# INTERCHINA INSIGHT

## THE LOCALISATION IMPERATIVE

### RESULTS OF INTERCHINA'S COUNTRY MANAGER SURVEY

### PART 2: IMPACT ON M&A DEAL STRUCTURES

For multinationals in China, the preferred route to localisation is increasingly becoming M&A. But multinationals need to take an approach to deal-making that suits the current business reality in China, and in terms of deal structures, that means being innovative and flexible. Not only will this increase the chances of closing the deal in the first place, but also improve integration and enhance the performance of the business over the long-run.

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Strategy I Corporate Finance

In our last article on localisation we discussed how multinational companies operating in China have reached a crossroads where geopolitical and commercial drivers are combining to make such a local strategy essential.

Based on the results of our latest survey of 150 China country managers conducted in April 2021, (click **HERE** to download the report), more than half are considering M&A in response to this imperative, whether that be through acquiring Chinese businesses, bringing in strategic investors with relevant local resources and capabilities, or refocusing in China by spinning off non-core units.

In this second article, we look at the main deal structures currently being used for M&A transactions in China. These reflect the more innovative and flexible approach to deal-making being taken by multinational companies, not only seeking to increase the chances of closing the deal in the first place, but also to improve the performance of the business over the long-run.

Multinational companies are increasingly recognizing that successful localization hinges upon the right deal structures.

