

A Pocket Guide to Chinese Cross-Border M&A

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Introduction

Chinese companies are on a buying spree: over the past five years, outbound M&A volume has risen by 33% per year. In 2016, Chinese companies spent \$227 billion, six times what foreign companies spent acquiring Chinese firms. And Chinese companies were involved in ten of the largest deals worldwide in 2016.

What role will Chinese companies likely play in global M&A transactions in the coming years? What lessons have Chinese companies learned from their deals to-date, and what should they do differently going forward? What should companies outside of China do to ensure that the deals they strike with Chinese companies deliver the returns they are seeking?

These are just a few of the questions we address in this collection of essays by my colleagues in McKinsey's Strategy & Corporate Finance Practice. In "Making sense of Chinese outbound M&A", we tackle some of the myths circulating around this wave of Chinese outbound acquisitions – that all of the money flowing out of China is just a wave of capital flight, that the invisible hand of the government lies behind it, or that post-deal integration isn't important to the buyers.

In "Chinese outbound M&A: the decade in review", we take a look at the extraordinary progress Chinese companies have made over the past decade on outbound acquisitions, and assess their successes and failures.

One of the myths surrounding Chinese outbound M&A is that a lot of the deals being done are driven by the state, and by state-controlled sources of cheap funding. But in "Funding China's outbound acquisitions", we show why this is not the case. We then analyze the different sources of funding, and how these are evolving over time.

The most challenging part of most deals is what happens after closing.

Research shows that getting integration right is a crucial factor in the ultimate success of any deal. In “From active buyers to active owners”, we look at several possible models of integration, and discuss a few examples of what worked well.

Regulatory approval is a pervasive concern for Chinese companies acquiring targets abroad. While some deals have been blocked due to regulatory concerns, many more have been cleared but with remedies imposed. In “Paperwork and politics: navigating cross-border M&A regulation”, we pick apart the issues Chinese companies face as they confront complicated regulatory environments abroad.

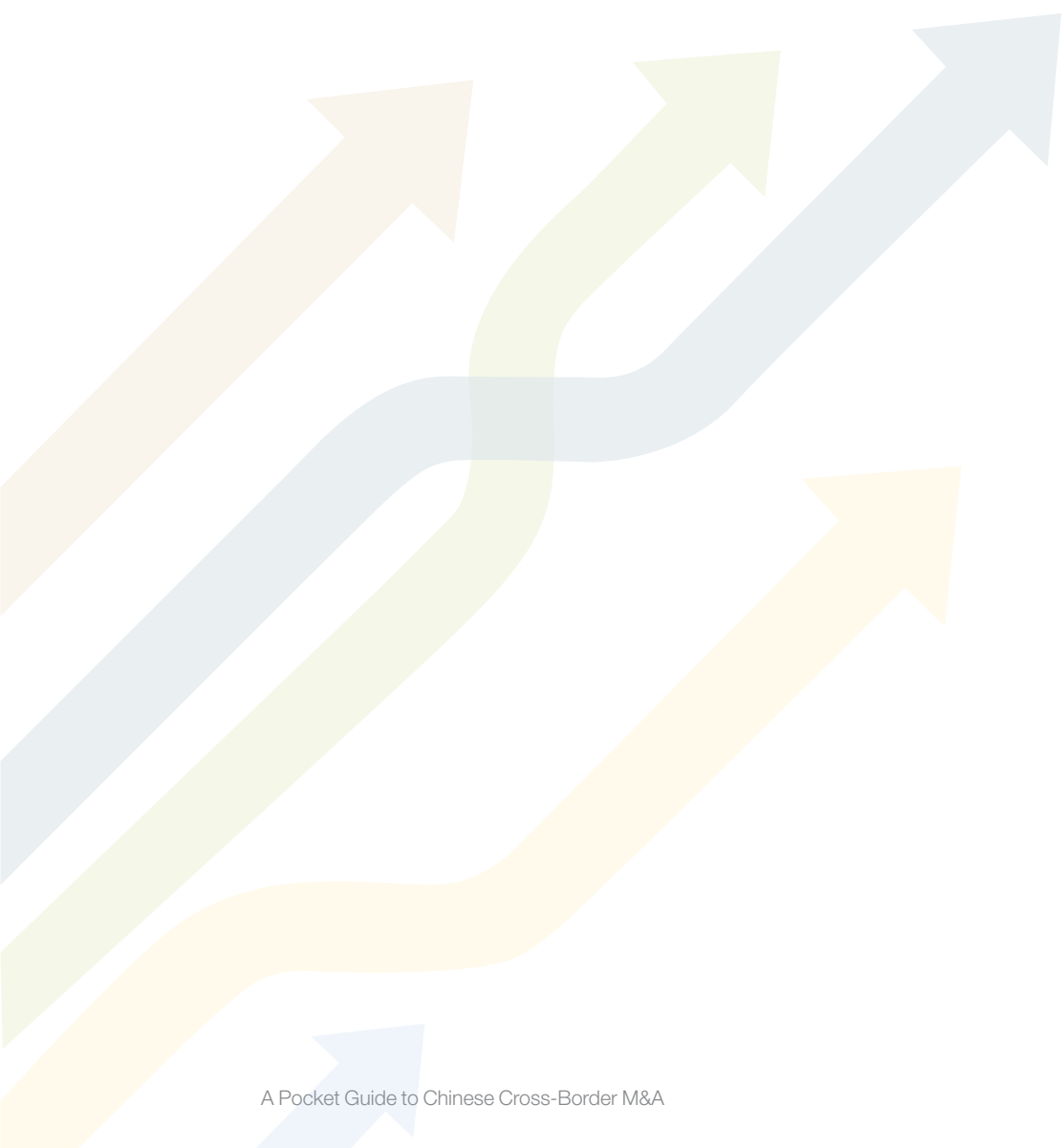
We hope you find these articles provide a useful source of insight and analysis that will inform your understanding of this rapidly changing market.

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Making sense of Chinese outbound M&A

The background features a solid teal color. A thick, dark teal diagonal line runs from the top center towards the bottom right. Overlaid on this are several semi-transparent arrows: a light blue arrow pointing right, a dark teal arrow pointing left, a medium green arrow pointing up, and a darker green arrow pointing down. The arrows intersect each other and the diagonal line.

David Cogman
Nick Leung
Paul Gao

The past year saw Chinese companies spend \$227.0bn on acquiring foreign companies – 6x what foreign companies spent acquiring Chinese firms. These ‘outbound’ M&A volumes have grown at 33% p.a. for the past five years though regulatory controls on foreign exchange have slowed growth in 2017. Chinese companies were amongst the ten largest deals worldwide in 2016 (e.g. current ChemChina/Syngenta acquisition going through regulatory approval process), and were involved in some of the most controversial transactions of the year, such as Anbang Insurance’s high-profile battle for Starwood Hotels & Resorts, which added \$0.4bn to the price that Marriott eventually paid, and Chemchina’s \$47bn acquisition of Syngenta.

Despite all the media attention, a number of myths around Chinese outbound acquisitions persist. Let’s discuss them one by one.

First myth – the ‘wave of money’

China, the theory runs, is awash with cheap capital, and that is now fueling a global shopping spree. It has almost \$3 trillion in foreign reserves, the world’s 2nd largest sovereign wealth fund, and four of the world’s largest banks by assets – all of which are extremely well-capitalized. Chinese companies therefore have almost unlimited firepower for overseas acquisitions, and that makes them willing to pay unrealistically high prices for high-profile megadeals.

It’s important to put this supposed wave of money into context. The total amount of China outbound acquisitions has grown dramatically, from

\$49bn in 2010 to \$227bn in 2016. However the absolute level is still very low. For example, in 2015, Chinese companies spent around 0.9% of GDP on outbound acquisitions; EU companies spent 2.0%, and US companies 1.3%. We are still relatively early in a long growth trend.

The big-ticket deals that make the headlines are also not representative of the majority of transactions. These are mostly middle-market deals: the median deal size over the past three years was only \$30m. And for the most part, the valuations paid were not significantly above normal market levels. However a Chinese company may have a legitimately different perception of valuation than their European or US peer. Non-state firms listed in Shanghai had an average PE in 2016 of 60x. If a Chinese acquirer is able to raise equity capital at this valuation, this will naturally make prices paid for overseas assets look much less irrational.

Moreover the source of the funding is often not even Chinese. Many of the deals with very high leverage were financed enthusiastically by Western banks. The financing of many of the largest deals in recent years was done by foreign-led syndicates of banks. Of course the Chinese acquirers accepted high levels of leverage for some of these deals, such as in Chemchina's acquisition of Syngenta, where \$33bn of the \$47bn purchase price was financed by debt. But from a Chinese firm's perspective, this is not a significant leap of faith. The Chinese economy has for many years relied heavily on bank debt more than on public equity markets, and most Chinese companies are more comfortable with high levels of leverage than their western counterparts. Moreover high-leverage megadeals led by financial sponsors are hardly unusual in Western markets.

Second myth – the invisible hand of the Party

There is a persistent suspicion that somewhere in Beijing resides a collective brain that directs Chinese companies' actions – and that the recent outbound acquisitions have been directed by this pervasive government planning.

The government does like making plans: the extent to which they drive corporate decisions, however, is greatly overstated. Central government sets an overall policy framework, and managers of state-owned firms are rewarded in career progression for advancing it, but they are acutely aware that they are responsible for their own decisions. With very few exceptions, acquisitions are identified and pursued by management teams for commercial reasons.

Being aligned with policy can, however, bring help in executing the deal. Approvals arrive faster, loans are more readily available, and at times government will quietly tell other Chinese bidders to drop out of auctions so that only one is contesting a deal. In some sectors – notably semiconductor, in recent years – there is active pressure on companies to find acquisitions. The deals they pursue may align with industrial policy, but mainly because policy reflects the interests of the firms in the first place, and the larger SOEs participate in shaping major policy instruments such as the five-year plans. But the responsibility for sourcing and execution deals remains firmly with the companies, and they are also responsible for their failures.

