

COMMERCIAL DUE DILIGENCE – AN ESSENTIAL TOOL FOR EVERY TRANSACTION IN CHINA

As a whole, FIE expansion via M&A has increased substantially over the past three years. This is partly due to consolidation in many industries and also because increasingly, growth via acquisition is proving to be a faster and sometimes better method to tap the China market. Against the background of lower transaction prices and increased opportunities in China, we advise clients to continue this strategy in a more focused manner.

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In our work with GMs, Business Unit Leaders, Strategy Heads and CFOs, two reasons arise for failed acquisitions: lack of information and failure to build relationships. Negotiations often break down in the early stages when decision-makers of both parties fail to agree on basic issues such as business plan feasibility and valuation methods. This is because validating the deal rationale and building deep relationships during the financial and legal due diligences is impossible.

Our clients confirm that the best way to achieve sufficient information and to build the necessary relationships is via discussions within the target and with third-parties such as industry observers, suppliers and customers. The fast-changing environment both inside and outside of China is a further reason why commercial due diligence has become essential. Finally, deals here are much more about creating mutually beneficial partnerships than about pure financial transactions.

What is commercial due diligence (CDD)?

CDD is a complete process of investigating a target in terms of its strategic, commercial and organisational capabilities relative to its market. It allows the buyer to gain a deep insight of the target's business model, success factors and competitive position in order to validate future investments. Specifically, a CDD assesses the target's commercial situation in three main respects:

- What drives growth in the target's market?
- How is the target positioned and perceived to grow in its market?
- How will revenues and profits from the target's core operations support its ambitions?

Why does it pay off?

Our clients have found that such insight:

- Confirms basic interest on both sides and further strengthens the partnership with the target
- Optimises buyer's tactics and negotiation power
- Reduces transaction risk and limits liabilities
- Results in a practical and realistic plan for post-acquisition integration including agreement on complementarity and synergies

For which cases does CDD apply?

This approach is widely used in M&A both for strategic investments by corporate and for financial investments by private equity. In addition, many clients have engaged us to conduct such diligence when making strategic supplier decisions.

How does it fit with other DD?

(Chart 1)

How does it differ from FDD?

Due to the broad nature of commercial issues, a CDD often also includes a basic legal and financial analysis. Below is an outline of the main differences:

(Table 1)

What are the successful deal ingredients in China and how does CDD play a role?

1. Define deal breakers before beginning the CDD or negotiations, and be firm on them
 - This will clarify your thinking in terms of when to drop the deal.
 - In case you decide not to proceed, you can use your funds to invest in alternatives.

As an example, for a specialty metal manufacturing client, the relationship with local residents turned out to be a deal breaker since



Chart 1 – Example Deal Process in China

	CDD	FDD
INTERVIEWS	Internal (Owner, Management Team And Staffs) External (Customers, Competitors, Suppliers, Distributors, Regulators, Industry Observers)	Internal (Owner, Management Team And Financial Staffs)
FOCUS	Projections And Future Potentials Based On The Status Quo Facts	Historical Result
TYPE OF INFORMATION	Both Qualitative And Quantitative (E.G. Critical Soft Strengths Such As In-house Technical Know-how, Strong Local Government Relationships)	Mainly Quantitative

Table 1 – How CDD differs from FDD

the manufacturing process currently used by the target had a large negative influence on the local community. As an aside, this highlighted how important win-win solutions between targets and locals are.

2. Fix a schedule

- Clear communication on the project schedule can convince Chinese owners, who are often inexperienced, of your seriousness, and can assure that they will cooperate with the CDD team efficiently throughout the process including interviews and data room set-up.
- This schedule should include key communication windows during the project in order to save time committed by the target.
- Such a timeline can also contribute to smoothing the process of internal approval, for example from a board of investors.

As an example, for most of our clients engaging in mid-market transactions, a 3-4 week CDD is necessary in order to enable closing within less than 6 months. Without clear communication and regular updates on the working schedule, the target may lose interest throughout the process.

3. Agree on rules

- Legal documentation and repeated commitment of confidentiality is paramount since Chinese owners lack deal experience and the awareness of the importance of confidentiality.
- Explain the nature and reasoning of the investigation and highlight the danger of manipulating information.
- Assure the mutual benefit of conducting CDD as it provides an ideal platform to confirm post-acquisition synergies and potential operational changes.

As an example, a local target was heavily influenced after talking with their competitors who were also conducting negotiations with our client. Without repeated reminders of confidentiality, this talk amongst targets could have created complications for all the clients' projects at once.

4. Ensure your discussions encompass all levels of the target

- Map your negotiation team; assign them different roles during negotiations.
- Communicate at different levels in the target company. It's a good way to triangulate the data to identify inconsistencies during the investiga-

tion.

- Example: qualitative inputs from workers on assembly line, engineers from QA and production departments are important facts to identify the potential for cost optimisation.

5. Use the process to familiarise yourself with the relevant people

- Get to understand the working style and personality of the decision makers.
- Better understand who the influencers are (including shareholders, management team, local government officials, relatives or partner companies).

As an example, we dealt with a Chinese entrepreneur who owned 20 companies involving different types of businesses, using them to evade tax and enable other "flexible arrangements" between the entities. The shareholders of the 20 companies were friends and relatives who had significant influence over the target even though they had no direct investment relationship under the legal framework.

In closing, carrying out a CDD is not only essential in providing information for successful transactions, but also highly beneficial to the long-term post-acquisition relationship. By applying some or all of the elements mentioned above, you can ensure the success of both the buyer and seller.



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