

# A New Era of M&A in China

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***Despite the global economy slowing to a standstill, China is still bustling with merger talk as Asia's largest M&A market.***

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This year alone has seen several high-profile deals such as China Petroleum & Chemical Corp.'s \$7.2 billion acquisition of Swiss-Canadian independent Addax Petroleum Corp. and China Minmetals Corp.'s \$1.2 billion takeover of Australian miner Oz Minerals Ltd. However, a larger number of deals, often smaller in size and nonresource related, are taking place in high-growth sectors such as IT, logistics, healthcare and cleantech.

The recent flurry of investments in these higher value-added sectors, both domestically and abroad, signals the beginning of a powerful trend that will dominate the future of the Chinese M&A landscape.

Many Chinese companies are sitting on large cash balances. They have the ambition, scale and potential to buy out foreign assets and become the new global challengers.

According to the Ministry of Commerce, or MOFCOM, total outbound investments in 2008 increased twofold to \$52.2 billion. The upward trend seems to be on track this year with an outbound volume increase of 37.6% year over year during the second quarter.

Previously, Chinese acquisitions mainly targeted industries such as mining and financial services. However, recently other sectors such as high-tech, medical equipment, software and biotechnology have been gaining traction, reflecting a shift in focus to other industries that will contribute to China's long-term economic growth.

There are two main drivers for the recent boom in outbound M&A in China. One is timing: The global financial crisis has led to a significant discounting in foreign assets, particularly in the U.S. where current valuation multiples make U.S. companies more affordable. Meanwhile, the renminbi has gradually appreciated against the dollar -- 6% since the beginning of 2008.





The second and perhaps more interesting reason is China's changing attitude toward business expansion. Chinese companies no longer want to just produce cutting-edge goods; they want to create and own the intellectual property and know-how in order to shed the image of being domestic original equipment manufacturers.

Foreign acquisition is the quickest way to upgrade. It not only helps to improve distribution and market presence abroad, but also allows transfers in technology and management expertise. Chinese car maker Geely Automobile Holdings Ltd., for instance, bought out Australian automatic transmission supplier Drivetrain Systems International Pty. Ltd. in March to expand its product line and ability to develop competitive transmissions.

Chinese firms are now interested in pursuing a different strategy -- one that emphasizes R&D, product design, brand value and market insights. This is clearly demonstrated by a SmithStreetSolutions analysis of the Shanghai Stock Exchange 50 Index, which found that the intangible assets of those firms increased more than 1,400% from 2003 to 2008.

There is now a strong emphasis on the value-added component that was largely absent before when lower competition and depressed wages allowed Chinese OEMs to thrive without having to upgrade. However, a combination of greater market pressures and resource availability has been pushing domestic firms to move upstream in the value chain.

Chinese management has also become better prepared to take on the task of global acquisition by leveraging the influx of foreign talent into China. Since the crisis began, a record number of professionals from around the world have migrated to China in search of new opportunities. A recent job fair in Beijing hosted by Chinajob.com attracted 1,300 foreigners, more than double the number from the year before.

Furthermore, ZheJiang Noblelift Equipment Joint Stock Co. Ltd., a material-handling equipment producer, announced in April that it would spend Rmb10 million (\$1.5 million) annually to hire top managers with overseas work experience. The fact that Chinese firms are making it a priority to recruit senior personnel from abroad demonstrates a maturity in the way they do business.



Though inbound investments have seen a sharp drop since the crisis began, recent numbers indicate a hopeful rebound. MOFCOM reported that inbound M&A deals reached \$1.03 billion in the first half of 2009. The figure is a decrease of 1.4% from last year, but represents a growth of 0.7% to 2.4% as a proportion of total foreign investments into China.

On the industry level, value-added sectors occupy a greater portion of foreign investments than before, in line with the pattern that we have seen in outbound M&A. According to SmithStreetSolutions' analysis of M&A trends over the past few years, the biggest change occurred in the information technology industry, where M&A activity was barely existent in 2004 but now represents over 10% of all inbound dollars.