The role of government – or lack thereof – can also be seen in how they use the government-linked investment funds. There is a very substantial amount of capital available to investment funds controlled by central government, such as the Silk Road Fund, the Africa Fund and CIC. If there really were an invisible hand directing acquisitions, the government would be using these to co-invest with corporates. In practice this rarely happens. The Silk Road fund, for example, has only done one investment to date into a company, compared with dozens of project financing deals.

The only government-linked fund that has done numerous investments into foreign companies is CIC. However these deals are portfolio investments, done purely in pursuit of its commercial remit to make returns and not in pursuit of any policy objective; moreover a significant portion of its portfolio is deployed into fixed income securities and funds.

Third myth – it's all capital flight

Between 2005 and 2014 the RMB had only strengthened against the dollar, and a generation of managers had come to take that as given. From 2014 onwards, however, it has progressively weakened, and growth continues to slow. Many managers found themselves looking for ways to move capital offshore, and acquisitions provided a quick way to do that in large quantities. Are the acquisitions of prestige assets – hotels and property in major cities, often at relatively high prices – simply companies getting money out of China into 'safe' assets?

Capital flight is unquestionably happening through multiple channels, of which overseas acquisition is only one: through 2016 the government worked hard to close these loopholes which in Q1 resulted in a significant drop-off in deal volumes. The question is whether it was a major driver of the growth in outbound M&A. Between 2015 and 2016 outbound deal volumes grew by 125%: this was clearly an acceleration compared to the growth rates in the preceding five years, ranging from 7% to 41% growth. Some of the deals done – real estate deals in particular – made little apparent sense for the acquirers beyond simple financial diversification. Yet the growth in outbound M&A had started long before 2014: the capital flight of the last few years has contributed, but it was never the primary driver.

Fourth myth – crazy gamblers

For many sellers, having a Chinese buyer participate in an auction can be a frustrating experience. Their decision-making often appears opaque and irrational, with limited visibility on their funding, priorities or intention to actually complete a transaction.

What appears to be irrationality, however, is often decision processes that aren't fully transparent to the sellers. A Chinese buyer, particularly a state-owned company, has to work with a complex set of stakeholders both inside and outside the company, and the person communicating with the seller may not be able or willing to explain these considerations.

Among many Chinese buyers there is also a suspicion that the standard M&A sales process does not play to their strengths. It is designed to place buyers in competition on an equal footing, and limit their access to the target company; this is exactly the opposite of the one-on-one negotiation and closer relationship-building with the counterpart that they would prefer. Moreover many management teams remain unfamiliar with the process itself, and do not understand well how to navigate it. This is changing fast, particularly among the private companies that have business development staff with international experience, and among the more sophisticated SOEs with experienced deal teams, but there is still far to go.

This impression often masks a genuine desire, even need for some of these transactions. For Chinese companies that are approaching the limits of growth in their domestic markets, access to technology, brand and distribution networks abroad can be critical to their growth plans. Hence sellers often receive extremely mixed messages, that can be challenging to decode, and frequently write these off as ‘cultural differences’, when in fact they reflect the unique circumstances of these buyers.

Fifth myth – integration isn’t important to these buyers

In many deals, there is relatively little discussion of what will happen post-deal apart from securing the management team – and often the acquired managers are pleasantly surprised by the degree of autonomy they enjoy after the deal. This has led to the perception that Chinese companies aren’t particularly interested in integrating their acquisitions into the parent companies to the same degree that a US or European acquirer would want to.

It’s certainly true that Chinese companies are more likely to take a ‘hands-off’ approach to managing acquisitions post-deal than would most Western companies. However this is largely because in the past, they lacked the capabilities to integrate: they simply didn’t have enough managerial bench strength that could function in the acquisition’s region that they could insert into the company. It’s not that they didn’t want to integrate: they doubted

their ability to do so. The lack of focus on integration is one of the reasons that over the past ten years, the track record of success by Chinese acquirers has been extremely mixed.

Consequently the integration models used look quite different. In most western countries, there's a fairly well-understood approach to post merger integration – speed is critical, you eliminate overlaps and pursue synergies aggressively. Many Chinese integrations chose to prioritize stability first, keeping the company separate and looking at one or two major areas of synergy, such as R&D sharing or localization of product manufacturing in China to reduce cost.

As the track record shows, the approach to integration made a significant difference in the success of these deals. Those that had an organized and systematic approach to integration on average showed much better results than those who kept the asset at arms' length, managing through the board and treating it essentially as a financial investment.


There is, in most cases, a solid logic behind these acquisitions, be it acquiring capabilities, building a footprint outside of China, buying brands or technology. However without a plan to capture that, potential synergies are simply numbers on paper. Increasingly Chinese companies are recognizing this, and developing more concrete integration plans earlier in the deal process. The bottleneck for most is building the resources to execute those plans – developing a cadre of managers with experience both operating abroad and in integrating acquisitions that they can deploy. This is easier said than done. Often deep functional experience is required – engineers and technical staff to support technology transfer or procurement, marketing teams to support cross-selling, IT staff to support platform consolidation – and the teams need to be able to function in the acquisition's language and working environment as well as the acquirers'. There are not, for instance, many Italian-speaking Chinese aerospace engineers available on the job market.



We are still at the beginning of a long growth trend, and the persistent myths surrounding these deals reflect this. Chinese companies will in time be an important part of global cross-border M&A, and that means levels of activity substantially higher than what we have seen to date. This will require some adaptation on both sides. However Chinese companies need the brands, channels, technology and relationships that these transactions can bring; and the investee companies benefit from access to the rapid innovation, scale and cost advantages of the China market. In the long run, everyone gains from China's participation in the global deal market.

Chinese outbound M&A: the decade in review

David Cogman
Gordon Orr



We are now a decade past Lenovo's acquisition of IBM's PC division – the first major outbound acquisition by a Chinese company. Since then, over six hundred and fifty deals of greater than \$100m have taken place. Chinese investors, financial and strategic, have gone from being rarities in the international deal market, to regular participants in major auctions.

In the post-2008 era, there has been considerable discussion of the impact of outbound Chinese investment. However this analysis mostly considered the impact on sellers – whether this new source of capital is bidding up asset prices, and whether host governments should fear Chinese buyers – or looks at the role that capital outflows play in China's broader economic development. While these are relevant questions, more important is the experience of the buyers themselves. Were the investments successful? Did they create value for companies? If not, why not?

In this article we take a hard look at the experience of the past decade. The track record has been mixed. A majority of deals did not clearly accomplish their original objectives. The most significant reason for this was simply bad timing, something that no company can fully guard against. But in large part it is also due to what Chinese companies did – or did not do – after closing deals.

Historically, many Chinese acquirers had limited ability to manage acquisitions post-deal. This affected their ability to extract synergies: genuine operational integration was often not possible. With the emergence of a pool of Chinese management capable of operating internationally, that no longer has to be the case. More companies are taking a hands-on approach to integration, recognizing the importance of actively managing

their acquisitions while appreciating the real differences in culture and operating model. We expect that in the coming years this will become the norm, rather than the exception.

Assessing the track record¹

Evaluating the ‘success’ of an acquisition is always subjective. The experiment has no ‘control’ – we never know what both sides would have done if the deal hadn’t been done. Looking at short-term share price reactions to deals tells you whether the market liked the concept when it was announced, but says nothing about execution. To really assess the success of a deal, we have to go back to the original objectives, and look at whether they were met.

By this standard, the results of the past decade look less than impressive. Around 60% of outbound investments by Chinese companies, close to three hundred deals of almost three hundred billion dollars, created little or no value for acquirers.

The resource curse

The deals with the worst success rate were the resource acquisitions of the late 2000s. The decade preceding 2008 had seen the price of China’s resource imports rise by 18% CAGR on average across 10 years. This was rightly seen as a threat to chinese companies’ international competitiveness, and as a national security issue.

As a result, 43% of the deals done in the past decade (217 deals, representing 56% of total outbound investment value) – involved natural resources. 80% of this happened during the run-up in commodities prices, before they peaked around the time of the financial crisis; the remainder happened in the three years following, when a dip in prices appeared to present a buying opportunity. However commodity prices in most cases

¹ For our analysis, we screened out those deals where little or no public information was available on acquiror or target, leaving slightly over 500 transactions.

remain below the price at which these deals were done. In 84% of the deals we reviewed, representing 89% of deal value, these deals did not create value for the acquirer, losing on average around 10% of the initial.

