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Making sense of Chinese outbound M&A

Misperceptions of Chinese deal making can undermine otherwise good deals. Here's a closer look behind persistent myths.

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The past year saw Chinese companies spend $227 billion on acquiring foreign companies—six times what foreign companies spent acquiring Chinese firms. These "outbound" M&A volumes have grown at 33 percent per year for the past five years though regulatory controls on foreign exchange have slowed growth in 2017. Chinese companies were among the ten largest deals worldwide in 2016 (for example, the current ChemChina/Syngenta acquisition, which is going through the 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 $0.4 billion to the price that Marriott eventually paid.

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 second-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 $49 billion in 2010 to $227 billion in 2016. However, the absolute level is still very low. For example, in 2015, Chinese companies spent around 0.9 percent of GDP on outbound acquisitions; EU companies spent 2 percent, and US companies spent 1.3 percent. 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 $30 million. 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 from their European or US peer. Nonstate firms listed in Shanghai had an average price-to-earnings ratio in 2016 of 60 times. 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 $33 billion of the $47 billion 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 it drives corporate decisions, however, is greatly overstated. The 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 the government will quietly tell other Chinese bidders to drop out of auctions so that only one is contesting a deal. In some sectors—notably semiconductors, 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 state-owned enterprises (SOEs) participate in shaping major policy instruments such as the five-year plans. But the responsibility for sourcing and executing 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 companies 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 Africa

Fund, China Investment Corporation (CIC), and the Silk Road Fund. If there really were an invisible hand directing acquisitions, the government would be using these to coinvest with corporates. In practice, this rarely happens. The Silk Road fund, for example, has only invested in one company to date, 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 CIC's commercial remit to make returns and not in pursuit of any policy objective; moreover, a significant portion of CIC's portfolio is deployed into fixed-income securities and funds.

Third myth—it's all capital flight

Between 2005 and 2014, the renminbi had only strengthened against the dollar, and a generation of managers came to take that as given. From 2014 onward, however, the renminbi 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 the first quarter 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 percent: this was clearly an acceleration compared with the growth rates in the preceding five years, ranging from 7 to 41 percent 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 past few years has contributed, but it was never the primary driver.

Fourth myth—crazy gamblers

For many sellers, having Chinese buyers participate in an auction can be a frustrating experience. Their decision making often appears opaque and irrational, with limited visibility into 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 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 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.

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.

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; they 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 postdeal 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 postdeal 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. 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 postmerger integration—speed is critical; companies 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 companies that had an organized and systematic approach to integration, on average, showed much better results than those that 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 China, or buying brands or technology. However, without a plan, 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 acquirer's. There are not, for instance, many Italian-speaking Chinese aerospace engineers available on the job market.

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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. ■

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