for example, has faced difficulty in securing regulatory approvals in the US. But in certain sectors, Chinese outbound investors have had notable success. Take the hospitality industry. In an all-cash joint venture transaction, Shanghai's Jin Jiang Group and Maryland-based real estate investment firm Thayer Lodging Group purchased Interstate Hotels & Resorts, a leading independent hotel operator in America. Jin Jiang is keen to gain Western third-party management experience to expand its presence in China and global markets. Thayer expects strategic returns from the undervalued Interstate brand and to expand its footprint in the growing Chinese hospitality market.⁵

2 <http://www.pwc.com/us/en/press-releases/2010/recovery-to-growth.jhtml>

3 PwC, “The US-China Cleantech Connection: Shaping A New Commercial Diplomacy,” 2010.

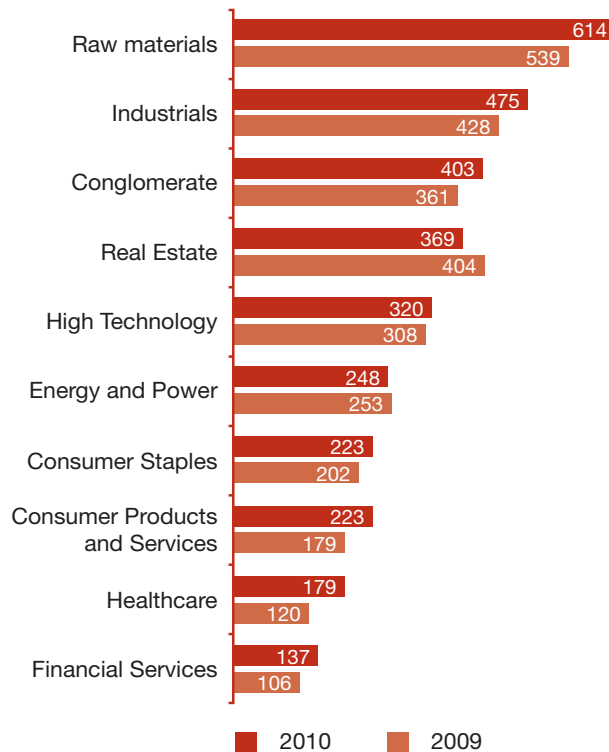
4 American Chamber of Commerce in Shanghai, 2010-2011 China Business Report.

5 Jason Q. Freed, “Thayer, Jin Jiang Hotels Purchase Interstate” Hospitality World Network, December 18, 2009.

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Integrate with China, locally

Figure 2. Deals continue to be broadly spread with most sectors, including high tech, consumer products, and healthcare, experiencing growth
Top 10 sectors by number of domestic and inbound corporate deals, 2009 vs. 2010



Note: Raw materials include mining, metals and chemicals.
Source: ThomsonReuters, China Venture and PwC analysis

China's current five-year plan, the 12th, targets slightly slower growth with greater environmental protections, higher rural incomes, a larger domestic market, and faster urbanization. Contrast that with the '80s when China aggressively sought foreign capital and relied on exports to drive growth. The earliest joint ventures (JVs) between multinationals and Chinese domestic companies proved to be "forced marriages," so most investors eventually set up wholly foreign-owned enterprises (WFOEs) for full control of their operations.

Revive interest in joint ventures

That approach worked well at the stage of China being simply part of the global supply chain. There is now a clear shift of focus toward China as a market in its own right. Operating in China for the China market requires certain attributes from local partners, e.g., a distribution network to penetrate the market, intellectual property to tailor products to local tastes, and relationships to secure central or local government support. So multinationals are once again exploring JVs in China. Consider medical technology company Medtronic, whose JV with medical device maker Weigao is accelerating expansion and distribution in underserved niches such as pacemakers.⁶

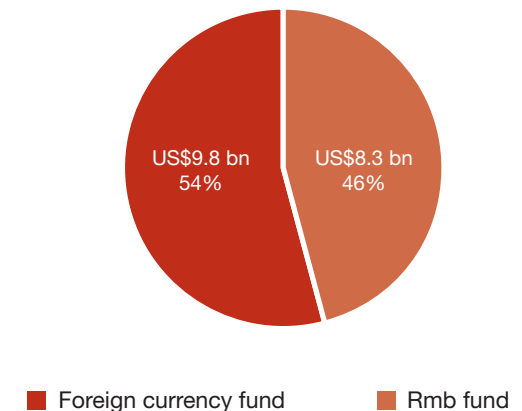
⁶ Laura Santini, "Medtronic Moves to Widen China Footprint," *Wall Street Journal*, December 18, 2007, and Medtronic press release, "Medtronic Inaugurates Its New Regional Headquarters Building in Greater China," March 08, 2011.