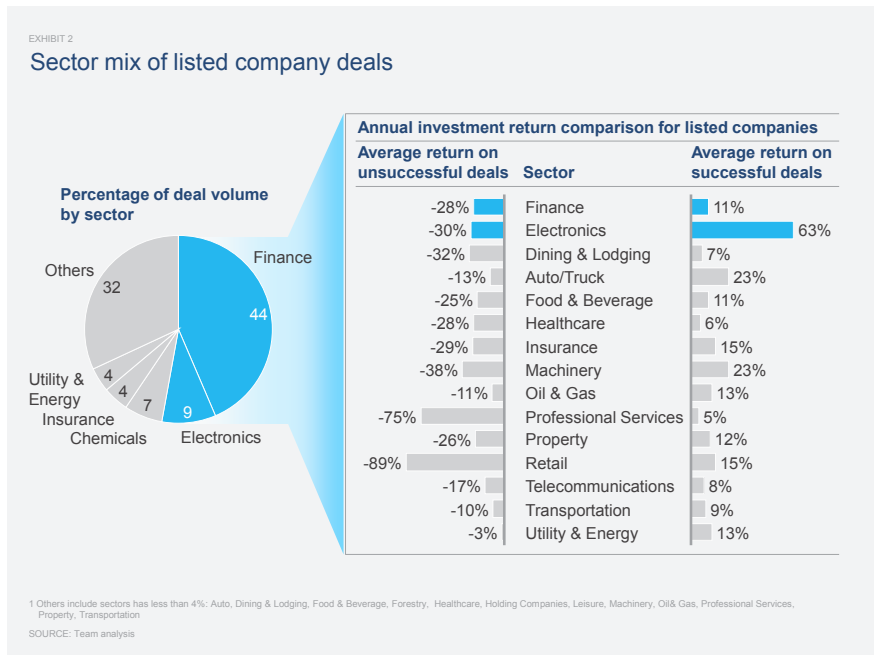


Financial diversification and relationship-building deals

A second group with low success rates are investments into listed companies that remained listed post-deal, primarily motivated either by financial diversification or to build a relationship with the target – 24% of the deals done (119 deals, worth 18% of total value) had this profile. These targets generally kept a high degree of independence after acquisition. While this kind of investment had been successful domestically, not so abroad. On average, the companies invested lost ~7% of their value per annum from the date of investment to today. If we included the opportunity cost – making a similar minority investment into domestic Chinese equities, which have risen on average 15% per annum since 2008 – the track record would look considerably worse. Bad timing again played a major role here: the majority

of these deals were concentrated in financial services and computers & electronics, each of which lost around 30% of their initial investments on average. The hardest hit sectors were retail and professional services: the investments made there lost on average more than 70% of the initial investment.

Majority investments into listed companies did slightly better than minority investments. On average, the share prices of these deals lost ~2% per annum since investment; however, the range around this was wide, with more than half of the deals yielding positive returns. There is also more evidence of synergies being captured by the acquirers in their core business in majority control deals – bringing technology or products into the China market, and creating genuine growth in the acquirer’s profits.



Identifying the successes

For the slightly over a quarter of the deals done that do not fall into either of the above categories, we analyzed the stated objectives of each deal – product, technology, or cost – and looked at whether these had been achieved subsequently. We found that ~70% of these deals clearly did achieve their objectives. For control deals, that success rate rises to 75%, vs. 60% for the non-control deals.

Looking across the full set of deals, level of control does matter. 34% of the total 505 deals was non-control investments, of which only ~30% was successful. For the control investments, the success rate rises to around 45%.

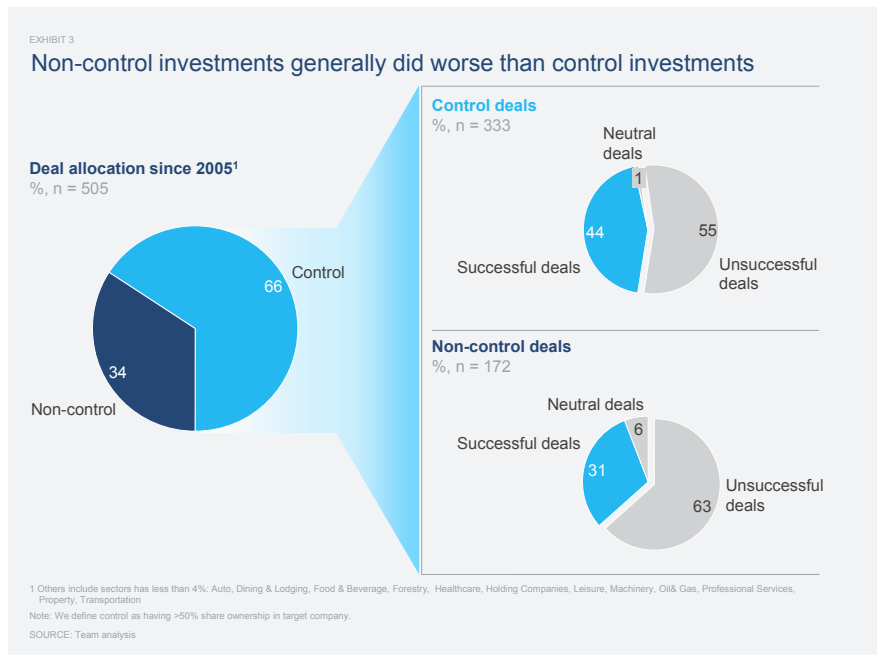
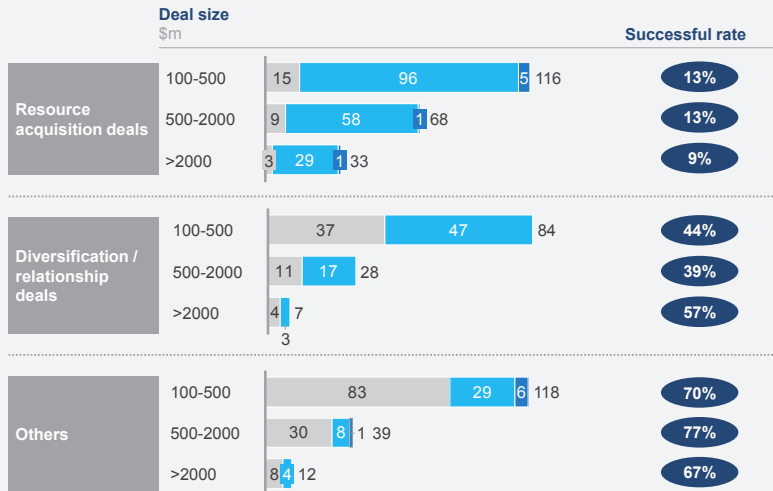


EXHIBIT 4

Success rates by deal size and type

■ Successful
■ Neutral
■ Unsuccessful



SOURCE: Dealogic; expert interviews; McKinsey analysis

This paints a stark picture overall. Of 505 deals and \$432bn of deal value, only 200, worth \$146bn, have achieved their objectives. Moreover this happened at a time when M&A was, in fact, creating value for most companies. In the post-2008 period, when money became historically cheap, equity markets were encouraging companies to acquire for the first time in decades, to convert cheap funding into productive assets. Asian acquirers in particular were rewarded richly by their investors for acquiring. For example, the market more consistently rewarded Asian acquirers, on average, than Western acquirers for the value their deals were expected to create.

The challenge of integration

What, then, caused problems for Chinese acquirers? The primary controllable reason for failure is lack of integration post-deal. In too many cases, the Chinese acquirers were reticent to take control post-deal.

Chinese companies do not pay a higher premium than other buyers. Over the past year, the average premium paid by Chinese acquirers was 25%, vs 32% for all cross-border deals. But they do pay a premium, and that requires that they will extract synergies, which is usually only possible through active management of the asset post-deal. Therein lies the challenge.

The majority of Chinese companies pre-2010 – and indeed most today – had very limited ability to operate overseas assets. Where they had managers with international experience, their experience tended to be in sales or procurement; the cadre of experienced managers who had run businesses outside China was small, usually even smaller in the SOE sector where salary constraints often prevented hiring managers returning from overseas. Moreover that experience needed to be relevant, managers needed to be capable of operating in the language and business culture of the target's home country.

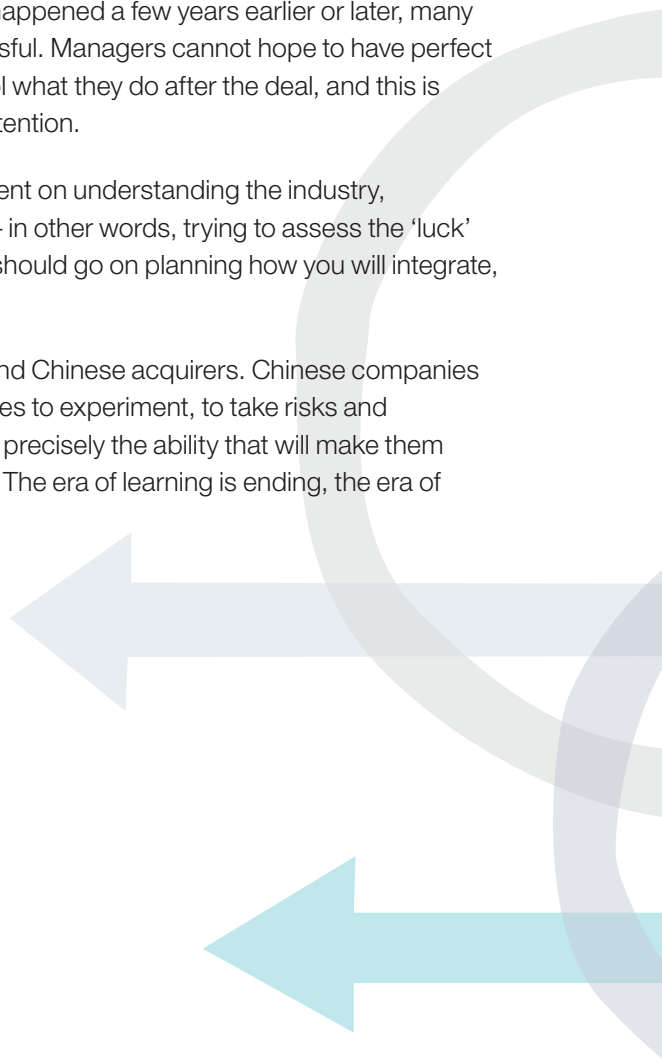
Where next for Chinese acquisitions?

These are still early days for outbound Chinese investment: what we will see over the next decade will be a multiple of what was spent in the past. For example, Chinese companies spent 0.9% of GDP on outbound acquisitions in 2015: US companies spent 1.3%, and EU companies 2.0%, investing 2.4x and 3.2x the dollar amount Chinese companies spent respectively. In 2015 Chinese companies invested \$612bn within China in acquisitions alone. We are at the beginning of a long growth curve, and the successes and failures of the past decade are most useful in providing lessons for future deals.

