

DUE DILIGENCE IN CHINA

The Encyclopedia of Small Business defines Due Diligence as “a program of critical analysis that companies undertake prior to making business decisions” and, in China, that program requires significantly more than the practices commonly utilized in the West.

Prior to discussing the nuts and bolts of performing good due diligence in China, it is imperative that we ask ourselves some major questions regarding the decision under consideration.¹ What, explicitly, do we hope to achieve by the proposed transaction? What is the end game and what are the alternatives? Why is the proposed deal better than a greenfield operation?

Similarly, it is also wise to explore all of the reasons why local management recommends a certain approach in regard to a transaction. In our experience, many transactions in China are ego-driven and undertaken only to build the resume of local country management. Foreign-educated local managers are in high demand and tend to change jobs more frequently than in the West. Often, they will recommend actions that are in their own professional interests and not in the business interests of their employers, leaving unsuspecting PE funds and multinationals to pay the tuition. Ultimately, the head office will often need to send in a turnaround team to clean up a mess or wind down a failing operation that should have never been set up in the first place.

What will the company look like after the transaction and what is the reason for the transaction? Can a greenfield or some other business arrangement achieve the same result? What is the price and timeline of the alternative? If the transaction is to be a joint venture, will you be creating a formidable competitor after the marriage ends? What are the risks of the transaction and what mitigation strategies can you develop? After a sober review of these major issues, if the contemplated transaction still looks like the best strategy, you are ready to begin the due diligence process in earnest.

Two Types of Due Diligence



¹ For the purposes of this chapter, we will define the business decision as a merger, acquisition, investment or joint venture agreement.

PRE LETTER OF INTENT (Covert DD)

Cast a Wide Net

Once it is decided to proceed with a transaction, it is important to look at all the possible targets.

Many foreign firms will pursue a venture with their current supplier or, even worse, the first firm they find that is in their business. This mistake can be very costly as it can cause a firm to tie up with weak partner. Before revealing your intentions or making a commitment, it is important to learn all the players and their relative standing.

Diligence in this stage should be mostly from a market research or survey point of view. Once all the players are known, a proper analysis can be made of them and their relative strengths and weaknesses.

Search engines, B2B sites and other databases are a good way to get a general catalogue of who the players are. It is important to use the Chinese language and search engines for this, as western search engines such as Google are relatively incomplete in comparison to their local counterparts.

Pareto

The next stage is elimination of most of the candidates. Most people assume that China is one market. This is not the case. The Chinese market suffers from a great deal of local protectionism and, in many industries, national players have yet to emerge. Even in a market as fragmented as China's, however, we have found that over 80 percent of local players have no realistic prospect of going national.

Of the top 20 percent, a SWOT analysis should be completed for each potential candidate.² Again, from our experience, 80 percent of this group will exist solely because of some type of local subsidy or protectionism.

Thus, as a rule, the weaker 96 percent of Chinese businesses will eventually become extinct. They have no realistic long-term sustainability prospects, and we recommend our clients to look only at the strongest candidates of the remaining 4 percent.

Credit Reports

Once the remaining 4 percent has been identified, it is time to conduct some background checks on the companies. There are credit agencies available similar to Dunn and Bradstreet that generate some useful credit reports. Although, it should be noted that it is important that a competent financial analyst review the reports with a critical eye and follow up directly with questions to the target companies or develop a list of questions to ask for each company should it not be eliminated from the list of

² SWOT analysis: a common analysis technique that examines and weighs strengths, weaknesses, opportunities and threats.

suitors for other reasons. While such information can be quite useful, it is prudent to nonetheless treat it as highly suspect.

At this time it is often smart to have someone call the sales office posing as a possible client, initiating the more grassroots pre-LOI business intelligence work.

Cloak and Dagger

If things still look promising, one should visit the town of the target. Confirm that the physical operation exists before contacting the target.

Many firms are actually trading companies and do not own the factories they claim. It is not uncommon to have signage changed on a facility the day before a client is to arrive for a sales contract signing ceremony and a factory tour.

Have one of your team have a meal or two in restaurants that are nearby and talk to the waitress about the company. The meal is a very important part of Chinese culture and often people drink too much and company secrets become common knowledge. Drunk, disgruntled or laid off workers are usually pretty forthcoming with pertinent information.

We also recommend that you have background checks done on the principals of the company. There are dedicated firms that specialize in this type of diligence and it is wise to use them. There have been numerous incidences in the press of top management in Chinese NASDAQ-listed companies that have embezzled or diverted funds to private projects or personal companies. It is even more commonplace in the private firms. The enforcement and concept of law in China is not the same in the West and it is very difficult to win any type of litigation.

