The key factors of a successful transaction in China

An article by Pickering Pacific and Occient International, presenting the factors essential to the successful acquisition of a China-based company

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China is a very attractive market for foreign companies. Many choose to spur their development in this market by acquiring local companies: over the past three years, the number of acquisitions of Chinese businesses by foreign buyers has fluctuated between 400 and 600. While M&A opportunities are numerous, successfully completing a deal with a Chinese partner presents considerable challenges, as the difficulties encountered by Carlyle, Danone or Coca-Cola demonstrate. Understanding the key success factors of a transaction in China can help foreign buyers circumvent some of the most common traps. More specifically, they should give particular attention to and adapt to the China context the following factors: the strategy, the preparation and allocation of relevant human resources, the transaction process, and the definition of a clear set of objectives.

Strategy

A foreign buyer should account for the China specifics in the design of his acquisition strategy. While China is united politically, it is a collection of distinct markets, each having its own business culture, mentality, and language. Consumers' tastes and shopping habits mirror this diversity and often vary between markets, in addition to being different between urban and rural areas within each of these markets. Second, particular styles of management and sets of constraints and opportunities characterize each type of business ownership existing in China (i.e., state-owned, privately owned, and semi-state owned). These variations translate into different incentives for foreign buyers to carry out M&A deals and different processes to follow. Third, despite China's increased openness and modernization, information on markets and businesses can still be opaque and should be not be trusted at face value. Given the above complexities of the China market, foreign companies are well advised to allow for more time and more contingencies in the planning of their acquisitions in China.

The unrealistic expectations of some foreign investors in China

A foreign company (whose name we cannot disclose) planned to enter the Chinese market for specific electro-mechanic devices, of which it was one of the world market leaders. In order to do so, it considered acquiring a small distribution company specialised in similar types of products. While this company was based in Shanghai, it believed that such an acquisition would give it access to all Chinese consumers, i.e., 1.3 billion people. This assumption discarded the fact that the distribution network of the target company covered at best Shanghai and its outskirts. Expanding this network to other parts of China would have required additional large investments, including other acquisitions.

Network and resources

Understanding and properly using networks of influence and social relationships (also known locally as the concept of *guanxi*) remain central to the success of any business endeavour in China. In the context of an acquisition, it is essential to identify and include the relevant Chinese partners at each step of a transaction in order to successfully complete it.

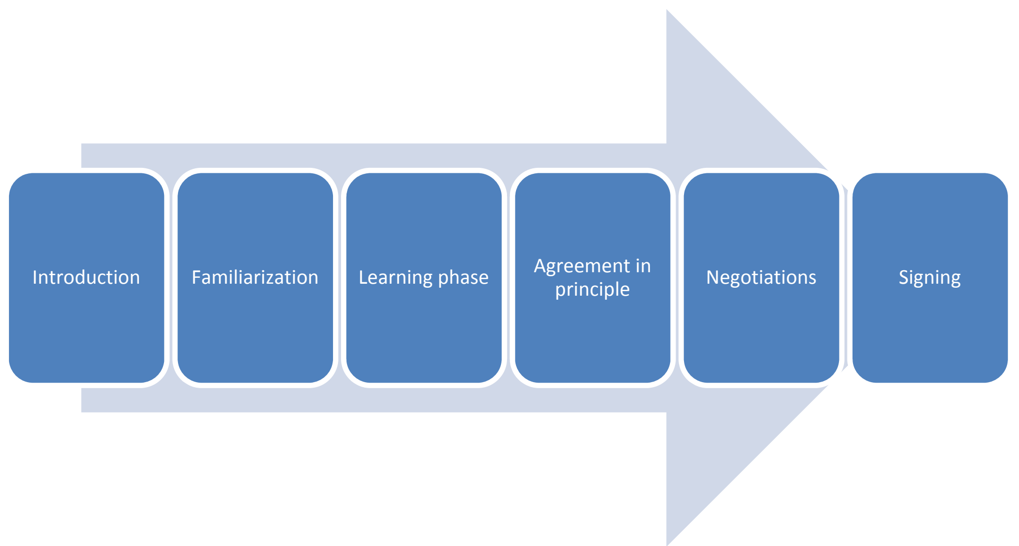
Building a good team of negotiators is also an essential element in the success of a transaction in China. Because the Chinese business culture is difficult to understand for a foreigner, it is advisable that such a team be composed of at least one person born and raised in mainland China. This negotiator should take part in all the negotiation meetings in order to ensure that communications are clear and that all subtleties are well understood. This person, who should at least speak Mandarin fluently and have a good understanding of the local business culture, will be in a better position to decipher the hidden agendas of the different parties involved in the transaction, in particular those of the individuals representing the seller's side. Ideally, this negotiator should understand the M&A process and its steps, have the ability to quickly acquire a broad grasp of the target's industry, and be exclusively and undisputedly on the buyer's side. For the sake of continuity in the management of the relationship with the target and its stakeholders, it is advisable that this person stays involved with the integration of the target after the closure of the transaction.