The last decade reminded us that success in M&A will always depend on good decisions backed up by good luck – and one can never ignore the latter. If the resource deals had happened a few years earlier or later, many would have been hugely successful. Managers cannot hope to have perfect timing. However they can control what they do after the deal, and this is where they should focus their attention.

Considerable effort is always spent on understanding the industry, projecting pricing and demand – in other words, trying to assess the ‘luck’ side of the equation. More time should go on planning how you will integrate, as this is fully within their control.

We remain optimistic for outbound Chinese acquirers. Chinese companies have almost limitless opportunities to experiment, to take risks and learn from their mistakes. This is precisely the ability that will make them successful as acquirers abroad. The era of learning is ending, the era of execution is about to begin.





Funding China's outbound acquisitions



David Cogman
Arthur Shek

Many foreign companies assume that there is effectively unlimited capital made available for Chinese companies to buy abroad, and that capital comes with at least implicit political direction. Reinforcing that perception, more than 5,500 Chinese investment funds have been formed over the last five years, with aggregate capital of over US\$300bn, many of which have objective that include supporting foreign acquisitions. This raises some understandable questions: will asset prices get bid up to unrealistic levels? Is support from financial investors changing the deals strategic investors are doing?

We looked more closely at the type of outbound cross-border deals being done from China – acquisitions of non-Chinese assets by a strategic or financial Chinese investor – where at least one fund partnered with a strategic investor to make the acquisition. From 2013 to 2016, there have been 249 such deals – where a fund co-invested with a strategic buyer, and one or both were Chinese. The results do not support fears of inflated valuations. Indeed, they reveal an interesting pattern in how these funds are working with strategic investors, which suggests that their motivations will remain predominantly commercial and not policy-driven.

Two models of collaboration

Most of the deals over the past four years fall into two broad groups: China-led deals, driven by Chinese strategic investors' interests, and foreign-led financial investments, mostly into early-stage companies.

'China-led' club deals, involving at least one Chinese fund and one Chinese strategic investor, represent just under a third of the deals. These were relatively large acquisitions, with an average size of \$539m, investing into mature and established foreign companies. On average three Chinese players co-invested, with the occasional foreign investor joining in. These deals are in almost all cases acquisitions of foreign assets by Chinese corporates, with various funds participating to provide financing and deal execution support. When involved, the foreign investors were usually funds; 22 of these deals had a foreign financial investor, and only 13 a foreign strategic investor.

Of the remainder – the 'foreign-led' deals – the vast majority had only one Chinese investor. In most cases, this was a strategic rather than a fund – and the deals had, on average, 4 foreign investors. Over 70% by value were venture / growth capital: the average deal size was only \$90m.

The growth in these co-invested deals is clearly coming from the 'China-led' transactions. These went from 18% to 36% of deals by number, and 11% to 87% by value over the last three years. Within these, the Chinese-only deals were larger – USD614m on average – and 18 of the 20 were for a 90%+ stake.

For the larger deals, the benefits of Chinese ownership are increasingly important to the sellers. In four out of top five transactions in 2015 and 2016 (Pirelli, Playtika, Lexmark, and KraussMaffei), targets' management team had concrete and specific plans to capture revenue growth from China or Asia after the deal: for instance Club Med stressed the value to them of tapping into Chinese outbound tourism as part of their growth strategy when they took investment from Fosun.

At the other end of the size spectrum, motivations are quite different. In the early-stage investments – which account for 172 of the 180 'foreign-led' deals – the Chinese investors were typically passengers rather than drivers. Foreign parties outnumbered Chinese by 4:1 in the buyers' syndicates. Outside the venture capital deals, the opposite was true: the ratio was 2:1,

and in 3 of 8 deals the buyers took majority control. For this latter group, the choice of partners is largely driven by provision of local expertise: for instance Tianjin Tasly Pharma's acquisition of South Korea's Genexine was co-invested by several South Korean funds, such as LIME Asset Management; Zoomlion's acquisition of Italy's Ladurner Ambiente was invested by Mandarin Capital, an Italy-centric Sino-European mid-market fund.

On both Chinese and foreign sides, the funds were primarily venture and growth capital investors. The most active global funds in these investments were GGV (11 deals) and Sequoia Capital (10 deals). All of their deals are of the early-stage type, in which the majority of them are in the tech space, co-investing with Chinese internet companies. (9 out of 11 for GGV, 8 out of 10 for Sequoia). The most active Chinese funds were Hony Capital, with a variety of acquisitions including some large ones (Lexmark and Playtika), and Ping An fund which partners mostly with healthcare strategic players to invest in healthcare venture deals, with 6 deals each.

The changing profile of deals

The type of co-investment deals is also changing fast. Today's deals are noticeably bigger, more often for majority control, less dominated by the state sector, and heavily technology-focused.

The average deal size jumped from US\$111mn in 2013 to US\$233mn in 2016. Excluding the smaller venture capital and growth capital investments, it more than doubled from US\$459mn to US\$950mn. This includes some very substantial deals, such as the USD4.4bn acquisition of Playtika led by Shanghai Giant Network, Hony Capital, and Yunfeng Capital; and the USD3.6bn acquisition of Lexmark led by Apex Technology, PAG and Hony Capital. There were six deals worth more than half a billion dollars each in 2016, compared to only one in 2013, the USD2.3bn acquisition of Activision Blizzard participated by Tencent.

Chinese buyers are increasingly seeking outright control. In 2016, 9 out of 10 acquisitions of equity stake in a mature company were outright acquisitions, and the tenth involved acquiring a 90%+ stake. In 2013, 44% of these deals involved only a minority stake changing hands. This reflects the changing role of these deals. Many of the earlier ones were financial investments where a strategic investor was a less active participant: these days, they are increasingly strategic-led investments where funds provide financial support.

Perhaps the most striking change – though not unexpected – was the rapid fall in importance of state-owned enterprises (SOEs). 15% of deals in 2013 involved an SOE: in 2016, it was only 6%. This is partly because SOEs rarely invest into early-stage deals – it falls so far outside their expertise and experience – and partly due to the anti-corruption that gathered momentum from 2013 onwards, which has made SOE managers increasingly cautious.

SOEs are mostly found in the ‘China-led’ transactions: they were present in only 10 of the 180 ‘foreign-led’ deals. Where they participated in those, it was generally to facilitate acquisition of technology, such as SAIC’s investments in SDCmaterials, CarSavvy, and Speaktait, which they did with the objective of acquiring new capabilities from automotive catalyst materials to online auto marketplace and virtual assistant. However the deals they do are substantially larger. The average deal size for all the transactions involving SOEs (25 in total) was USD801m, compared to USD143mn for the 224 private-sector deals. They were also more likely to be repeat acquirers. ChemChina and China Life Insurance are the most active SOE buyers: each has led two acquisitions (Pirelli and KraussMaffei for ChemChina, and investments in Uber and various property investments for China Life).

The decline in SOE importance has been offset by a dramatic rise in the fastest-growing part of China’s private sector – the internet companies. 63 of the 180 ‘foreign-led’ deals involved one of the Chinese internet companies. The targets for most of these deals have are based on the US, and the typical profile is a pre-IPO tech deal where a Chinese investor joins a funding

round. Examples of these include Snapchat (invested by Alibaba), Lyft (Alibaba), and Social Finance (Renren).

More broadly, the tech sector dominates the target landscape. It represents 55% by number and 58% by value of deals. The remainder is highly consumer-centric: healthcare represents 19% of deals, and consumer goods 9%. However the tech deals were not all consumer technology. China's push into semiconductor space is visible in the deal lists, with investments such as STATS ChipPAC and Integrated Silicon Solutions. This is true across SOE and private sectors, though the SOE sector is slightly heavier in industrial and resource deals, collectively accounting for just under 30% of all SOE investments.

Understanding the funds

The types of funds collaborating on outbound deals are a diverse group, but are mostly not state-linked. Of the fund/strategic collaborating on outbound deals are a diverse group, a total of 551 funds participated. 442 of these were foreign funds, 96 were private-sector Chinese funds, but only 12 of the funds had direct government ownership. Across all these three types the average deals participated per fund was only 1.5-1.6, showing that while some funds are more active (as discussed above), outbound investment is not an area which is particularly concentrated.

Over the past five years around 5,500 investment funds have been formed in China, and approximately 600 are 'government guidance' funds – effectively funds of funds to support and attract investment primarily for local startups. The larger government-linked investment funds, they have also played a surprisingly limited role in facilitating outbound investment to date. Only a few have been active in outbound investment. CIC has done considerably more, but their investment remit requires them to invest outside China, and in most cases their direct investments are not done together with Chinese strategic investors. A few others acquirers, such as CITIC, have state-owned roots, but are now fully commercial entities substantially free of policy direction.

Putting ‘cheap financing’ in perspective

It is clear that equity funding from financial investors is not – yet – playing a significant role in providing cheap capital for Chinese acquirers. The ‘co-investment’ deals were worth, in aggregated, \$47bn from 2013 to September 2016. During the same period, Chinese companies announced \$412bn of outbound acquisitions, and around \$534bn of outbound direct investments.¹ We estimate that the funds contributed only around \$10-15bn of the total capital – not nearly enough to make a difference in pricing.

The ‘policy funds’ have in a few rare cases supported deals to advance national economic development objectives. ChemChina’s acquisition of Pirelli in 2015 and KraussMaffei Group in 2016 were both backed by central government funds – the Silk Road Fund and Guoxin International Development respectively. These deals strengthened ChemChina’s tire and chemical machinery businesses, aligning with central government’s broader plans to upgrade its manufacturing sector under the “Made in China 2025” plan. Changjiang Electronics’ acquisition of STATS ChipPAC in 2014 was supported by the National Integrated Circuit Industry Investment Fund, a fund intended to expand China’s footprint in the semiconductor ecosystem.

