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Peeling the Onion

Mergers and Acquisitions in China

Given the relatively limited number of investment vehicles available to foreign investors looking to enter into China, the emergence of a mergers and acquisitions (M&A) market has come as a welcome surprise. With the relaxation of many industry-related regulations, increasing sales of State-Owned Enterprises (SOE) and restructuring of Foreign Invested Enterprises (FIEs) in China, the opportunities for M&A activities are booming, and many foreign companies are fully exploiting such newfound investment methods.

It is important however that foreign companies considering such M&A opportunities first fully understand the China market, the M&A process in China and the specific regulations that govern it, most importantly, what they are buying and for how much. M&A in China is not just about buying an onion from a greengrocer, it requires understanding about where that onion was grown, where it has been and what lies beneath its skin.

China has committed to establishing itself as the manufacturing centre of the world and at the same time it's recent entry to the WTO will result in an explosion of service industry opportunities across finance, logistics and other such services over the coming years. Natural growth of a new FIE in China can take some time to prove successful and profitable. In contrast, taking over a well-established existing company cuts the build-up phase and time to

market period. By acquiring an already successful company therefore the risk of failure is significantly minimised and the acquiring company may take advantage of existing operating facilities, distribution networks, production knowledge, intellectual property and existing financial and legal structures.

With this in mind and awareness that many domestic Chinese manufacturers are already producing high quality goods at low cost, foreign companies are beginning to capitalise on China's lucrative manufacturing base. Likewise, as foreign companies restructure and look to spin-off operations, there are an increasing number of profitable and efficient FIEs up for grabs.



The China Process

Ensuring an M&A deal is completed effectively and efficiently requires strict adherence to a process which in China, primarily includes the following:

Objectives: Foreign companies must understand what they are trying to achieve through an M&A transaction, as this will greatly affect their choice of target industry, market segmentation, geography, corporate structure, operating objectives, taxation implications and business scope.

Target Identification: Having established a clear objective and specific industry, foreign companies must then target specific type of company that might satisfy these objectives. This decision will be based on considerations such as corporate transparency, regulatory restrictions and required approvals, existing and ongoing liabilities, asset size, management capabilities and distribution abilities.

Due Diligence and SWOT Analysis: The due diligence involved in any M&A in China deal can be a tricky process, particularly because many domestic Chinese companies may be uncooperative in disclosing their records. Under such circumstances, most foreign investors will require comprehensive representations and warranties, indemnities for breach, and security for those indemnities. These arrangements are often unfamiliar to many Chinese companies, and obtaining acceptable terms and conditions that incorporate them is often a challenge.

In conducting due diligence it is essential to understand the relevant Chinese accounting regulations, laws and business practices since in China these areas overlap to a very large degree (primarily due to the rules-based systems of law and accounting). Regulations which are often misunderstood by foreign companies and provide the most risk through an M&A deal include:

1. Statutory benefits and Individual Income Tax;
2. Corporate taxes (including VAT, Business Tax and Income Tax);

3. Commitments and contingencies;
4. Industry regulatory restrictions and controls;
5. Related party transactions; and,
6. Off balance sheet items.

Planning: In China any profit or loss derived from the transfer of real properties or intangible assets is subject to business tax at the rate of five percent. The legislation that governs this tax is therefore applicable in any M&A deal that involves the transfer of assets that include real property and intangibles, such as copyrights and trademarks. In an acquisition where the acquiring company acquires all the shares, or equity interest in the target company, the business tax consequences will depend upon the shareholding structure of the target company. At the same time, the investing entity may also be provided dual tax relief from any China taxes (such as withholding tax or dividend tax) through tax treaties. This may impact the decision on the best jurisdiction for a possible holding company to be located.

The basic accounting rules concerning M&A stipulate that the new or surviving FIEs will be entitled to the remainder of applicable tax holidays (where certain requirements are met) but to no new tax holidays, and that the assets of the pre-merger FIE must be carried over on the books to the new or surviving FIE at book value.

Companies wishing to spin-off assets or specific entities must carefully consider the tax implications of any proposed transaction as to whether it might be better to sell the assets or company as a whole, how much tax losses can be carried and over what period.



What is Best for your Operations?

Form of transaction: China's evolving M&A regulations, combined with high tax rates and non-transparent industry regulations often mean that the most efficient method of acquiring or spinning-off assets may often be to conduct the transaction 'offshore'. Key items for consideration include:

1. Investment vehicles:

Many FIEs in China operate under a holding company, usually based in Hong Kong or other tax efficient jurisdictions. If an investment in China is held in such an arrangement a second offshore company can simply purchase the shares of the first company under the laws of the applicable foreign jurisdiction.