For a deal to be important in the eyes of the seller, the team of negotiators should also include a seasoned senior member. This person should preferably be a foreigner who is a long-standing employee of the buyer and is at least as senior as the seller's main decision maker. He should have the ability to build a positive and strong relationship with the seller's negotiating team. He could do so, for example, by sharing his passion for the business with his counterparts and by taking an active part in the banquets that are often organised in the course of such negotiations and on which Chinese businessmen rely to get to know more personally the buyer's team.

Transaction process

Acquisitions by foreign buyers can take a long time in China. A typical process follows six successive phases: (1) introduction of the foreign buyer to the seller, often through the intermediation of a trusted common contact; (2) a period of "familiarization", during which the seller and buyer get to know and become comfortable with each other; (3) a learning phase during which the buyer spends time understanding better the target, its business partners, and all the other stakeholders of the transaction (e.g., the administration, the Communist Party); (4) once the buyer has decided to pursue the acquisition and has built a strong relationship with the seller, a period of discussions with the seller to obtain his agreement in principle to sell control; (5) a long phase of negotiations and management of the hurdles that are likely to surface at this stage of the process; and (6) once the business terms are agreed upon, a final phase during which the legal documents of the transaction are signed. While ample time should be allowed for the first five phase, this last phase should be run as quickly as possible.

The phases of a successful transaction in China



The large number of stakeholders in a transaction largely explains why acquisitions in China are often complex and time-consuming. These different stakeholders include, among others, the shareholders of the target, its employees (managers and workers), the public servants of the local and central administration, and the officials of the Communist Party. Some of these parties, for example the majority shareholder of the target, its CEO, and the Secretary of the local bureau of the Communist Party, may have the power to bring to an end or facilitate a transaction. Each of these parties typically has its own sets of interests and objectives to defend and promote. In most cases, their respective interests vary; at times, they are in direct opposition. Understanding these interests and their divergences can be difficult given that they tend to focus on different types of return (e.g., money, career, influence, power, etc.) and to remain hidden (or at least not openly stated). In this context, the presence of a seasoned Chinese negotiator can be critical in order to decipher and address the web of hidden specific interests.

Given that managing the human dimension of a transaction is often complex, a foreign buyer should spend time building and nurturing positive working relationships with all the stakeholders of the deal (e.g., shareholders, board, top and middle management, central and local authorities, etc.). Because relationships matter more than contracts in China, these bonds will be a strong asset in the medium and long term, and be decisive for the eventual success of the acquisition.

Negotiations are typically one of the most challenging phases of an acquisition, but even more so in the China context. Two factors explain the added complexity of negotiating with Chinese counterparts: time and "face". The notion of time is different in China than in most Western countries. Chinese business people know this and are likely to leverage this divergence as a negotiation tactic and to use "waiting periods" to their advantage. "Face" is a concept that must be taken into account in any type of relationship in China. Chinese hate to "lose face". It is therefore critical to remain respectful and polite at all times, and to give consideration to the various elements that could be important motivators for the seller besides the financial factor, such as the seller's status in the community.

Objectives

Parties to a transaction are first and foremost interested in the benefits that they will be able to derive from it. A contract being insufficient, whether it is from a cultural, practical, or legal point of view, it is essential to define clear and mutually beneficial objectives in order to consolidate the relationships between the various stakeholders and ensure the long-term success of an agreement. With this goal in mind, efforts should be made to the extent possible to align the various interests, for example by agreeing on an earn-out clause or negotiating a combination of put and call options. However, regardless of the soundness of an agreement, the actualisation of the synergies identified during the preparation and negotiation of the deal will eventually hinge on the success of the integration phase. In order to be successful, an integration must be prepared well in advance, include the "right team" and mix of people, and not only start as quickly as possible after the closure of the transaction but also end quickly. In China, the “right team” is composed of employees who speak both Mandarin and English fluently, understand both the seller’s and buyer’s business cultures, and have the ability to “blend” in with the target’s staff. A successful integration would also ensure the transfer to the buyer of relationships that are critical for the normal continuation of the target’s business, in particular relationships with key customers and/or suppliers, and the local and central authorities.

Anticipating the difficulties of an integration – Most Chinese SMEs located outside the main Eastern cities do not have or have few personnel fluent in English. As a result, relationships between key managers of the foreign owner and those of its newly-acquired China-based business can be complicated by problems of miscommunication. The combination of these problems and the typical difficulties encountered during an integration, often leads to very difficult, and sometimes inextricable situations.

To grow through acquisition in China, it essential to prepare a development strategy that is clear, has specific objectives, and can be implemented by the relevant team of people. The business opportunities offered by this giant market are often extraordinary. But the risks are commensurate. This is why careful planning and execution of an acquisition are even more important in the context of China.

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