However these deals are the exception. The majority of policy funds’ overseas investments is proprietary investments in infrastructure or resources companies, and project finance. Taking Silk Road Fund as an example, only 1 out of its 6 overseas projects announced (out of 10 deals in total) is a co-investment with a Chinese strategic.

There is still considerable funding available for outbound Chinese deals – but as always, this comes from the banking system, and not from the funds. It is not limited to the Chinese state-owned banks: international banks seem just as willing to finance Chinese outbound acquisitions at very high levels of leverage. Some of the largest deals we examined had substantial financing from foreign banks and public debt markets. US\$7.3bn financing

¹ Note that this is for all announced deals. Our previous article analyzed completed deals greater than \$100mn USD.

for ChemChina's US\$8.6bn acquisition of Pirelli was arranged by J.P. Morgan. A consortium of 17 international and domestic banks arranged the financing for ChemChina's acquisition of Syngenta, for which US\$33bn of the US\$47bn deal value was financed through debt. Similarly, US\$3.5bn acquisition loan from a mix of international and domestic banks was arranged for Tencent's US\$8.6bn acquisition of Supercell.

Where next for the funds?

We are still in the early days of Chinese outbound M&A, and the different actors are still defining their roles. The growth in these corporate/fund partnerships reflects clear needs on each side. Domestic corporates clearly value the support from funds in deal execution. Domestic funds are increasingly seeking opportunities to participate in the early-stage investments overseas. A small number of funds, domestic and foreign, are bridging a gap between domestic buyer's aspirations and their ability to source foreign deals.

What is clear is that state-directed funds are not yet a swing factor in Chinese companies' ability to finance deals, or to pay high valuations. For this, one need look no further than the traditional culprit, the banking system. Rising interest rates in the developed world and an eventual tightening of credit in China will, in time, rein this back somewhat, as will recent Chinese government talk of slowing down outbound M&A to reduce the risk of capital flight. However the banks – Chinese and foreign – are simply responding to the needs of Chinese companies, and their interest in outbound acquisitions will only grow in the coming years.

When Western companies were starting to acquire across regions in the 1970s and 80s, they did this primarily on their own: deals involving multiple buyers and some financial investors, were rare, though in those days the private equity industry was considerably smaller than it is today. From the outset Chinese buyers have gone in a different direction. We should expect funds to be a feature of Chinese cross-border M&A for the foreseeable future.

From active buyers to active owners

The background is a solid light green. Overlaid on this are several overlapping, semi-transparent geometric shapes. On the left, a greyish-blue shape extends from the edge towards the center. In the center, there are two overlapping shapes: a medium blue one in front of a greyish-blue one. To the right, a dark teal shape extends from the edge towards the center. At the bottom, there are two overlapping shapes: a medium blue one on the left and a light teal one on the right. The overall composition is abstract and modern.

David Cogman
Gordon Orr

The most challenging part of most deals is what happens after closing. Research consistently shows that whether you get the integration right or wrong plays a much bigger role in determining a deal's success than any other factor, including the price paid.

There has long been an accepted 'standard' model of how to integrate acquisitions in the US and Europe – do it fast, eliminate duplicated costs early on, move to a single operating model as soon as possible. Speed and decisiveness are the most prominent features. Asian acquirers have often been circumspect about this, sometimes choosing to prioritize stability over speed, and take their time over integration¹.

As Chinese companies have become more active acquirers abroad, constraints on management's international experience and bench strength has forced them into difficult choices. They often acquire to broaden their capabilities and reach: but how then to integrate those acquisitions when you have very limited existing activities in their markets before the deal?

Chinese acquirers today are extremely diverse, and there is no single 'correct' model of integration for all situations. We have seen almost every possible approach be successful in one situation and fail in another.

Looking at the experience of the past decade, however, most post-deal management fell into one of five broad approaches. Of these, two did not really involve meaningful integration, but were essentially arms-length management of an asset. Three involved actual integration, but to differing degrees:

- **'Hands-off'**, where the acquirer keeps the target's operations separate and manages it primarily through a board;

¹ See "Invasion or Diplomacy", [[MoF reference]]

- **'Turnaround'**, where the buyer uses management appointments, compensation, incentives and financial reporting to put pressure on a standalone asset to perform better;
- **'Full-on'** integration, where the target is as far as possible brought into the acquirer's management systems, requiring restructuring of how the target functions as a business;
- **'Selective'** integration, in which the target is kept largely separate, but in one or two specific areas where there are significant synergies available there is much closer collaboration; and;
- **'Progressive'** integration, which starts by integrating one functional area and gradually expands to others.

Part of success is knowing which approach to apply in which situation: each of these models have specific strengths and weaknesses. However there are useful lessons to be drawn from both successful and less-than-successful deals where they have been employed.

Minimalist post-deal management

Standard thinking on integration is that you should do it as fast and as comprehensively as possible, involving as much of both organizations as possible without risking business stability. This approach pervades Western business literature on the topic.

In the early years, most overseas acquisitions by Chinese companies did largely the opposite. They lacked managers on either side who could really work together, and they quickly found that the two companies' management models were incompatible. Even the most basic corporate processes like budgeting, planning and HR looked so radically different that there seemed little point in trying to harmonize them: what works in a Chinese context could not be expected to work in a Western context.

They therefore focused on governance mechanisms as the primary point of contact. Discussion on strategy, investment and budgeting took place at the level of the acquiree's board. Typically there was one 'bridge' person on each side – a pair of senior managers who would talk regularly and informally about issues – but there was no consistent 'pairing' of managers in functional areas such as finance and operations as would normally be seen in post-merger integration, nor was there transplanting of management processes from one company to the other.

This was a rational response to a challenging problem. Examples abound, and the companies can be happy with the outcomes. State Grid exercises control of ElectraNet mainly through governance mechanisms at the board level, but has little involvement in ElectraNet's operational decisions. Chinese managers implanted into ElectraNet tend to play liaison roles, rather than direct operational management. A similar setup was put in place at Putzmeister after Sany's acquisition. There is little direct involvement of Sany in the day-to-day business, and Putzmeister's management team remained largely intact. Annual planning and long-term strategy are aligned with Sany management by means of their participation in Putzmeister's supervisory board.

This approach remains the ingoing assumption for many acquirers. In several Chinese outbound deals in 2016, including Ctrip-Skyscanner, ChemChina-Syngenta, COFCO-Nidera and Midea-Kuka, there was explicit announcement pre-deal that the target would retain separate management and operations for several years after the deal. This was in part to reassure stakeholders, but also reflects a sensible degree of caution by the acquirer.

This model can be effective if value creation derives from routing the acquirer's order flow to the target company, or from taking IP from the target to further develop in the acquirer. However this raises the question of whether the benefits could have been achieved through standard commercial cooperation, without the need for a full acquisition; or whether the deal was really just a financial investment.

The risks involved are obvious. Success is highly dependent on a few personal relationships. If the model is used solely for regulatory or political reasons, it cuts off the acquirer from direct access to the ‘controls’ for the business. Significant operational improvements in the target are usually impossible, even if the acquired business suffers a performance downturn post acquisition.

Minimizing these risks requires establishing a ‘control environment’ early on in the deal – defining a set of basic management information that you see weekly, monthly and quarterly that will highlight any problems early enough to take action. What that information looks like varies from deal to deal, but it is never purely financial: it usually includes key indicators in operations, marketing and sales, and sometimes R&D and product development. This is not easy to do: it requires a deep understanding of the target business, and familiarity with what could go wrong. Companies pursuing a ‘hands-off’ approach to post-deal management often do so precisely because they lack this deep understanding.

Full integration

Some Chinese acquirers attempted full integration. These were in most, but not all cases, unsuccessful; in some cases spectacularly so. Generally these were deals with large cost synergies, requiring genuine integration to capture.

An example of this was SAIC’s acquisition of Korea’s Ssanyong Motor. On the face of it, this looked like a good deal: for half a billion dollars they acquired a complete IP and R&D platform with which to develop domestic Chinese products. Where the deal ran into problems was in turning around the Korean business. Chinese managers tasked with this had lacked the operating and cultural skills to make this work. Their attempts to restructure management and put in place new working practices quickly lost them the support of the incumbent executives, union and workforce. Unions rallied public sentiment against SAIC, Korean media supported them. In 2009 the

company entered bankruptcy, and in 2010 majority control was acquired by India's Mahindra & Mahindra.

Complaints from the Korean side against SAIC were for illegal technology exports, but underlying issues were more fundamental. From the outset the Koreans resented attempts to impose SAIC's operating model. Those involved on the Korean side felt that they were disrespected and misunderstood by the team that managed the asset. Had SAIC chosen to keep Ssanyong's operations largely separate, perhaps it would have retained enough goodwill to carry it through a turnaround. As it is, it left a cloud over Chinese acquirers' reputation in Korea that persists to this day.

The stand-out success from the early days of outbound investment was Lenovo, and in their multiple acquisitions we find a very different story on full integration – one of how and when it can be successful.

Lenovo's goal was to become global #1, but expanding organically beyond China was proceeding very slowly: this deal would in one stroke take them from domestic leader to global leader. However the economics of this deal depended heavily on capturing operational synergies. Synergies worth almost as much as the price paid for the acquisition were available through procurement, but only if the two businesses were fully integrated.

To achieve this, Lenovo was willing to tear up and rebuild its own organization in the process: without that level of commitment, the deal probably would not have worked. It accepted that many of the current Chinese management would need to step back, at least for a while, and re-learn how to operate in this new environment. They also revamped their board to bring in more international experience to guide management. It was also willing to create new management processes in which foreign and Chinese leadership could both operate, which involved some painful choices, such as exiting previously successful managers who couldn't adapt.