⁷ David Barboza, "Private Equity Firm, Using Local Currency, to Create Funds With 2 Chinese Cities," *New York Times*, August 24, 2010.

Build equity in renminbi

Savvy investors have noticed that China is trying to diversify the sources of capital available to Chinese entrepreneurs. As a result, China's private equity (PE) market, which happens to be the largest in Asia, is undergoing a transformation. In 2010, more than two-thirds of the 580 PE transactions announced (a 66% increase over the previous year) were initiated by domestic funds. And as Figure 3 shows, almost half of the funds raised by private equity were Rmb-denominated. Can foreign funds succeed in this relatively tough environment? Certainly. Blackstone, TPG, and the Carlyle Group are all teaming up with Chinese municipal governments and private entities in Rmb funds to further penetrate the Chinese market.⁷

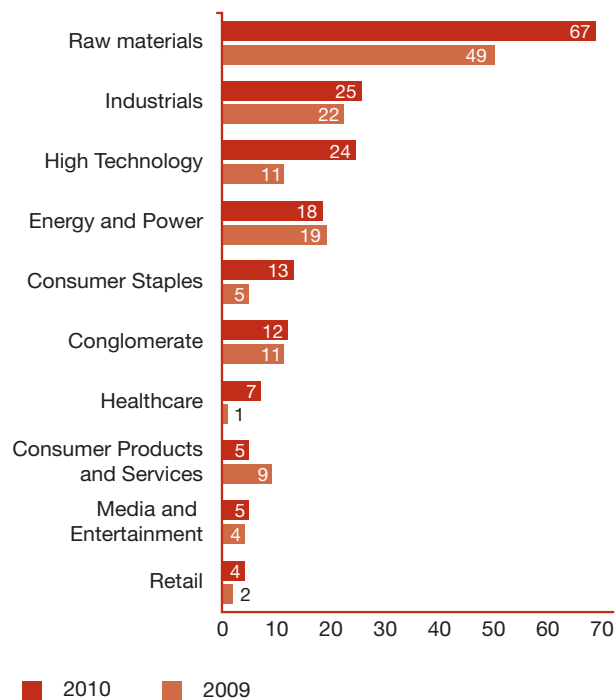
Figure 3. China is building up domestic PE capability
PE fund-raising in Chinese and foreign currency in 2010



Source: AVCJ and PwC analysis

Partner with China, globally

Figure 4. Outbound deals in the raw materials sector continue to dominate, but Chinese companies are also setting their sights on technologies and know-how
Top 10 sectors by number of outbound deals, 2009 vs. 2010



Note: Raw Materials include mining, metals and chemicals.

Source: ThomsonReuters and PwC analysis

With its prodigious appetite for everything from natural resources to world markets, China is reshaping not only itself, but also the global economy. China's hunger for resources is well-known, but Figure 4 shows its recent efforts to acquire technologies, brands, and consumer products to "bring back to China."

China has much to offer in return. Zhejiang Geely Holding Group, which acquired the Swedish brand Volvo from Ford Motor Company last year, is investing \$10 billion worldwide to enhance Volvo's status as a global luxury brand.⁸ Chinese SOE CNOOC, which recently bought into shale oil and gas leases owned by Chesapeake Energy Corp., is funding most of the drilling costs in the US, while acquiring new technologies in shale oil extraction.⁹ And conglomerate Fosun Group, with its ties to wealthy Chinese investors and a stake in French leisure group Club Méditerranée SA, is joining forces with the Carlyle Group to pursue overseas investment targets in luxury goods and services industries.¹⁰

But capital is not all that China brings to the table. Some of the most promising deals currently being negotiated involve Western companies securing access to China's domestic market in exchange for helping Chinese companies access global markets.