China's information technology outsourcing, or ITO, sector, for example, is highly fragmented with more than 3,000 providers and presents an attractive area for industry consolidation. SmithStreetSolutions projects that the ITO sector will grow at a compounded annual growth rate of 22.3% up to 2011 and will experience a surge in merger activities as larger firms seek to expand client and product offerings by acquiring smaller and more specialized firms.

One explanation for the growth of investments in high value-added segments is China's increasing exposure and influence in the international markets. China's high value-added industries, which include pharmaceuticals, software and insurance, are expanding faster than traditional enterprises and contribute to a mounting share of foreign trade.

According to the Ministry of Industry and Information Technology, exports of electronics and information products accounted for more than a third of China's total exports last year, contrary to popular beliefs that Chinese trade is mainly driven by low-end manufacturing. Additionally, of all Chinese companies currently listed in the U.S., more than half belong in the technology, service, or health and science categories, reflecting a need for growth capital as well as interest from American investors.



Firms in these sectors are attractive acquisition targets due to their exceptional growth in spite of the downturn. The Chinese software industry, for example, is one of the fastest growing, maintaining a rate of over 20% since the second half of 2008. Last year, revenue of China's top 100 software producers rose a staggering 84.4% to about \$30 billion, according to People's Daily.

Not wanting to miss out on this opportunity, foreign corporations have been quick to expand their foothold in China. Exigen Services Ltd., the U.S.-based application outsourcing provider, announced in June that it has acquired the China-based software outsourcing services firm Taihoo Technologies for an undisclosed amount. Such a deal further solidifies China's role as a producer of knowledge-intensive products and services in the global arena.

As China continues to open up its economy to upgrade its brands, technology, and international presence, new policies have been implemented to make it easier for cross-border M&A.

Following the announcement of China's fiscal stimulus package, China Banking Regulatory Commission, or CBRC, overturned a long-standing restriction on the granting of bank loans for equity investments in China. The new guidelines are expected to boost both inbound and outbound M&A by expanding sources of financing for domestic investors and foreign players with a presence in China. The government's positive stance toward M&A is further reiterated by its active promotion of the "Go Global" policy as well as the March release of MOFCOM measures favoring outbound investments.

The new regulations also attempt to clarify and streamline the approval process for acquisitions. A series of directives issued since August 2008 explicitly delegated approval authority over certain M&A transactions and foreign investments to provincial, municipal and local governments. Nonstrategic deals under \$100 million no longer need to go through central MOFCOM, which may significantly cut down regulatory hurdles as local authorities tend to be more eager to approve investments.

In addition, both central and local governments have undergone procedural reforms to speed up the approval process. Some previously unspoken rules are now written into the system to give the government clearer and greater control over the process.



Some argue that the regulations have made M&A in China more complex and unwieldy, citing the government's rejection of Coca-Cola Co.'s bid for juicemaker China Huiyuan Juice Group Ltd. based on the recently instated anti-monopoly law.

But in our view, the government is taking a careful and hands-on approach to ensure that investments are made strategically and in line with long-term goals. With the exception of deals involving state-owned enterprises or industry leaders, dealmaking should be easier, particularly for smaller ones that can stay off Beijing's radar.

We believe M&A activities will increase as the financial crisis continues to wind down. The bulk of the deals will not be like the megaenergy acquisitions that have dotted the front pages of newspapers. Rather, they will be clustered in nontraditional, fast-growing industries and will often go unnoticed due to their size. Their number, however, will be significant and will have a profound effect on China's development. Particularly noteworthy are those that focus on technology and service as they will most likely lead the next phase of Chinese output.

The Chinese government has made the conscious decision to immerse the country into the global financial system, but it is testing the waters before fully jumping in. With a slew of new policies supporting outbound investments, we will likely witness many domestic companies rising to global status.

As a matter of fact, China already ranks second (after the U.S.) in terms of total market capitalization in a list of Top 500 Global Companies for 2009 released by the Financial Times. Continuing with the trend, future M&A transactions should reflect this upgrading of the Chinese economy.

#### **About SmithStreetSolutions**

[SmithStreetSolutions](#) is a leading Shanghai-based consulting and advisory firm with operations in Shanghai and New York, offering Corporate Strategy Development Services, China Advisory, Investment Research and Analytics, and Production Services.

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