After acquiring IBM's PC division, Lenovo identified 200 high-potential future global leaders emphasizing 'world-sourcing' to locate functional centers based on where the best talent was available, meaning that many decisions would no longer be taken in Beijing. These were all steps that few Chinese acquirers were willing to take then: indeed even now, most would still be unwilling.

Lenovo institutionalized its approach to integration after this deal, and did more than five subsequent acquisitions using a similar template. This was a significant investment of time and effort, only justified by the commitment to further growth by acquisition. Today, 60% of Lenovo's top 20 leadership team are non-Chinese, all with extensive international exposure.

Many companies – Chinese and foreign – often think that 'integration' means bringing the acquired company into your management model. Often that isn't the best choice, and indeed to get the best results from the deal you need to use what you've bought to change your own business. In Lenovo's case, it took them from being a Chinese company to an international company with Chinese heritage. For most Chinese acquirers, that would be an unappealing choice: they want to become an international business without changing too much about how they operate at home. As many foreign acquirers have found as they expanded abroad, that is hard to do.

Turnarounds

One type of deal that rarely appears in lists of outbound acquisitions is the purchase of a distressed manufacturing business. Post-2008 there have been plenty of acquisitions of financially distressed businesses, such as real estate assets where the owner has a cashflow problem, or the resource acquisitions where the commodity price had fallen. But it was relatively rare to see a Chinese buyer purchasing a manufacturing company in or near bankruptcy, buying with the intention of 'fixing' the business. Few Chinese companies have these skills. The ability to 'fix' a distressed business is a scarce and special ability. In the growth-focused China market of the 1990s and 2000s, very few Chinese managers ever needed to develop this particular skillset.

There were a few early examples of this, such as SEC's purchase of printing equipment manufacturer Goss International in 2007, which they subsequently divested to PE firm American Industrials Partners in 2015. In recent years there have been a small but growing number of Chinese companies attempting a genuine turnaround of a foreign business. Perhaps the most notable example was Shuanghui's acquisition of Smithfield. Much was made at the time of the political and financing aspects of this deal – investments into US agriculture are politically sensitive, and the deal was highly leveraged – but what happened post-deal is far more interesting.

Smithfield before the deal was very loosely organized: it had three distinct operating centers in Kansas, Chicago and Virginia, and a large number of independent operating companies, resulting in considerable duplication and redundancy across their US operations. The top management were long-term veterans of the company, on high salaries but with limited incentives to shake the company up.

Shuanghui saw synergies in accessing a reputable US meat brand. However it didn't stop there: it wanted to strengthen US operational performance. It first consolidated the operating centers to two, with the goal of eventually reducing to one. It streamlined shared services across all operating entities, and reorganized into business units with primary P&L responsibility, rather than the fragmented operating companies that dominated pre-acquisition.

It also introduced Shuanghui's business reporting system – transplanting all the processes and templates into Smithfield. These were much more detailed and rigorous than Smithfield's previous performance management system, and also required much more frequent reporting. It also put in place a much stronger performance-based compensation system than had previously existed. Over a 2-3 year period it retired the previous management tier, and installed a new top management team, promoted mostly from within. This 'changing of the guard' had considerable signaling value to Smithfield's staff. Shuanghui was not importing managers from outside, it was bringing through the next generation of leadership, giving them a platform in which they could individually grow and prosper.

Shuanghui only deployed one full-time senior manager to Smithfield. The implementation work was all carried forward by the Smithfield employees themselves. The board of Smithfield, however, is composed of three Shuanghui representatives and the new Smithfield CEO: accountability is very clear.

This model – changing management, imposing a tougher performance management system, simplifying the organization, and strengthening financial incentives – is essentially the model that private equity investors use on portfolio companies, though the PE investors perhaps use more financial leverage and allow the management to make more personal profit if they deliver. But the philosophy is very similar. This raises the question: if Shuanghui could do this with only one manager in the company, why can't everyone else do it? Are turnarounds really that difficult?

The short answer is that you need the right conditions for this sort of deal to work, and those conditions have not been seen much in recent years due to equity market valuations. Smithfield was not cheap: Shuanghui paid ~9x EBITDA for the asset. At that valuation, few financial investors would be interested in a 'buy-to-fix' deal: the risks were high relative to the potential rewards. Hence Smithfield was able to operate with these inefficiencies, as there were few potential buyers able to come in and fix them. Shuanghui, however, could count on significant synergies with between the Smithfield brand and its Chinese operations to backstop financial performance. Even if it wasn't entirely successful in the turnaround, the deal would still probably have made sense financially on the basis of those synergies. It was additionally fortunate in that there was an ambitious second tier of managers in Smithfield that supported change.

It's clear from this example that turnarounds are perfectly possible. If valuations cool off in the coming years, then over the next decade we should expect this kind of turnaround to become a common part of the globalizing toolkit of Chinese acquirers.

Selective integration

In recent years there are an increasing number of deals where the acquirers have attempted to selectively integrate one or two business areas, while managing the overall relationship with the target through a board. Under the right circumstances, this can be effective. A few examples illustrate common features of this model.

Petrochina – Ion: combining technology with market presence

When a subsidiary of Petrochina acquired geophysical survey technology company Ion in 2010, Petrochina was already one of the world's largest contract explorers for hydrocarbons. Ion had arguably the best 3D seismic imaging equipment in the industry. The industrial logic of combining the two was compelling. However Ion was a relatively flat, informal and entrepreneurial Houston-based company and Petrochina remains a large and complex SOE.

What Petrochina had, however, was a small group of managers who had accumulated many years' experience running exploration operations outside China. These managers shared a common technical language and frame of reference with Ion's management. Hence they became the 'bridge team' between the two companies. Management of Ion was done primarily through the board, but there was extensive and close collaboration on how to rapidly deploy Ion's technology and expertise into Petrochina's exploration operations. Other functional areas were left largely untouched.

CSR – Dynex: accelerating scale-up of R&D

In 2008 Dynex, a mid-sized UK based semiconductor company focused on selling modules into the railroad sector was 75% acquired by China state owned CSR (one of China's largest railroad equipment producers who at the time were ramping up their high speed rail capabilities). CSR provided Dynex with new capital to scale up their R&D and to expand their sales force into new geographic markets. CSR brought the Dynex products to market

in China through their own products and channels. Dynex management now includes several executives from CSR, including the head of R&D and of sales and the board has four Chinese members out of a total board of nine.

Making selective integration work

This approach is appealing, though it is not easy to execute. Making selective integration work requires a few key skills that not all companies possess.

First, the acquirer needs the ability to manage an asset through the board. This is not as simple as it sounds. Boards are cultural phenomena; their authority and role varies significantly across countries. The legal role of a board in China is quite different from the US, Germany or the UK. Some companies and individuals are notably skilled at doing this – for instance, this is the standard operating model for Hong Kong conglomerates such as Swire and Jardine Matheson – but many are not, and view the board as little more than a legal formality.

Second, the acquirer needs bench strength in the specific integration areas. The acquirer needs a cadre of people – maybe as few as a dozen – which can interact at a working level with the target, and have credibility with the target’s managers.

Third, the acquirer needs a deal team capable of negotiating the right kind of arrangements prior to deal closing. Negotiating in this context doesn’t mean writing it into the legal agreements, but rather reaching a practical mutual understanding with the other side, with no confusion or ambiguity. This is harder than it sounds. In some situations, notably tightly controlled auctions where access to the target is restricted by the sale process rules, it may be outright impossible – one of many reasons why Chinese acquirers still do not like competitive public sale processes.

Progressive integration

Geely's acquisition of Volvo in 2010 was a milestone in the global auto industry: it was the point where many in the MNC auto community woke up and realized that domestic Chinese auto makers were serious in their international ambition. Domestic brands had not, at that point, achieved notable success in the domestic market relative to Sino-foreign JV brands. None of them had meaningful presence outside China, and none had integrated foreign operations into their business: in the case of the Sino-foreign JVs, it was domestic operations that integrated into the global product platforms.

Auto integrations pose unique challenges. Value lies primarily in achieving scale through consolidating product platforms and procurement. This is hard to do without doing a full-on integration of the two companies, hence most post-merger integrations in auto are very hands-on and involve extensive restructuring of one or both sides.

Geely's management were aware of the risks involved. Having bought Volvo out of financial distress in 2010 at a relatively attractive price, they had more time on their side than most acquirers. They decided, sensibly, to walk first before running. The easiest and highest-value part of the integration was sharing R&D and manufacturing expertise from Volvo into Geely, and this was the first area of focus. The next area was a significant step-up: finding operational synergies across production platforms in procurement and product roadmap. This was a multi-year effort. The next step was to look at the marketing and distribution footprint, and find areas that could be consolidated.

The pace of integration has been slower than was anticipated at the outset. Yet the company has defied the skeptics who predicted culture clash and financial underperformance. Geely traded off returns against risk in this approach, and having avoided the short-term danger of becoming another SAIC-Ssanyong, it had time on its side to achieve its strategic goals with the business.

Working with partners: can co-investors help?

The problems we have discussed include a mismatch between management systems, and lack of experience operating in a foreign environment. Can these be addressed by involving a financial investor as partner? Numerous co-investors, primarily buyout funds, actively seek opportunities to partner with Chinese acquirers in these situations. Their greatest value is in the pre-deal stage. They can be very helpful post-deal; however they create one significant additional problem, which is orchestrating their exit from the investment.

Funds bring deep experience in deal execution and in managing the stakeholder issues surrounding them. This is of significant value to Chinese companies that lack the network to generate proprietary dealflow, providing opportunities that they otherwise wouldn't see; and it helps them navigate the deal process more efficiently. Partners are less consistently helpful in navigating government and other stakeholders, such as Huawei's failed bid for 3com: even Bain Capital as co-investor was unable to get the deal through CFIUS review.