Companies that have been quick to appreciate China's strengths have been among the earliest to collaborate creatively with Chinese partners.¹¹

New ways to stay in the driver's seat

Some are giving up traditional forms of control to access new capabilities. General Motors has reduced its stake in Shanghai General Motors Company to 49%, allowing the Chinese partner SAIC the right to approve strategy and budgets. But GM has secured its place in China, the world's largest auto market, as well as funds to expand its operations in other high-growth markets like India.¹²

Bring back to the US

General Electric's partnership with China's state-owned transportation company CSR Corporation takes advantage of China's growing expertise in certain niches. GE and CSR are establishing a US-based company to build high-speed rail corridors in Florida and California as well as to compete against European and Japanese companies in related opportunities worldwide.¹³

8 Norihiko Shirouzu, "Volvo Details its Plan under Geely," *Wall Street Journal*, February 25, 2011.

9 David Winning and Jing Yang, "Cnooc, Chesapeake Agree on Deal," *Wall Street Journal*, January 31, 2011.

10 Owen Fletcher, Fosun Seeks New Fund-Raising for Carlyle Joint Fund," *Wall Street Journal*, November 16, 2010.

11 PwC, View Issue 13, "Doing business in a changing China," 2010.

12 Norihiko Shirouzu and Patricia Jiayi Ho, "GM, SAIC Reshape Partnership," *Wall Street Journal*, December 5, 2009.

13 GE Newscenter, "GE Signs LOIs with China's Ministry of Railways Valued at \$1.4 Billion" January 19, 2011.

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Adapt to China's turning point

Still, for every successful relationship, there are many more that end in frustrations, prompting investors to point a finger at China's economic nationalism. But some businesses see China's new assertiveness as a sign of economic progress and not a rejection of foreign investment.

With greater power comes greater regulation

Recently-issued regulatory guidance, to supplement existing M&A rules, e.g., the antimonopoly law and national security reviews, are daunting—except for those who welcome the growing clarity of process underlying each decision. China's antimonopoly bureau has approved most mergers, giving several conditional approvals and rejecting only one. National security reviews are not new, but the guidance around them is—leading some to view it as China's version of the Committee on Foreign Investment in the United States (CFIUS).

China's new regulatory focus simply reflects China's growing clout. This became evident when PRC Ministry of Commerce (MOFCOM) recently approved Panasonic's acquisition of Sanyo on the condition that the combined entity divests certain overlapping businesses.¹⁴ With that, MOFCOM joined US and EU antitrust regulators as a global force of authority.

Analyze tax policy, review traditional structures

The Chinese government has always used tax and regulatory policy to guide economic development, such as preferential tax policies in the form of tax holiday and reduced income tax rate, to attract foreign investment in the early days. Now tax authorities are understandably trying to improve enforcement and increase consistency.

For example, the objective of the recently-released "Circular 698" is to scrutinize offshore structures that hint at tax avoidance. Often, these are special purpose vehicles (SPVs) used by Chinese sellers to dispose equity offshore without incurring any tax liability in China. In response, foreign acquirers are stepping up their due diligence to ensure they do not end up with the seller's tax liability. They are also demonstrating the "commercial purpose" and "substance" behind SPVs, such as investment management activity.¹⁵

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Ultimately, an expanding and maturing Chinese economy means more opportunities for all, especially those who can find a common platform for growth with Chinese businesses.

¹⁴ Julia Kong, "China's Merger Review System Evolves," *China Business Review*, May-June 2010.

¹⁵ PwC News Flash, "China's anti-tax avoidance effort against overseas indirect equity transfers swings into action," June 2010.

Upcoming 10Minutes topics

Next-generation business intelligence

The business information companies collect has changed radically in recent years, with more unstructured data available through the Web, email, blogs and other multimedia sources. Tried-and-true methods for managing traditional data are no longer up to the task. 10Minutes explores how leading companies are treating different types of data differently, to gain greater insight into their operations, customers and performance.

Cloud computing

Recent disruptions in cloud services have underscored the importance of managing the risks involved, as companies reap the benefits of cloud computing. Four 10Minutes supplements address the significant roles that the CEO, CIO, CFO, and Internal Audit executive can play.

Growing by understanding the consumer better

Businesses now realize that consumers do not necessarily rely solely on rational analysis when they make decisions. Rather, many factors like emotions play a significant role. This 10Minutes focuses on how businesses can use behavioral economic principles to better understand their customers—particularly relevant now, when companies are making big bets on customer-centric growth strategies.

How PwC can help

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deals in China, please contact:**

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