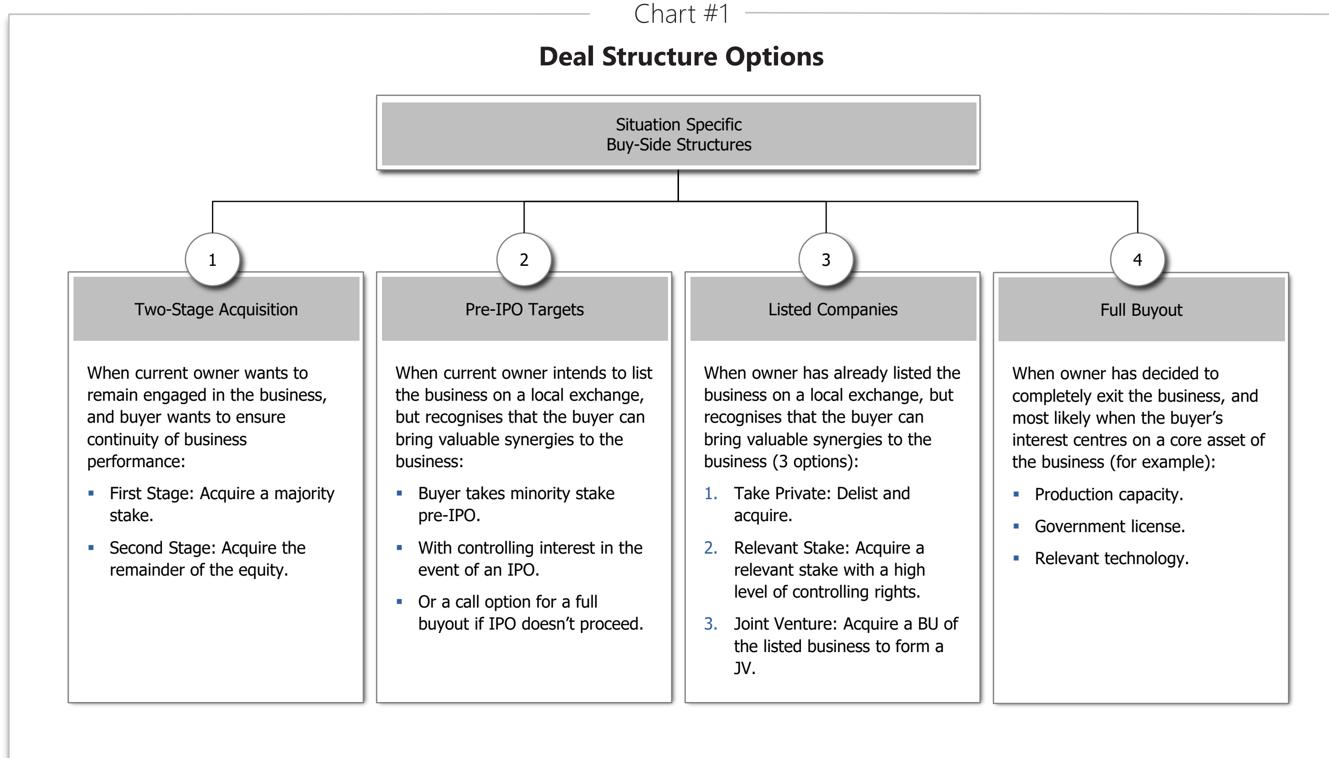
## Buy-Side Structures

### Two-Stage Acquisition

In addition to taking a partial or full share in one transaction, a two-stage approach to buying a company's equity has become much more common in recent years, typically purchasing a majority stake with the option for a full buy-out a few years down the road.

The big benefit of this structure is that it ensures a smooth transition by keeping the existing owners involved in the business, providing them with an equity upside to ensure continuity of business performance. It is the main way of mitigating against risks inherent in ownership changes, such as the exit of key managers or loss of customer relationships, risks that are perhaps more material in China than most markets.

Chart #1





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This type of deal suits the vendor too. Chinese companies are under great pressure to perform well, but some will naturally feel they have reached a ceiling of what they can realistically achieve without new investment, technology or markets. Yet they still want to remain engaged with the business that they have helped nurture and grow, and a two-stage approach is therefore a very suitable model.

A two-stage acquisition can also help both parties agree on valuation, a key source of deal failure in China, especially when the target is a rapidly growing business. The structure allows for an acceptable ticket from the buyer's point of view in the first stage, with an earnout mechanism for the vendor to realize the full value potential of the business in the second stage.

The acquisition by Bystronic AG, the worldwide leader in sheet metal cutting and bending solutions, of Shenzhen DNE Laser, a laser cutting machine builder, was one such example. In the first transaction, Bystronic took a 70% stake in DNE with an option for a full buyout, and in the second transaction Bystronic acquired the remaining 30% stake. The process facilitated the controlled integration of a local player into the more complex ecosystem of a multinational.

**Pre-IPO Targets**

Another pool of targets for multinationals to consider in their acquisition strategy are Chinese companies considering an IPO in the near future.

Here multinationals face two options. They can either try to persuade the target to enter into a two-stage acquisition instead of an IPO as detailed above, or they can simply acquire a minority stake in the target. In the latter instance, we have been successfully framing deals such that the buyer has controlling interest should the target proceed with the IPO, and a call option for a full buyout in case the IPO is not successful.

Both options depend on the buyer being able to convince the vendor that they would bring substantial synergies to the business, providing a better opportunity than proceeding with an IPO alone. Many Chinese companies are looking for brands that would help them move upmarket, technology to move ahead of the competition, or access to international markets that would boost sales. Such synergies support their IPO ambitions.

We saw a good example of this when we advised French automotive parts manufacturer Faurecia on its acquisition of Jiangxi Coagent Electronics, a private Chinese company specialising in infotainment and interior electronic solutions. Faurecia was keen to expand its product portfolio and accelerate its expansion into China, and initially took a minority stake. At the time, both parties also agreed on the option of a full buyout, which Faurecia successfully triggered when Coagent did not proceed with its IPO.

This case illustrates how multinationals can be flexible, and how flexibility can serve multinationals well. By taking a minority position in a Chinese company first, not only does this keep the door open for complete control, but also blocks competitors from making the same move. And as a minority shareholder, influence over the Chinese company is still possible, either through minority shareholder rights or the pursuit of operational synergies.


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**Listed Companies**

In the past multinationals didn't tend to look at the Chinese stock market as a source of deals. However, it is sometimes the only route to making a sizeable acquisition in China.

