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China Portfolio Reposition – Managing Divestitures and Restructuring

The Chinese economic environment has changed dramatically over the last few years. For multinationals this warrants a careful review of their China operations, and of the long-term competitiveness of their portfolio and divestment strategy, says Barry Chen.

Author

Barry Chen, Partner-in-Charge

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The Chinese economic environment has changed dramatically over the last few years. For multinationals this warrants a careful review of their China operations, and of the long-term competitiveness of their portfolio and divestment strategy, says Barry Chen.

Multinationals have been restructuring, and sometimes divesting, of their Chinese operations for many years now. Indeed, in recent times we ourselves have advised on a string of divestments for overseas businesses across a broad range of sectors.

For instance, we advised premium global shipping company Odfjell on the divestment of its equity interest in three liquid chemical storage terminals/joint ventures in China. The divestment was due to a global initiative to exit certain terminal operations where Odfjell felt it was not capturing synergies.

We have also advised ALS Global, a global leader in testing, inspection and certification, on the sale of their China laboratory operations, and Acorn International on the sale of its famous posture correction brand. And we've also advised Aviko, a worldwide leader in potato processing, on the divestment of its equity interest in a JV.

Divestment doesn't always mean withdrawal

But divestment does not necessarily mean withdrawing from China. In fact, in recent years many multinationals have used Chinese divestment to further grow their business in the country while retaining stakes in their Chinese operations.

Likewise, Chinese companies continue to have a strong appetite for picking up the assets of multinationals which may be better managed from a compliance point of view, have very professional management teams, and have excellent technology, plant and equipment.

That said, driven by the continued fallout from Covid-19, slowing economic growth, increased competition, and continued geopolitical tensions, what is noticeable today is the heightened attention being given to strategic reviews in China with a focus on underperforming parts of portfolios and on possible restructuring and divestitures to lighten the load and make China operation more competitive.

Continued supply chain challenges due to covid restriction mean some multinationals are choosing to diversify their supply chains.

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Surveys

Our recent survey of more than 200 CEOs of multinationals in China indicates that a clear majority, over 70%, are still committed to China. However, this does not conflict with wider objectives to make their China business more competitive by restructuring and divesting underperforming parts of portfolios.

The wider divestment trend we are seeing is also borne out if you compare our survey of multinationals in 2022 with that of last year. In our survey last year of their corporate strategy, only 9% said they would probably divest or restructure from China in the coming two years, citing portfolio focus as by far the most important reason. The vast majority of multinationals at that time still said that organic growth was their main corporate strategy.

Fast forward to a survey of almost 250 companies in June this year and a very different picture emerges. Today some 38% of companies said they are considering divesting a business in China. Again, portfolio refocus is cited as the biggest reason with almost half citing this.

Portfolio refocus

As we mention above, what is driving this refocus is ultimately the need to remain competitive. In response to both specific Chinese and more general global challenges, having an active portfolio review right now is essential for multinationals, driven by the desire to both optimise financial returns and realise synergies within their global business.

Likewise, the huge change in the Chinese macro-economic environment in recent years, alongside this increasingly competitive landscape, is forcing permanent change on multinationals. It is therefore critical for them to understand the long-term implications of these changes and whether they should exit or stay in China. Whether they should continue to grow and spend capital, or whether they need to find options to dilute their risk profile.

The question is even more pressing given that the best time to sell is not to wait until a business deteriorates to the point that there is no longer any value in the company, or the market is flooded with sales.

And the picture is further complicated by the fact that many multinationals facing these questions will already have JV partners in China too. So the question they need to ask is whether the JV partner is still aligned with their goals, and if not what they need to do to address this.

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Divestment options

For some multinationals one answer to the above challenges will undoubtedly be a divestment strategy. But what form should this take? In short, there are three broad choices which will all depend on the individual situation:

- **A complete exit.** Companies may choose this route if they feel that their Chinese operation is consuming too much management time, that its performance is beyond repair, that it has no long-term competitiveness, and that it will never achieve meaningful scale in the country. Importantly, they also need to believe that there will be no material global implication to their business across the rest of the world.

- **Partial divestment.** In this way a multinational 'stays in the game' but a new partner helps drive growth. This option has become increasingly popular with multinationals which are both happy to cede control to a local partner to fund growth and to make the business a separate entity for listing either in or outside of China.

- **Divest a China business via a separate IPO.** This is a relatively new trend and one which can help multinationals create more 'China-centric' organisations which are closer to the market and which can help generate more motivated management teams. A good example is Yum China which operates the KFC, Pizza Hut and Taco Bell restaurants in China. The company was split off from its US parent and listed on the New York Stock Exchange in 2016 and the move has translated into healthy organic growth, market share gains and value creation for shareholders at both Yum China and Yum! Brands. However, unsurprisingly, the company has been hard hit by lockdowns in China and it said in July this year that the Covid-19 outbreaks in China continued to significantly affect the restaurant industry and its operations in the second quarter.

Process issues

With any divestment strategy multinationals face fundamental questions about what kind of process they want to adopt and need to think hard about potential issues they may face.

