Hot Focus

M&A Traps Hard to Avoid, “China Premium” on the Rise

How Diligent Should Due Diligence Be in Cross-Border M&A?

By: Teng Fei, IBD Reporter

American machinery giant Caterpillar’s painful fall into an M&A trap has been a continuously fermenting media story, and has once again led to a heated debate on the issue of risk prevention in cross-border M&As.

In its January 18th announcement, Caterpillar alleged that it “has uncovered deliberate, multi-year, coordinated accounting misconduct” in Zhengzhou Siwei Mechanical & Electrical Equipment Manufacturing Co., Ltd, a Chinese company that it had acquired last year, misconduct which led to a non-cash loss of US$580 million in the Corporation’s fourth quarter.

In recent years, cross-border M&A has become an important path for Chinese enterprises to “advance outward.” But some studies have shown that it is quite common for Chinese companies to pay premium prices, prices which appear to still be on the rise. The risks associated with such M&A deals should not be taken lightly.

On condition of anonymity, one Chinese lawyer told IBD that even highly experienced multinationals such as Caterpillar could hardly avoid all M&A traps. He added that Chinese companies, considered “novices” in cross-border M&A, should be extra cautious.

In an interview with an IBD reporter, Jeff McDermott, the founder and executive partner of US-based Greentech Capital Advisors, suggested that, in order to control M&A risks, firms need to build a list of suitable M&A targets and establish contacts with those target companies early.

“Professional and thorough due diligence is the only way for companies to reduce M&A risks,” said CIC researcher DUAN Jiaxuan in an interview with an IBD reporter. When Chinese enterprises pursue cross-border acquisitions, they should hire qualified professional institutions such as accounting firms and law firms to assist with due diligence.

Identifying the Causes

Some reports have said that in this particular case of accounting fraud, insufficient due diligence on the acquirer’s side was the root cause of the scandal.

So what should be investigated with regard to due diligence? What does due diligence entail? As Duan explained to an IBD reporter, due diligence means that in the process of an enterprise acquiring another company, the acquiring company, by working with intermediary agencies, conducts an assessment of the selling company’s administrative framework, production system, business conditions, financial situation, growth prospects and market risks. This involves the investigations of multiple items, including the target

company's historical data and files, the background of senior management, etc. This is the acquiring company's risk assessment of the M&A deal.

According to Duan, two possible reasons could have led to this particular scandal: one, major differences exist between the accounting principles followed by Chinese and international companies, causing the foreign due diligence team's failure to discover Siwei's financial problems; two, members of the acquiring company's management who were responsible for the project may have intentionally turned a blind eye.

As the anonymous lawyer above attested, the accounting firm hired by Caterpillar was a reputable institution. If the information and data Siwei provided were real, it was virtually impossible for there to be negligence in their reviewing work. One possibility could be that, after weighing all the various factors, the buying side still decided to proceed with the acquisition despite facing such risks.

"Particularly, a lawyer can help a buyer to devise a 'safety net' mechanism, which boosts the acquiring company's confidence." The so-called "safety net" this lawyer referred to is a commitment document, in which the seller guarantees the buyer that the information provided is real and reliable, or else the seller must compensate the buyer's damages.

"Generally speaking, the information that the seller provides can never be absolutely complete. This may cause the buyer to underestimate risk. Only when a deal is closed can the buyer have access to all the information and realize that the actual risks are far bigger than previously estimated," this lawyer said.

Risk Warnings

The aforementioned lawyer also told the reporter that, regardless of how Caterpillar stepped on this M&A "landmine," the lesson learned for Chinese enterprises here is that even highly experienced multinationals such as Caterpillar cannot avoid all M&A traps, and Chinese enterprises, considered "novices" in cross-border M&A, should be extra cautious.

According to the latest statistics from China's Ministry of Commerce, in 2012, China experienced non-financial direct investments of US$77.22 billion, a year-over-year increase of 28.6%. As China steps up its out-bound investment, Chinese companies also face accumulating M&A risks.

A survey conducted by Columbia University showed that the average "China premium" in cross-border M&A was going up. Statistics show that the average "China premium" was only 10% in 2008, while in 2011, this average jumped to almost 50%. Among energy sector M&A deals in 2012, The China Three Gorges Corporation offered a 53.6% premium over EDP-Energias de Portugal SA's stock price; the CNOOC offered a 61% premium in its bid to acquire Nexen, a record high "China premium" in 2012.

How to reduce M&A risks is becoming a real challenge for Chinese enterprises seeking out-bound investment opportunities. According to Duan, professional and thorough due diligence is the only way for companies to reduce M&A risks. "In particular, one key of due diligence is to try everything to acquire as much information as possible on the selling company's operations, management and productions, an aspect to which the acquiring company must attach full importance. The acquiring company's assessment

of its own business and acquisition capacity also plays an important part in controlling M&A risks. Furthermore, the acquirer should investigate the selling company's industry, including the seller's growth potential and industry risks. Only by understanding the situations of both the buyer and the seller and the environment of the deal can one minimize M&A risks," said Duan.

When interviewed by an IBD reporter, McDermott suggested that the best way to avoid premium risks was to make a "shopping list," in order to ascertain which companies are the most suitable targets. In addition, before these targets are put out for sale, the acquirer should take the initiative of approaching them early, in order to establish long-term friendly relationships and possibly become the selling company's buyer of choice, or at least to create awareness and acceptance with the seller.

McDermott argues that the process of evaluating the seller is also very important. "Once the deal enters the sales procedure, the acquirer should, with assistance from his investment bank and his legal and audit advisors, conduct an evaluation of the target company with thorough due diligence, in order to come up with a proper price. Otherwise, the premium risk will be really high."

The aforementioned anonymous lawyer suggests that it is also extremely important to select the right accounting and law firms, as they are the professional agencies that actually conduct financial and legal due diligence. "In doing due diligence, Chinese enterprises should select qualified and reputable agencies for their own protection. Otherwise it will not help companies to discover problems and take the appropriate remedies. Although the acquiring company has the final say in a purchase, the buyer should also fully respect opinions and advice from professional agencies."

McDermott added that the acquirer should hire an investment bank to conduct thorough research on the target company's products, services and competitions.

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