We have been involved in three types of such deals:

- Take Private: Negotiate the delisting then acquisition of the target (if listed on the OTC market) or issue a public tender offer (if the target is listed on the main board, and the acquiror takes a 30% stake or becomes the largest shareholder).
- Relevant Stake: Acquire a relevant stake in the target without becoming the largest shareholder, allowing the target to remain listed while securing a high level of controlling rights (e.g. board representation, appointment of key executives).
- Joint Venture: Acquire a business unit of the target to form a joint venture, which would then allow the sharing of information and technology between the firms.

Multinationals have only closed a limited number of such acquisitions to date. But interest and ambition are strengthening, and in our view, the pursuit of listed companies will become more commonplace.

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### Full Buyout

Compared with the past, full buyouts in China have dropped in attractiveness for multinational companies. Although they provided the buyer with full control, valuations were often prohibitively high, especially given the risks to the continuity of business performance from the change in ownership.

However, there are still situations where a full buyout is the preferred deal structure. A common case we see is when the deal motivation centers on a core asset held by the target rather than the target's overall performance. This could be production capacity, government license or relevant technology.

One such case that we advised on was the 100% acquisition by Roche, a world-leading healthcare and bio-tech company, of Shanghai IEN, a blood products distributor. As Shanghai IEN owned a relevant drug distribution license and good supply practice certificate, the deal strengthened Roche's drug distribution capabilities in China.

## Sell-Side Structures

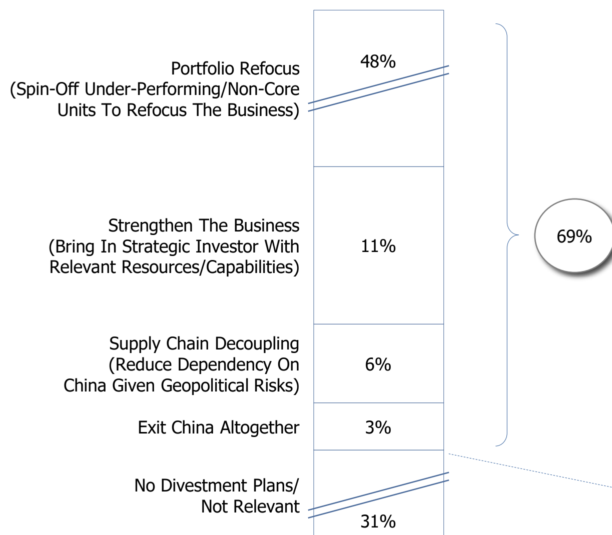
In our survey, two thirds of multinational companies also told us they were considering divestments, a much higher share than in previous years. This is generally not about leaving China, but refocusing portfolios by spinning off under-performing or non-core assets.

However, a small but still significant 10% of companies intend to bring in a strategic or financial investor to the China business, adding relevant resources and capabilities to help strengthen local operations.