THE LETTER OF INTENT

Once the covert diligence is completed, companies are again ranked and analyzed. Usually, the selection from among the few remaining suitable candidates becomes self evident. At this time, one should approach the chosen firm with the proposition of a deal.

Westerners are often in a hurry to complete a transaction, but rushing the process can be costly and even fatal for a company's China entry strategy. We recommend a methodical and deliberate approach.

At this time, it is wise to sign a Letter of Intent or a Memorandum of Understanding. This a simple, non-binding agreement used for the purpose of giving each party comfort. Usually, it states that a company will reveal certain parts of its business to you in exchange for you investing, acquiring or merging. Often a nondisclosure provision is included.

Many PE firms have dedicated teams for this sort of negotiation. If, however, they have not completed a transaction in China, we recommend that outside professionals that have negotiated Chinese JVs or acquisitions be retained.

An important provision that should be included in the LOI/MOU should be a “No Shop” clause. It is not uncommon for a Chinese firm to begin side negotiations with another PE firm or strategic player to drive the price higher. Some of the smaller Chinese PE firms will not do any due diligence, but it is rumored they have been known to pay off low-level personnel in companies to learn whom the foreign players are diligencing. Although not strictly-enforceable, combining a No Shop clause with a binding offshore arbitration clause will discourage most such skullduggery.

Often the Chinese party will not agree to a formal on-site due diligence team visiting without a previously agreed-upon price. Many firms do not grasp the concept of discounted cash flow (DCF) or other future cashflow valuation methods. It is not uncommon that prices are termed in multiples of sales or net assets. If this is the case, it is wise to put clawbacks into the agreement that will reduce the price once full acquisition costs are understood following the formal due diligence exercise.

POST LETTER OF INTENT – (Overt or Formal DD)

This stage is the overt due diligence that most people think of when discussing due diligence. There are two major methods for doing this in China: (1) an options approach; (2) a cross-functional approach. Conducted correctly, due diligence can be expensive, so people will often try to cut corners using a staged or options approach.

DD Methodology #1: Options Approach (Staged Approach)

A staged approach to diligence will explicitly define and enumerate obvious deal-killers in advance, and then look for those deal-killers first. If they are not found, the team will proceed deeper into the due diligence process.

Advantages of the options approach is that it may save money as it allows the investor to discontinue the diligence process before the diligence is complete and, should the deal go through, it affords the team a better assessment of the company culture and key staff (due to the fact that more time is spent on-site); something that is often overlooked as a factor in the success of a transaction.

Disadvantages of this approach include that it is more time-consuming and is not as rigorous, so it may not uncover all of the off-balance sheet liabilities.

If the pre-LOI diligence steps have been done correctly and only the very top candidates are being considered, then the cross-functional approach is the better due diligence methodology.

DD Methodology #2: Cross-Functional Approach

This method employs a team of dedicated professionals from different disciplines.

Its chief advantages are that the company can be more thoroughly valued and understood as each member of the team looks at the same information from a slightly different perspective; i.e. a lawyer reviewing a contract for legal risk, an

operations professional reviewing a contract for execution risk and a finance professional reviewing for financial risk.

In addition to the varied perspective the cross-functional approach brings, another advantage is that the time it takes to complete the diligence process is greatly reduced. This is important, as the diligence process is inherently disruptive and can cause anxiety in a company, creating tension in the deal. The sooner the team gets in and out, the less disruption takes place, and upper management is more open to completing the transaction.

When using this approach, it is critical that members of the team meet on a daily basis during the site visit to discuss their findings and compare notes. As in the West, checklists are one tool that should be used. We recommend that the checklist be kept on a common database and that each member of the team answer the same question independently. It is not uncommon to get conflicting information, which should be flagged for follow-up, clarification and reconciliation.

The greatest disadvantage of the cross-functional approach is cost and coordination between the various participants, as the true experts usually come from different firms.

Additional Checklist Items: China-Specific Considerations

As mentioned above, checklists are an important tool to cover the standard issues encountered in the West. In China, however, they really are just the beginning.

In addition to a standard DD checklist, additional considerations that should be reviewed are:

- How does the central government classify the industry? The PRC government has classified industries into four categories: encouraged, neutral, discouraged, forbidden. Government policy dictates whether and on which terms an industry can have outside investors.
- Hidden owners/ stakeholders: In the 90's, verbal contracts became legally-binding, and there are many people in the firm that are able to demand that it honor such agreements. It is also not uncommon for local government officials to receive certain benefits or services from a firm that are not recorded and for these services to be expected to continue.
- Shadow companies – two types:
 - Type one is the most often-discussed. It is when a JV partner will set up a mirror operation of the new operation after a transaction. It is most common if the foreign firm is a strategic investor that upgrades knowhow or methodologies. In this type, it is not uncommon to run two payrolls through the company—one for the company itself and the other for the shadow.