Zoomlion's 2008 investment in Cifa is a good example of how the dynamic changes from pre- to post-deal. A triumvirate of financial co-investors – Hony, Goldman Sachs and Mandarin Capital Partners, a Sino-European fund with strong links to Italy – helped source and complete the deal. They provided heavy support on diligence, negotiation and funding, and setup corporate governance post-closing, without which the deal would have been considerably harder for Zoomlion to execute, perhaps even impossible.

They also helped find and install a new CEO. However post-deal the company struggled in operations and R&D – two areas where the PE investors did not bring much to the table. Revenues fell, and before too long the PE-backed CEO was replaced by one of Zoomlion's choice. However despite poor financial performance – revenues in 2011, only three years out from the initial investment, were less than 40% of pre-deal projections

– the financial investors still managed to exit with respectable returns. PE investors put considerable effort into the structuring of these deal to protect their downside, and typically the strategic investor takes greater risk. This is because the majority strategic investor has greater ability to manage the asset post-deal than minority financial investors. Nonetheless it is uncomfortable when the strategic investor does more operationally, but makes lesser returns.

In Lenovo's first outbound deal, the acquisition of IBM's PC business, two foreign funds – TPG, General Atlantic – invested alongside Lenovo, and brought considerable expertise in deal execution and risk mitigation as well as in providing international credibility to Lenovo, who had almost no profile outside China at the time. However their ultimate interest was in the returns they could generate, while Lenovo's core motivation was in developing an international platform for growth over the coming decades. This initial deal perhaps needed the funds' involvement to achieve success. In subsequent deals, Lenovo chose to be the sole investor.

In recent years a new kind of partner has emerged: local Chinese funds, some private-sector, many with some form of government funding, who help Chinese companies execute acquisitions. Staff in these funds, particularly at the junior level, are typically Chinese nationals with international experience – people who have studied and worked in investing abroad – hence they bring experience that the companies they partner with lack. The limited partners are predominantly Chinese institutions, and they often do not have the pressure of the fundraising cycle that foreign funds feel, allowing them to be more relaxed on the timing of exit for their investments.

It is too early to say whether these funds will behave differently from their foreign counterparts. However they provide a middle-ground, and the numbers of co-invest deals with them involved has grown very fast in the past few years. Take, for instance, Chinese retail operator Sanpower's acquisition of Brookstone Holding, a US-based retail store network. They were supported in this by Sailing Capital, a Shanghai-based fund set up

to assist Chinese companies acquiring overseas, relying primarily on RMB sources for funding but whose investment team has a background working for foreign investment firms such as PAG. Early results appear positive: it has opened three stores in China already, including a flagship in Shanghai, has increased the pace of format innovation and marketed more aggressively toward younger age groups.

There is clearly a role for funds to support outbound acquisition. However it's less clear that they can play a major role post-deal in integration. In all the examples we looked through, we found few where the fund had played a meaningful role in operational improvement or restructuring.

Building the toolkit

The fundamental challenges that we have highlighted above mostly come down to three areas: the historic lack of a managerial cadre that can function in a foreign acquisition; incompatible management systems; and differences in corporate culture. Over time, it is becoming easier to address these. The pool of internationally-experienced Chinese nationals with experience in multiple corporate cultures continues to grow, and Chinese companies' management systems continue to become more sophisticated.

That said, there are a few necessary elements to successful deals that Chinese companies will not develop unless they make the effort to do so. The first is to develop their own 'playbook' for these acquisitions. As with any corporate function, you become good at M&A by codifying and standardizing how you do it – by finding out what works for you individually. Lenovo did this after its purchase of IBM's PC division, and it has served them well in subsequent acquisitions.

The second is developing the ability to run a company in a light-touch manner primarily through the board. This is something that no company or manager has naturally, and how you do it outside China is substantially different from within China. It is a question of knowing what management information to look at, how frequently, where you need transparency

into operations and how to achieve that. Most successful private equity investors acquire this skill through the course of their careers by sitting on multiple investee company boards, but it is not reasonable to expect a corporate manager to know how to do this.



As many Chinese companies have come to realize, there is no magic bullet for integration. Investing in your own skills and capabilities gives you more options to choose from, but you still have to make the right choice and execute well on it. As these companies' deal teams mature and build experience, we are seeing more thoughtful and ambitious approaches to post-deal integration. This is good, as without raising their game on integration, they will struggle to create value from the current wave of deals.

Paperwork and politics: navigating cross-border M&A regulation

David Cogman
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The experience of a foreign company investing in China is very different from that of a Chinese company acquiring abroad. However they share one thing: concern around the regulatory approval process. Companies on both sides fear unfamiliar, lengthy and potentially politicized review processes, in markets where their access to policy-makers is weaker than at home.

The effects of this are largely invisible. Every year an unknown but significant number of deals die, or never get past exploratory discussions, because one or both sides feels the chance of clearing antitrust or foreign investment review is too low. The vast majority of deals that go through review, both in China and abroad, are approved without remedies: typically fewer than 5% of those that reach this hurdle actually fail at it in the EU and US. However those that are not approved unconditionally are most interesting, as they show where the line is drawn.

Acquirers worry about the formal antitrust reviews, and rightly so, as the process is time-consuming and sensitive. But the history of regulatory decisions suggests they should be more concerned about how they build political support for deals. Typically when deals run into problems in the regulatory process, often it is failure to orchestrate support among critical stakeholders that makes the difference.

Chinese firms abroad

Regulatory approval is a pervasive concern for Chinese companies acquiring abroad, and understandably so. In their domestic market they are extremely sensitive to the interests of political stakeholders, and they expect this to be important abroad. However they lack the frame of reference for how they deal with them; they are often unfamiliar with how to interpret guidance, or lack access to the right channels of communication. This is

not helped by the fact that every jurisdiction has different stakeholders and review processes.

Partly for this reason, Chinese corporate acquisitions tend to be concentrated in a relatively small number of countries. The US accounts for 28% by value; Australia for 8%; and the EU 32%, of which Germany alone represents 14%. To be sure there are very significant amounts of foreign direct investment in emerging economies – approximately 17% (Russia, CIS, Central and Latin America, Southeast Asia and India) over the past three years – but these are almost all in the form of infrastructure investment and not acquisitions of existing companies.

Despite all the concern, only a very small number of deals have actually been blocked, the majority within the last few years. However this is due to precautionary avoidance. Many Chinese acquirers will pull out of discussions if they perceive a risk that regulators would impose remedies. Moreover in many auctions, the sell-side are still cautious about taking Chinese bidders past the first round unless they can provide convincing arguments that they will clear antitrust and foreign investment review – which nobody can say for certain ex ante.

Blocked deals

The profile of deals blocked outright is striking. To date ten have been halted by regulatory review – eleven, if one counts an aerospace deal discussion blocked in the 1990s. Of these, eight were acquisitions in the US, and the ninth was subject to review in the US despite being a European company. Only one was blocked by EC for anti-trust reasons (e.g. HK based Hutchison Whampoa's acquisition of the UK telecom O2 in 2015). Chalco's 2009 bid for Australia's Rio Tinto received significant regulatory scrutiny on security grounds, but it was ultimately halted by shareholders who considered the terms too generous to Chalco. CNOOC's 2005 bid for Unocal did raise antitrust concerns, though the latter was blocked primarily on security concerns. Hence to date, only one has been blocked due to anti-trust review: all others were due to foreign investment review.

Seven of the ten deals in the US were technology deals, and almost all were blocked during the CFIUS review process: the bid for Fairchild Semiconductor by a Chinese consortium was halted by Fairchild as they believed it would not clear CFIUS. Only two recent deals were not technology-related – SANY’s investment through Ralls Corporation’s into a wind plant that overlooked a military installation, which was stopped by presidential order, and CNOOC-Unocal, which had energy security implications. These aside, the concerns are around technology with either a military use or strategic importance passing into Chinese control.

Deals with Remedies

A far greater number of deals have been cleared with remedies imposed: however this again has more to do with national interests than competition. This is perhaps not surprising, as antitrust concerns focus on reduced competition within a market: a Chinese company entering a new geography via acquisition is less of a concern than a consolidation merger between two players in the market.

Since 2006, around 5% of all deals acquiring into the EU have had remedies imposed by the European Commission. China is running at a slightly lower rate: since 2012, there have been 80 Chinese acquisitions of EU companies, of which 20 have been reviewed and only three received remedies. These were all telecoms deals that raised standard antitrust concerns – Hong Kong’s Hutchinson Whampoa acquiring telecom players in Austria, Ireland, and Italy. For example, during Hutchinson Whampoa’s acquisition of Orange in Austria, the remedies imposed against reduced competition were divestment of radio spectrum and operating rights to a new entrant in Austria – ensuring that the market continued to have four players – and wholesale access to Orange’s network for mobile virtual network operators. Both of these are standard remedies often seen in mobile telecoms consolidation deals.

Chemchina’s recent acquisition of Syngenta, currently under review, seems likely to become the fourth deal to clear with remedies, after the parties

submitted proposals in January around how to address EU concerns around their overlapping portfolios.

Since 2006, less than 3% of all inbound US deals had remedies due to antitrust concerns. The DOJ and FTC do not make their data public, but reviewing the HSR annual reports since 2006, no individual Chinese acquisition was specifically discussed, nor any significant general concerns over Chinese acquisitions raised.

CFIUS also imposes remedies when clearing deals; indeed the rate of conditional approvals is significantly higher than for antitrust review: around 8% of transactions from 2009-14. China plays a significant role in CFIUS reviews – during 2012-4, around 20% of all cases notified to CFIUS were Chinese acquisitions, the highest share from any one country. The themes emerging in the investigations are typically access to critical technologies, control of strategic supply and relationships with the US government. In these cases, divestment of select assets or operations is the usual remedy. Examples include the CNOOC/Nexen case - CNOOC had to give up operational control on oil & gas producing facilities in the Gulf of Mexico given its proximity to a US naval base; Anbang's acquisition of Strategic Hotels & Resorts, where it was forced to divest properties physically close to US military bases; and Wanxiang's acquisition of A123, where it had to divest a subsidiary that provided batteries for the US military.