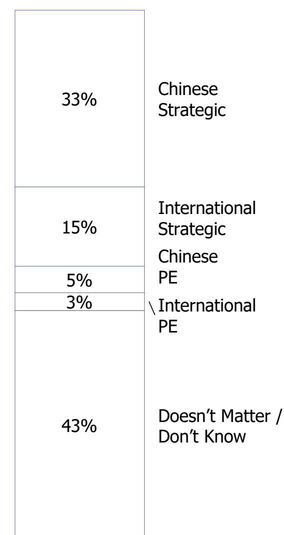
Chart #2

**Divestments**

**Divestment Motives**
Q: Are you considering a divestment in China, and if so, what is your main strategic motive?




**Potential Buyers**
Q: If considering a divestment, who do expect to be the eventual buyer?




Source: InterChina China Country Manager Survey (April 2021, n = 150).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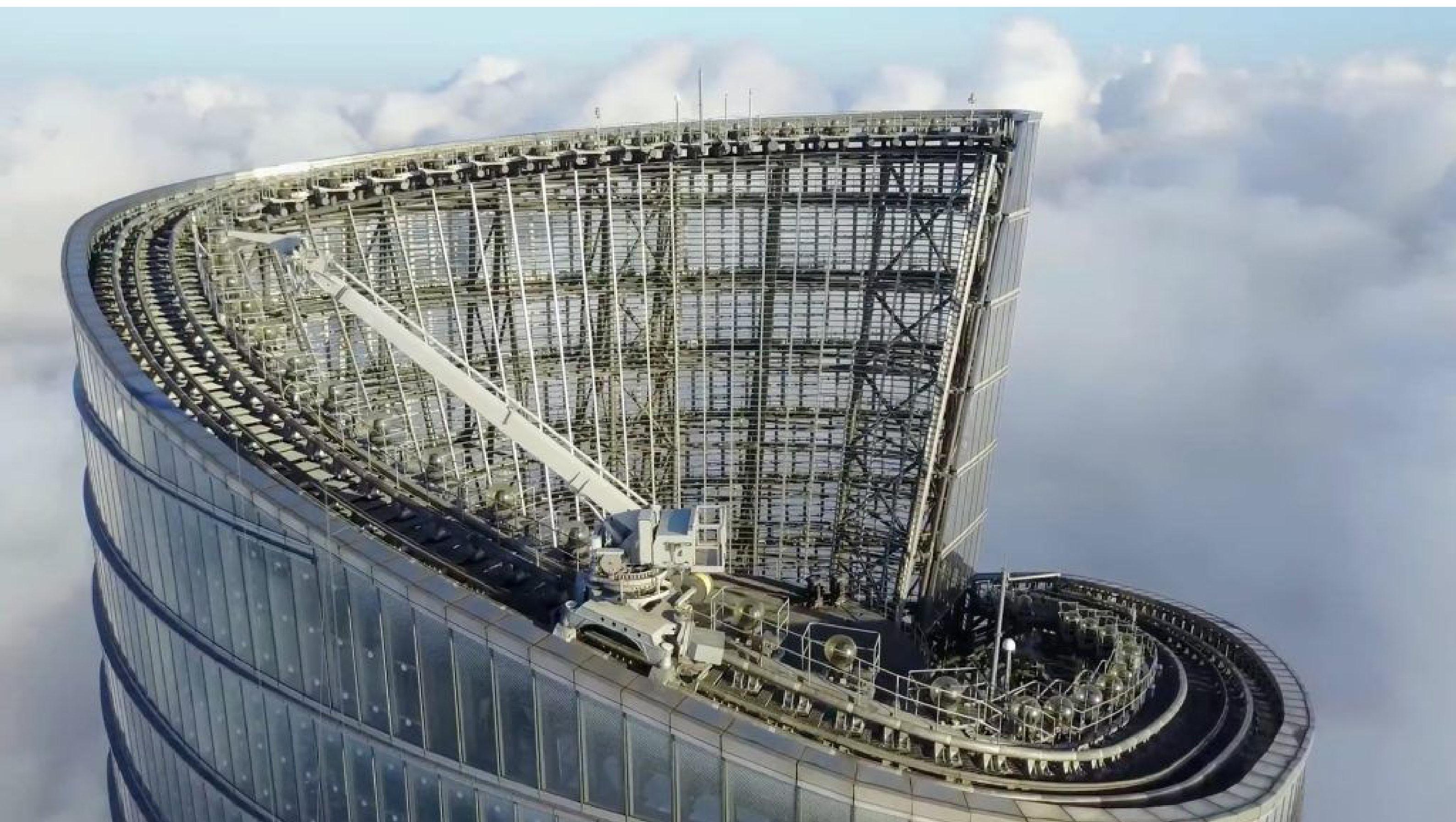
**Partnering With A Private Equity Firm**

An example of the more innovative and flexible approach to deal-making in China is actually on the sell-side, where multinational companies sell a minority stake to private equity firms and then partner with them to grow aggressively in China. Hot sectors for such deals currently include consumer retail and food service.

Many multinational companies are still resource-constrained in China, and PE investment could provide the funding to pursue acquisitions, and a channel for sourcing acquisition targets. A strong PE partner would also have a local team to support develop and realize growth plans, possibly including synergies with other portfolio companies. Investment by a PE firm could also plot a path towards IPO, given that a share buyback by the multinational is unrealistic in terms of speed and price.