In keeping the entire transaction outside of China, the Chinese government is not permitted to regulate such actions and the foreign investor will not need to seek their approval. Indeed, when establishing operations in China, many FIEs structure their investment through intermediate offshore holding companies, precisely to permit such flexibility for any subsequent transfer of their interests.

2. Type of Activity:

So long as the M&A takes place within Chinese jurisdiction, according to a provisional regulation released in April 2003 guiding foreign investor's M&A activities in China, such activities are divided into two categories: equity M&A and assets M&A.

1. Equity M&A refers to a transaction where foreign investors purchase by agreement the shares of a Chinese domestic company or subscribe for an increased proportion of the shares in a domestic company.

2. Asset M&A refers to an individual FIEs purchase and operation of a company's assets, though sometimes this might also include a situation whereby that FIE will establish a new FIE so as to operate the newly acquired assets.

The adoption of an asset deal or a share deal for an acquisition in China largely depends on the individual commercial and tax objectives of different foreign investors. These may include limiting existing liabilities of a company, changing of business operations or structural considerations.

Generally speaking there are a range of forms and M&A activities available to investors and it is important to carefully consider each one depending on the circumstances, tax considerations, ongoing strategy, etc.

3. Exit strategy

As is the case in setting-up any new business it is of utmost importance to consider the exit strategy of the company should the entity wish to be closed down or later sold.

For this reason, using holding companies for M&A activities provides a practical solution, although tax implications must be considered. For example a foreign company that does not have an establishment or place of business in China that sells an equity interest in an FIE will be subject to the payment of a withholding tax of 20% on any gain realised from the sale of the equity interest. This rule would therefore apply to an offshore holding company that sells a joint venture stake in China and has no other presence in China.

Where companies wish to close down their operations in China, a liquidation is generally required. Liquidation of an FIE must be approved by the Ministry of Commerce and certain procedures must be followed including establishing liquidation committees, payment of creditors, clearing of liabilities and payment of outstanding taxes.

Purchase Price: Price negotiations in China can sometimes resemble haggling matches witnessed in local markets. This problem is further exacerbated due to the limited market information available in China and also the difficulties in predicting future cash flows or revenue streams based on non-transparent accounting records and a rapidly developing domestic consumer market.

In consequence, and as a result of historical and cultural factors, it is often the case that asset valuations are used rather than more common Discount Cash Flow (DCF) models. This is particularly the case for manufacturing operations where it is much easier to attach value to equipment and land and then simply estimate a value for goodwill on top. This method, however, is becoming more problematic as Intellectual Property and branding (intangible assets) become more valuable in China and manufacturing efficiencies are rapidly improving.



Whereas there is some flexibility in pricing limited liability of private companies in China, SOEs are a separate matter. In acquiring or selling a SOE a state-registered valuer must perform an independent valuation of the SOEs assets. This process consistently proves to be a deal-breaker however as the government is often bound by these often overvalued valuations when it comes to negotiating price. On the other side, the foreign company is faced with potentially paying a large premium over assets which may be very run-down, with little movement for price "negotiation".

Regulatory procedures: Not only do the relevant laws and regulations closely monitor deals, but one or more Chinese governmental authority must also approve every type of M&A transaction in China, making the entire process rather daunting and time-consuming.

The specific procedures for approval differ slightly depending upon the type of transaction, but there are several common characteristics. Since nearly all M&A deals in China involving foreign investors will result in the creation of a new FIE or an alteration to an existing one, the approval of the Ministry of Commerce is required. Whether an FIE should seek the approval of the state or the local office generally depends on the FIEs total investment amount, which must be stipulated in the FIEs approval documents.

Once the transaction has been approved, the FIE must apply for a business license, which would then include any changes to the previous license made necessary by the merger or acquisition, particularly if a transaction resulted in a FIE acquiring a line of business not already authorised by its existing business license.



In order to enhance the trust between parties involved in an M&A deal in China, the term of escrow has recently been applied into the relevant legislation. Under escrow one party may deposit documents, deeds, currency, securities or other assets to an independent third party, known as an escrow agent, who, upon satisfaction of certain stipulated legal conditions, hands the said assets over to the second party. The use of an escrow agent protects the interest's of any company involved in such a deal and means that any transaction cannot

take place until certain mandatory conditions are fully satisfied or until the transfer of assets has been completed. This new practice is worth recommending, especially given China's typically uncertain business environment.

The ability to buy, sell or merge companies in China represents a new paradigm for foreign companies to enter the market. The large professional services firms and investment banks in many countries around the world have the experience and resources to negotiate multi-billion dollar deals across a number of continents. However, in China only local knowledge, local experience and local appreciation of the business environment will prevail.

Peeling the Onion is a series of newsletters designed to assist your company with the financial and accounting control of your China operations. We are interested in receiving your feedback on our articles and any suggestions as to future topics are more than welcome at **newsletter@lehmanbrown.com**

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