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China – Expect more M&A transactions, but Tread Carefully

Simon Cheung Chun Kwok, CBI, CPA, IACVA
Merger and Acquisition International, Ltd., Hong Kong, China

The People's Republic of China ("China" or the "PRC") has emerged recently as one of the most popular countries for target acquisitions, and now must be considered a major player in the surging wave of international business transaction.

Merger and Acquisition play a most important role in foreign direct investment in China. The reason is IPO and MBO, as exit way of private equity is limited in China. This merger and acquisition trend is enhanced by the transaction that more and more multinational corporations have chosen M&A an as a easier and quicker channel to enter the Chinese market or to establish their regional manufacturing base.*

**These developments are not confined to foreign investors. Domestic Chinese corporations are also merging and acquiring one another, and the more successful among them have begun to buy out foreign investors. The result of all of these developments is a rapidly expanding M&A market in China.*

The most significant factor that will change Chinese M&A trends is China's entry into the WTO. As a WTO member, China will eliminate the non-tariff barriers in international trade, including tariffs, quotas, import licenses and subsidies.

Recently, China's economy reform, China's entry into the WTO, the economy globalization, the reconstruction of state owned enterprises, the reorganization of different industry and flourishing private enterprises are the driving forces for development of the M&A market in China.

Due Diligence in a M&A Transaction

Multinational corporations contemplating a proposed acquisition in their home countries would never think of proceeding without completing a thorough financial, tax and legal due diligence on the target. Surprisingly, this essential step is sometimes minimized or even overlooked when the acquisition involves shares or assets situated in China.

The M&A participants and their advisors must begin early in the transaction to explain the process to senior management of the Chinese target and strongly encourage their active participation and cooperation. On site visits and extensive follow up are usually essential. Even then, they lack the proper documentation of many intra-company transactions.

Financial Due Diligence

The scope of such investigation can range from a minimum effort, such as reviewing the available financial information, which is invariably prepared under the Chinese accounting standards that differ from international standards (US GAAP or IAS), visiting the target facilities, meeting with target management, to a maximum effort that would involve a full audit. In practice, the degree of financial examination usually depends on the size and significance of the acquisition, the degree of risk, the nature of the business, availability of financial information and resources allowed. Since Chinese accounting practices usually do not provide a true value of the corporation by western standards, it is common for international accounting firms to convert existing financial statements into international accounting standards.

Legal Due Diligence

At a minimum level, performing an examination of the documents and information generated including required business licenses and approvals certificate, land use rights, assets, taxes, labor, custom, operating agreement and litigation is essential.

Tax Due Diligence

Conducting satisfactory due diligence can be difficult in China. The common tax due diligence findings include aggressive tax planning, special transactions with unofficial local authorities, complicated or unofficial group structures, incomplete statutory and management books and records, personal tax compliance weaknesses, transfer pricing policies without supporting, income tax and VAT compliance weakness and, foreign exchange evasion.

The Future of M&A in China

The recent changes in Chinese M&A laws reflect China's movement toward a legal and economic structure that will accommodate the requirement of international business. Since there is an increased need for more foreign investment and the legal obligations, China will undertake in joining the WTO on or before 2006, which will continue to push China in this direction. For merger and acquisition transactions, the most significant impact of China's WTO entry may be the country's implementation and its commitment to open up the market, or raise the limits on the maximum foreign investment permitted, especially in several important service sectors: i.e. consulting, financial, telecommunications, insurance, and banking. Also, recent foreign investment entities have begun permitting investment in a much wider range of distribution and retail activities. The result will be an M&A market that is much larger and increasingly relevant to both foreign and domestic companies in China. ■

Simon can be reached at info@cpachina.com.hk