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"PEELING THE ONION - Part 4"



China to drive value ... but at what price?

With China one of the only growing economies in the world, coupled with the array of corporate meltdown's currently taking place in the United States, many companies are looking to China to diversify revenue flows, expand market share and, most importantly, **drive future sales growth**. Whether it is Japanese manufacturers such as Seiko looking to cut labor costs or American I.T companies such as Oracle or Agilent looking to jump on board the Chinese juggernaut, multinationals from all nations are re-thinking their global strategy and China has surfaced as the last frontier.

Conveniently, at present there is also a glut of factories and operations for sale in the market, as the Chinese government continues to **sell off State Owned Enterprises (SOE)** and many multinationals rationalize their non-core and non-profitable investments in the mainland. However, with all this market movement and Foreign Direct Investment flowing in and out of the country, multinationals need to even more carefully **evaluate their investment options** and analyze growth opportunities.

In the 1990's many multinationals threw endless dollars into the 'China pit' with the idea that China was, without a doubt, the great big market of the future. Whilst many would argue that this claim certainly still rings true, CFO's no longer have endless budgets to blow on over-priced Chinese investments, and CEO's realize that their heads are on the chopping boards if investments prove not to be in the best interest of shareholders. On the flip-side, as multinationals begin to re-structure their existing operations within China itself, including **divesting assets and re-negotiating joint venture terms**, shareholders are demanding greater financial scrutiny and market understanding.

In light of this, comprehensive and diligent valuation of factories and businesses in China is becoming the most integral aspect of investment decisions. Gone are the days of companies claiming that they need to be in China 'regardless of the cost'. Understanding the intricacies of all the risks and future returns is now on top of the CFO's agenda.



The China (X) Factors!

All corporate finance books will warn that valuations must be viewed with caution, citing reasons such as "There is no such thing as absolute value, "All value is relative", that "cash-flows are uncertain", and that "value is subjective". However, in China, there are **many more factors** that play vital roles when estimating value.

Whether it be trying to calculate the value of a joint venture asset, valuing injected registered capital, assessing intangible assets, or even an entire business operation, financial advisors and management must consider a multitude of China-specific factors. Unless this deep understanding of the China market is grasped, multinationals may just as well write out 'open cheques' and have their CEO's seek the aid of career-transition consultants which are seemingly over-inundated at present.

In China valuations prove even more difficult for the following reasons:

Quality information: The quality of a valuation is heavily dependent upon the quality of the information on which it is based. In more developed nations, valuers rely on industry seminars, published studies, market research papers, broker's reports, annual company reports and other publicly available information to **understand the company, industry and market conditions**.

However, in China the lack of public information and immaturity of supporting industries (such as the financial services industry) means that there is a void of reliable, 'independent', quality information. As such valuers are forced to rely on information provided to it by the valuation target itself, existing 'in-house' research and analysis, and market information from external overseas sources.

Indicators and benchmarks: Once a valuation has been completed, analysts generally evaluate their conclusions against past **comparable company valuations, industry benchmarks** (e.g. price/earnings ratios) and **market indicators** (e.g. market share and size). In China at present, however, with the amount of investor speculation in the stock-market, lack of transparency in financial information, and limited scope/number of listed companies, it is difficult for valuations to be 'sanity' checked against market price.

Though the growing number of **mergers, acquisitions and divestitures** in China is proving a valuable source for such comparisons, the 'database' of such information is still very limited. Similarly, with the rate of growth and change in the China market across all industries, the applicability of these indicators is somewhat questionable.

Accounting practices: The current world-wide scrutiny of accounting practices and lack of confidence in financial statements is causing investors to question the degree of 'creativity' which is built into many company accounts. Such **'creativity' is the bane of all valuations** - predicting cash flows and earnings (two commonly-used methodologies for valuing assets) is only feasible when viewed in light of historic data. In essence - Garbage in, Garbage out!

In China moreover, the lack of accounting practices and under-developed accounting system means that reviewing a company's accounts may not necessarily truly reflect the financial performance of the company. Furthermore, the difference between Chinese Generally Accepted Accounting Principles and International Accounting Standards requires that valuers fully **understand both sets of principles**. As such, conducting business due diligence and audits (under international standards) is integral before any corporate valuation is undertaken in China.

Legislation: Whilst listing rules and corporate legislation in many other countries ensure expert 'independent' valuations are conducted and due processes are followed in valuations, the **regulatory environment in China** is very under-developed.

The "Ministry of Finance" maintains responsibility for regulating valuations (previously it was the "State Asset and Administration Bureau" (SAAB)). However, current valuation legislation is only applicable where "there is an asset transfer from a State Owned Entity". In these cases a PRC approved valuer is appointed and a valuation report is submitted to the Ministry. This ensures consistency in valuations, although it has been argued that it also gives rise to inaccurate and biased valuations.

For example, the government has only approved **three valuation methodologies** for tangible assets, sparking many financial analysts to argue that such limitations do not necessarily give enough scope for valuers to incorporate all factors into their analysis. Western financial analysts use tools such as the Porter Model to impound a range of internal and external 'business factors' into valuations. In China many valuations have not yet reached such a level of sophistication.

As such, multinationals must be careful in ensuring an independent valuer is engaged to "cross" **check PRC valuations** when required, and also to guarantee proper due process is adhered to in private valuations.

Other Factors: Some other considerations that need to be taken into account include:

- Valuation of intangible assets - a difficult process in any valuation, but even more so in China where there are many issues associated with **Intellectual Property**. Just as important is the fact that under Chinese accounting standards goodwill must be expensed and not capitalized as an asset.
- There is a lack of public/media scrutiny surrounding takeover bids. In the west such media attention plays an important role in ensuring greater clarity and fairness in corporate transactions and provides for **greater management accountability** in "friendly" takeovers. § The lack of corporate transparency in the operations of many local companies including fraudulent activities and operating structures.
- Lack of regulatory boards to oversee corporate transactions.
- The technological deficiencies of many of the run-down state-owned enterprises and private factories in China.
- The **overwhelming bureaucracy** of conducting business in China, including the multitude of government departments and bodies involved with foreign investments.

Once these aspects are comprehended, investors are able to better understand the difference between price and value in China! With many **companies paying exorbitant prices** to purchase assets in China throughout the 1990's, companies are now slowly realizing that the future cash flows (returns) from their investments are, as a result of the above problems, not even in the same ball park as they initially anticipated.



The End Game

Valuations are unquestionably going to play an integral role in shaping the corporate face of China for years to come. Just as multinationals are unraveling joint ventures gone wrong and selling-off unproductive factories, a new wave of corporations are looking to **China to shape their corporate future**. Thus, it is in the interest of both China and multinationals to ensure valuations represent sound commercial dealings and return on investments promotes long-term outlooks for all parties involved.

Valuations in the west are conducted in an arguably transparent and independent environment. The China market, on the other hand, certainly adds more dimensions to a valuation than just a fancy spreadsheet. Though many foreigners are now understanding the true price of goods in China's famous shopping markets, it would appear that when it comes to business deals many multinationals are still **buying the rotten onions at high prices and selling the good ones cheaply.**

Cameron Hume , LehmanBrown - Beijing.

*"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations.
We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."*

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