

# The Importance of Due diligence in M&A and JVs in China

By Thaddäus Müller

ON 8 AUGUST 2006, China's Central Government took a major step towards establishing more comprehensive and standardised guidelines for inbound foreign investment and released a new rule regarding Provisions on Acquisition of Domestic Enterprises by Foreign Investors. The new merger and acquisition rules, which took effect on 8 September 2006, encourage the possibility of more transparency in business transactions. In particular, they help M&A advisors to play a more defined role and suggest a more influential role for the central government.

It will take a little while for the practical impact of these amendments to be felt. The way the government enforces and interprets the laws will determine whether this change will ease uncertainties among foreign investors or present new obstacles. This is because some of the undefined terms they contain seem to give China's Ministry of Commerce (Mofcom) and other government authorities more decision-making power and leverage for giving approval to or denying the acquisition plans of foreign investors.

Foreign investors are still keen on buying assets in China, whether they are state-owned entities (SOEs) or privately held businesses. In 2006, M&A volumes were expected to rise by 40-50 per cent year-on-year, due to the increased incidence of privatisation and cross-border deals, as well as the growing number of private equity firms finally deciding to enter the market. The potential gains involved in acquiring an enterprise are large, since doing so allows companies to buy existing corporate success, capitalise on established distribution channels and acquire all-important relationships in China. Nevertheless, there are substantial risks involved as well.

## Importance of due diligence



The reason for the failure of an M&A or a JV can often be traced back to the starting phase. The success rate would significantly improve if foreign investors conducted proper due diligence on Chinese partners and acquisition targets. By carefully choosing and evaluating potential acquisition targets, the chances of a successful deal increase dramatically.

Many cases have proven that comprehensively and methodically 'de-risking' a deal, and understanding where the true commercial opportunities of a transaction lie, is the key to

a successful acquisition. Especially in China, the process of methodically developing a fact base for an investment decision should be regarded as a fundamental part of best practice in any transaction.

Proper understanding of a target company requires a combination of financial, legal and commercial due diligence, plus environmental and other forms of due diligence, depending on the industry involved. Undertaking such measures will minimize the risk by providing a thorough understanding of the company and its markets. It enables

potential deal-breaking issues to be exposed early on in the process, thus avoiding unnecessary investment of resources.

## The importance of commercial due diligence

### Financial due diligence

Financial due diligence can be an important tool in determining the value of a target in China, but it should always be just one aspect of an investigation. It is more limited than commercial due diligence, which focuses on information and issues related to the future of the targeted company, as opposed to a historical perspective. Commercial due diligence aims to develop a clear understanding of the target company within the value chain of its specific markets and its future growth prospects.

### Legal due diligence

Legal due diligence focuses on a range of issues, including corporate authority, ownership of assets, regulatory compliance, contractual rights and liabilities, and claims against the target. Such issues can substantially influence a potential transaction.

### Environmental and other forms of due diligence

Before completing a deal, it is important to ascertain the environmental status of any land involved. Chinese law covers all significant aspects of the environment, together with health and safety, and its requirements are frequently as stringent as Western law. Recognising the importance of environmental issues in the China context, and how environmental issues may impact on a target's value, has become a key part of any target or JV partner analysis.

### The commercial due diligence process

Commercial due diligence is often regarded as the key ingredient for finding the right partner for the deal, since only by going through the complex process of obtaining correct, complete and meaningful data can a reliable fact base be established. A detailed understanding of the target company's internal operations and processes, along with its efficiency, corporate culture and decision-making structures is crucial to predicting future performance.

However, such information is not easy to come by. Searching through annual reports or strategy papers composed by the target's management is largely a fruitless effort. It is much more rewarding to conduct face-to-face interviews with important stakeholders within the target. Before doing so, however, it is essential to map out decision-

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making structures and to try to unearth hidden influencers. Often, family ties or shared geographical roots prove to be the real bonds between top and line managers or between other parts of the executive staff. The publicly-available organisational chart may show only a number of figureheads who lack decision-making power.

Most of the information obtained should concern the target's surrounding industry and market segments. In order to be able to assess the target company's position in its market, the due diligence team has to make use of a wide range of secondary sources. These sources can derive from publicly available data, from information concerning direct and indirect competitors, and from the company's customers and suppliers, as well as from all sorts of industry experts and associations and from government and financial institutions. Unfortunately, in China there is no single, ideal information source, so all results have to be cross-checked. The team should spend considerable time speaking to as many different sources as possible and collating the data received from these sources. Varying by industry, the type of respondents typically spoken to can be categorised as follows:

- customers
- competitors
- former employees
- industry observers
- distributors
- suppliers
- regulatory bodies
- market leavers
- industry associations
- new entrants
- corollary suppliers.

It is helpful to involve researchers and consultants with different backgrounds in these interviews. Often the best results come from a consolidated view, with a Chinese and a Western person interviewing people jointly. Interviewers need to be experienced and well-prepared, since "sticking to the script" often does not lead to results. They also need to have the flexibility to alter the direction of a conversation and to recognise when an unexpected avenue during an interview is worth pursuing.

This kind of information-gathering is especially challenging in developing markets such as China. Not only is there a relative lack of accessible market data, but also the shelf-life of available data is short, due to the tremendous pace of change in the market. This is in addition to the fact that the key driver behind the performance of a Chinese company can be informal relationships that are not apparent when looking at hard data.

The main differences in China between classic forms of due diligence and the important commercial perspective lie in three main areas. Whereas classic forms of due diligence often focus solely on the status of the target company or the potential JV partner, the commercial perspective investigates the possibility of the target company meeting its commercial objectives in a dynamic industry value chain.

### Practical advice for due diligence in China

Foreign investors considering a merger or acquisition deal, or a joint venture, in China should consider the following key points.

1. Ensure that you are looking at the right acquisition target or potential joint venture partner. Many foreign companies end up initiating China deals with Chinese companies with which they already have a business relationship, or companies that have approached them with regards to a joint venture. Do not assume that such companies are an ideal target.


2. Conduct a comprehensive due diligence ahead of an M&A or a joint venture deal.

3. Only do as much due diligence as you need at any given time. It is often a good idea to conduct a preliminary due diligence before proceeding with a more comprehensive 'full' investigation. This is a cost-effective way to screen potential targets before deciding whether or not to initiate a full search.

4. Ensure that the scope of the due diligence project is adequate, and plan sufficient time to conclude it. Do not settle for less information than is required to make a decision on whether or not to enter into a deal.

5. Gain commitment from the target ahead of the due diligence process. Most Chinese companies are very reluctant to hand over information about their business or markets. It is crucial to convince the subject of the study that the purpose of the exercise is to facilitate a potential deal, and not to derail it.

6. Gain external information in addition to the data provided by the target.

7. Consider using specialists for the execution of the due diligence, since it is a specialized skill. This lets you focus on the bigger picture, while at the same time making sure that all the details are covered. 

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