National security and national interests

The US is far from the only country with a national security review. However CFIUS review is considerably more active than its counterparts in other countries, and less predictable. Some, such as Australia, have drawn clear lines around what is and is not acceptable – in Australia's case, this happened through the political debate surrounding Chalco's bid for Rio Tinto. Others, such as Germany or the UK, only rarely raise significant security concerns over acquisitions - the most notable recent case was Chinese investment into German semiconductor equipment manufacturer

Aixtron, where security concerns over sensitive technologies ultimately stopped the deal from proceeding.

What makes the US review unique is the degree of politicization. The formal review itself – the materials and analysis submitted – is cursory. The committee draws on extensive advice from elected and appointed officials in a relatively opaque way, and a flourishing ecosystem of advisers and lobbyists with connections to the committee has developed to help companies influence the discussions. The likelihood of approval depends as much on the political climate as on the facts of the case – something that worries Chinese companies given the tone of the new administration.

The first few attempts by Chinese firms to influence CFIUS review showed a lack of understanding of US lobbying and PR. When Huawei's bid for 3com was blocked, it wrote a public letter quoting Thomas Jefferson arguing the merits of free markets and protesting that it was not an SOE. In practice, the Chinese tech giants will always be viewed as close to the government, and as a developer of telecoms infrastructure equipment 3com was clearly a sensitive target. Over time, Chinese firms have become more adept at managing the process, and staying out of the spotlight. However Chinese deals going through CFIUS will always be vulnerable to lobbying by domestic interests, which the acquirers will find it hard to counter.

Foreigners in China

China's merger approval processes are the youngest of any major economy. Despite this, decisions are remarkably stable and predictable in their outcomes: the logic they follow, however, looks quite different from what is applied in other markets.

Their formal foundation was the 2007 Anti-Monopoly Law, which created a process for the seven different ministries and government departments involved to give input on deals, and the Foreign Investment Law, which when implemented will consolidate a raft of older legislation on foreign investment.

The Anti-Monopoly Law created a process that looked, in form at least, very similar to EU and US processes: it utilizes similar analyses, looks at the standard market concentration metrics, and imposes similar remedies. MOFCOM's Anti-Monopoly Bureau presides over the process, but itself is not the sole decision-maker: it consolidates the views of at least seven different ministry-level government organizations, and solicits input from many different commercial stakeholders.

The law does not clearly set out policy priorities, only broad grounds for remedies. The longest-standing and most comprehensive publication on policy is the investment guidance catalogue, compiled by the NDRC and MOFCOM, which sets out where foreign investment is acceptable and at what ownership level, existed for many years before. It is currently on its seventh version, and over the years has generally become more restrictive. Unlike most countries' foreign investment guidelines, it sets out where investment is encouraged and permitted as well as where it is not welcome. For many years the government has discussed moving to a 'negative list', which categorically lists where investment is not permitted, thus confirming that all other sectors are open, but that remains in the planning stage.

The catalogue, however, has never been the full story. There have always been additional published guidelines and a large body of unwritten rules – for instance, that strong consumer brands should not be acquired by foreign brands, or what kind of technology transfer is needed to get a Sino-foreign joint venture approved. While there are never definitive public statements on these rules, neither are they kept secret.

The vast majority of deals either pass without remedies, or are stopped prior to that point. Up to Q3 2016, MOFCOM had reviewed 1,563 investments, of which remedies were imposed on 27, and only two were rejected outright. The majority of the deals with remedies imposed were offshore transactions – where a foreign company acquired another foreign company, and required clearance in China due to a sales presence here.

Only three of the 27 were outright acquisitions of Chinese companies, of which two were blocked. Looking at these decisions, the sensitivity is clearly not just around protection of consumers, but also about advancing commercial interests – specifically in four key areas.

- **Protection of prominent local companies.** The review process is particularly sensitive to deals that affect emerging national champions. This is seen most frequently in tech deals that affect access to IP or components. When Google acquired Motorola, MOFCOM's primary concern was the impact on the many Chinese smartphone manufacturers, and imposed tough requirements: for example Google was required to license Android free of charge and in open source to all OEMs for five years after the deal – an eternity in this fast-moving sector. In Nokia's acquisition of Alcatel Lucent, Nokia was required to make essential patents available to Chinese telco equipment manufacturers under the FRAND rules – another strategically important sector for the country. However remedies went substantially beyond FRAND: Nokia was also required to notify Chinese licensees should it transfer its patents to 3rd parties.
- **Protection of national brands.** China has relatively few strong consumer brands, and anti-trust decisions have always sought to keep them in local hands. One of the first ever decisions – on Coca-Cola's acquisition of Huiyuan Juice – attracted much attention from commentators. Many argued that the given explanation of consumer protection was oversimplified, and in fact was to protect Huiyuan as a national brand...that it used the excuse of consumer protection to do just that, rejecting the acquisition on a complicated reasoning that persuaded few. The remedies applied in InBev's acquisition of Anheuser-Busch also prohibited both players from acquiring more shares in local breweries, specifically their respective shares in Guangzhou Zhujiang Brewery and Tsingtao Brewery. Neither of them were also allowed to purchase shares in two other local brands (Snow Beer and Yanjing Beer) without

MOFCOM's advance approval. The subsequent remedies imposed in InBev's acquisition of SAB Miller were more sophisticated, but had a similar objective. SAB owned 49% of domestic brand Snow Beer, and post-acquisition the combined business would have 40% of domestic beer market share. MOFCOM required divestment of their stake to state-owned enterprise China Resources, previously the majority owner, leaving the brand in Chinese hands.

- **Advancing technology transfer.** Approval of many acquisitions, and practically all joint venture approvals, are used as leverage to accelerate technology transfer in priority industries. When reviewing GE's joint venture with Shenhua on coal gasification, MOFCOM ruled that the deal was anti-competitive, but permitted it subject to remedies on how the JV treats customers to facilitate bringing a much-needed technology into China's energy sector. Western Digital's acquisition of Hitachi's hard drive business was initially subject to very aggressive remedies, forcing the two businesses to remain separate within China. These remedies were removed quickly after Western Digital announced an investment by, and technical collaboration with China's Tsinghua Unisplendour, a major state-owned enterprise in the technology space.
- **Protection of information security interests.** Anything touching on the internet, media or telecom sectors is subject to heightened scrutiny; a bright line is drawn around foreign control of 'online' assets, enforced by licensing requirements. The scope of this is extremely broad. For instance, when Wal-Mart bought a minority stake in online grocer Yihaodian in 2012, they were effectively prohibited from controlling the B2C 'marketplace' part of the business, or offering other value-added telecoms services: they were only permitted to operate the direct grocery sales to consumers. They eventually divested the business to JD.com, a major Chinese e-commerce player in 2016.

Foreign acquirers in China spend considerable time and effort preparing anti-trust submissions and presenting the merits of the deals. They spend

far less time building support among the main corporate stakeholders – the companies affected by the transaction. However it is those stakeholders that play a major role in forming MOFCOM's views of how the deal affects Chinese industrial interests – the information they provide will always be more persuasive than lobbying by a foreign investor.

There are practical reasons for this. Maintaining confidentiality pre-announcement prevents widespread discussions within the industry: post-announcement both sides are fully occupied in working toward closing. Moreover most companies pass the anti-trust process management to their legal counsel, and while they may advise networking with corporate stakeholders, they will not do that for the acquirers. It is rare to see senior management get involved in active stakeholder management before the point when problems have already come up, beyond the obligatory visits to MOFCOM, the NDRC and perhaps industry stakeholders. By the time they do get engaged, interested domestic companies will already have shared their views with MOFCOM, and an informal consensus may already have been reached.

When that view is negative, it typically becomes a frustrating and confusing experience for the acquirer. MOFCOM will not always disclose fully the specific source or nature of the concerns, nor will it necessarily give guidance before the ruling: it is under no obligation to disclose private conversations with industry participants. And once remedies are announced, the track record of getting them lifting is not encouraging. Only one transaction achieved that, and then only by bringing in a significant Chinese player in the industry as an investor.

Mastering regulatory management

There is a tendency in cross-border acquisitions to focus more on the form than on the substance of regulatory approval: the market share analysis, the technical arguments around market definition and contestability, the protections offered against security concerns, and above all the timeline and

discussions with the regulators themselves. This focus is understandable and to some extent necessary, as approval processes are complex and time-consuming.

Ten years ago Chinese companies operated at the most basic level in regulatory management: they provided the information needed but were essentially reactive in the process. Most Chinese acquirers today, have raised their game to the point where they are more strategic about their management of the process – they actively propose remedies, work with regulators on market definition questions and contribute their own thinking on how the deal will affect industry economics. Few, if any, are at the level they need to be – building political support for the deal by developing partnerships with the stakeholders, often other companies, that will be decisive in supporting or opposing the deal. Similarly, very few foreign acquirers in China operate at that level. However in today's highly politicized climate, this is where both sides need to be.

This work cannot easily be done ad hoc during negotiations or after announcement – ideally it needs to precede the deal discussions themselves. Stakeholder management – whether by MNCs in China or Chinese firms abroad – is often seen as little more than government relations. If companies are serious about cross-border acquisitions in either direction, this needs to change.

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About McKinsey's China Globalization Service Line

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Within our China team, we have a strong team of dedicated and affiliated consultants who have deep experience in cross-border M&A, both inbound and outbound M&A. We can partner with our clients throughout the M&A journey, navigate the uncertainties and challenges in cross-border transactions, and more importantly, assist in the design and implementation of the post-merger management.

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