Relevant PE players include both international funds well-established in China, such as TPG and Carlyle, as well as leading Chinese funds, including Primavera and CITIC Capital.

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# Summary

To strengthen competitiveness in China, a more localised approach is critical for multinationals, and the preferred route to localisation is increasingly becoming M&A.

Indeed, multinationals need to take an approach to deal-making that suits the current business reality in China. When it comes to deal structures, that means being innovative and flexible. Not only will this increase the chances of closing the deal in the first place, but also improve integration and enhance the performance of the business over the long-run.
Specifically, we see how a simple majority stake, or a two-stage acquisition, both help to keep Chinese owners of private companies involved in their businesses for longer. Together, they are the preferred deal structure for ⅔ of companies in our survey.

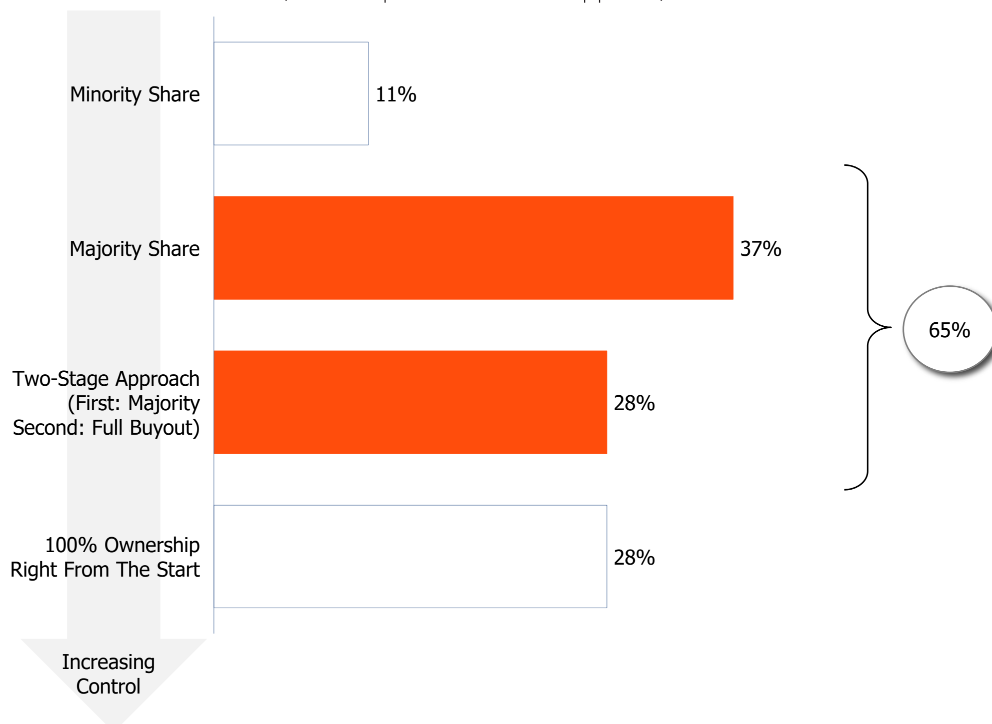
But many attractive targets will be intent on IPO or already listed. Whereas in the past multinational companies may have passed them over, now they are deploying deal structures that enable them to proceed, including minority rights protection and buyout options.

And the use of divestments by multinationals to bring in strategic or financial investors to the China business is demonstrating that acquisition is not the only path to localization in China. While still relatively uncommon, it will become an increasingly relevant option for an increasing number of multinational companies.

Chart #3

**Deal Structure**

Q: What is your preferred deal structure for acquisitions / JVs?
(n = companies with deal appetite)

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## About InterChina

InterChina is the leading advisory firm specialized in China. Our multinational and Chinese clients choose to work with us because we provide real understanding, deliver practical results, and know how to get things done. We are a partner led firm, and distinguish ourselves by the deep level of engagement partners have in client projects.


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