Whether seeking a full or partial exit, sounding out potential buyers and partners is an essential first step in terms of preventing many issues such as the financial capacity to consummate a deal, previous transaction experience, synergy potential, redundancy issues, or anti-trust or regulatory approval issues. Even when you have made the decision to exit, just shutting down operations overnight is rarely feasible. Not only is there the complexity of potentially dismantling supply chains that may have been built up over many years, but there are also heavy liquidation costs and complicated processes to resolve.

Dealing with JV partners

Dealing with JV partners is another area for careful consideration. We have recently advised on a number of JV exits and our experience suggests that although the JV partner could be a default buyer, in order to optimise valuation it is essential to run a third party buyer process. It is also important to build up a rapport between a potential new buyer and

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an existing JV partner.

All of which means that engaging an external advisor with experience of dealing with Chinese buyers is essential when considering a divestment. This will ensure objectivity, confidentiality, an expanded buyer's pool, management of a competitive bid process, and optimisation of the exit value. The advisor will also understand the Chinese buyer's real interest in the transaction, negotiation style, capacity to complete the deal, and what deal incentives for key management from the divested entity are required.

Open auction vs limited auction

If a complete exit is the chosen route then vendors need to decide on whether to pursue an open or limited auction.

In an open auction a broad range of potential buyers are contacted and there can be more than 10 bidders. The advantages are that strong competition of buyers achieves greater chance of getting the best price, and it gives an accurate test of what buyers are willing to pay for the business. The disadvantages are that it is easy for information to leak, there is a high risk of business disruption, and the process can be time consuming given the number of buyers involved.

In a limited auction only potential logical buyers are contacted. The advantages are that this gives a reasonably accurate test of what buyers are prepared to pay, the process is more controlled and easier to manage, and it minimises confidentiality breach and business disruption. The drawback is that it is difficult to achieve maximum value for the seller as you omit other potential acquirers.

Running an efficient process

To improve the chances of success, and to run an efficient process, there are a number of actions that can be taken:

- Try and identify deal-breakers prior to sale such as ongoing financial performance and likely synergies with the potential buyer.

- A realistic base-line valuation will provide a good foundation for negotiation and later stage decisions.

- Set expectations early to avoid wasting time with buyers which are not financially capable of completing a transaction.

- Understand how dealing with buyers in China can be very different to elsewhere in the world. Chinese buyers have a tendency to bargain hunt and place great value on tangible assets, while sometimes it can be challenging to have Chinese buyers stick to a timeline. Also, Chinese buyers often like to ask for valuation guidance early on before proceeding, as opposed to providing a valuation range at the Indication of Interest stage after the Information Memorandum has been distributed.

- Keep potential divestments confidential and limit the number of people within the organisation who know about the divestment.

- Appropriate deal incentive for key members of the management team is essential so that they cooperate in the deal process.

- Multinationals also need to conduct a thorough review of the following before divesting: any shared cost/allocated management fee which can be removed to reflect a fairer financial condition; where the IP resides and how to deal with IP rights post divestments; the assignment of customer contracts which are not generated from the China entity; transition services related to IT and back office support; procurements and sales support; any transfer pricing related issues.

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Optimising value

Finally, there are a number of specific actions that multinationals can take in order to optimise value from a divestment:

- **Make a right call on the timing of a sale.** This includes judgement on the future performance of the business, in terms of whether it will continue to deteriorate or marginally improve. From a preservation of value point of view, if the business requires continued funding and the prospect of improvement is not visible, then the right call is to sell now.
- **Preparation for sale.** Multinationals should have the mindset of financial investors, constantly looking at the return on investment and preparing the company for exit sometimes years before the sale. This includes setting up the right structure (e.g. putting the divested entity into a newco), preparing accounts, supporting infrastructure as if the business is a standalone entity, controlling costs, and scaling down on large future investments.
- **Identify the right buyer.** Find the right buyer prospects with the assistance of outside advisors who will look at the divested assets from a buyer's point of view. They will look at where the business potentially fits a buyer and at potential synergies.
- **Deliver a credible pitch.** This includes a strategic view of the business, intelligent explanation of past performance, and highlighting the potential of the business.
- **Tactical negotiation and process design.** Create competitive dynamics and negotiation tactics around the bidding process.

Author

Barry Chen

Partner-in-Charge, Shanghai
barry.chen@interchinapartners.com

Barry Chen provides overall leadership to InterChina's M&A advisory, corporate finance, and investment advisory practice. Barry has 20+ years of cross-border M&A, corporate finance, and strategic planning experience in the infrastructure/logistics, consumer, technology, manufacturing, retail, and financial service sectors. He has led and advised over 200 M&A and divestiture transactions, in the North American, Asia Pacific, and Europe at sizes ranging from $50 mn to $8 bn.

About InterChina Partners

InterChina Partners is the leading advisor on cross-border transactions related to China. We have been serving clients for over 20 years, closing close to 200 deals. We specialize in the acquisition and divestment of businesses in China, as well as Chinese outbound investment.

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InterChina

CONTACT US

+ 86 21 6341 0699

interchina@interchinapartners.com

Suite 1201, 100 Bund Square
100 South Zhongshan Road
Shanghai 200010, P.R. China

www.InterChinaPartners.com

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