- Type two is usually found in a state-run firm. Management will often go into business for itself by running a 2nd or 3rd shift or using company assets to run an unrelated business.
- Tax GAAP: With the exception of public companies, most firms keep records in the old PRC GAAP, which is currently referred to as tax GAAP. This GAAP is actually a mixture of cash and accruals and can severely misrepresent the company's financial condition.
- Land use rights: In China, you can not own land. However, you can purchase the land use right. It is mission-critical to confirm that the land use right is owned by the same company (not the parent or affiliate company) with which you are contemplating a transaction. It is also not uncommon to find that the land use right was never transferred correctly and that the land is zoned for farming or something else.
- Off-balance sheet liabilities: Off-balance sheet liabilities, such as unrecorded accounts payable and extra employees on payroll, are common in China and can pose a problem. A skilled team will know ways of bringing them out through the casual conversations they bring up over meals or during the course of the day.
- Contingent liabilities: It is important that all contracts are reviewed by competent professionals knowledgeable in Chinese legal language. Contracts can be very obtuse and interpreted differently by each party. It is best to err on the side of caution when identifying and quantifying these types of risk.
- Verbal agreements: As noted above, verbal agreements are legally-binding. A good team should identify, summarize and quantify these agreements.

Site Visit

The best site visits are conducted by a cross-functional team of finance, operational, HR, environmental and legal people at once. Each group will look at the company from a different point of view and, by comparing notes, will uncover more information than individual visits.

In the West, the diligence team would typically sit in a war room and pore over piles of documents. This will simply not work in China, as much of the documented information is intended to mislead the tax collector or other interested parties. The only way to understand the business is to walk around and talk to people.

Talking to lower line staff rather than management usually enables a diligence team to get a truer picture. Machine operators and security personnel are especially useful.

Process Mapping

It is often stated that a company will keep more than one set of books. How then does the diligence team determine if the books they are looking at are a true representation of the company?

One tool that we have found that is useful is process mapping. Mapping all of the processes, especially production, allows a team to identify bottlenecks, assets that are not used, and to model the business. It is not uncommon to find after a mapping session that a company's business is not collecting all of the accounting information.

Mapping allows the diligence team to quickly identify and assess control weaknesses that would be omitted from record keeping.

Only by mapping and then financially modeling the business using fraud and forensic techniques is it possible to confirm if the accounting records are realistic.

Letting the mapping process drive the interviews and your site visit is the quickest way to get up to speed on a business and forensically test whether the information that is in the accounting system is in line with what you see on the shop floor.

Supporting Documentation

Accounting departments in China often only work from an invoice or "*fapiao*." If an invoice is not generated then, as far as the accounting department is concerned, no transaction ever existed.

For this reason alone, a good team will look for other (including outside) documentation to support the accounting information. It is more common that other documentation will yield a truer picture of reality.

Modeling

Once the above is complete, we recommend using a spreadsheet program to model the operation using numbers the team firmly believes to be true as drivers. Particular attention should be paid to the process constraints and to the fixed and variable costs of the operation. It is not uncommon for a firm to falsify its records, and good modeling will easily identify whether the current ledgers are reasonable. During the modeling phase, it is important that the team make sure that the full costs are accrued. This would include the costs incurred from verbal barter agreements, off-balance sheet liabilities and the commitments associated with government favors and relationships or "*guanxi*"

Deal type

The diligence exercise should dictate the type of deal that is feasible. In many cases the risk of an equity deal is too great. Local management does not have the same concept of risk as does management in the West, and it may have put the company itself in peril. In this instance, an asset deal is a more viable solution.

Under a share deal, everything transfers, including aspects that may have remained murky following the due diligence process. Asset deals allow the company to pick and choose among the assets to change ownership and are conducted with the assistance of a professional asset appraiser. Note that for an asset deal to be viable, your firm will need a registered legal entity that is legally allowed to accept the assets

that will be transferred. In some cases, assets are not transferrable at all under local law and, in any event, different taxes often apply.

Business valuation

Business valuation techniques employed at this stage are by no means unique to China, but some special points are worthy of note. First and foremost, the valuation under any method should be driven by the due diligence numbers themselves, including all the hidden and off-balance sheet costs. The analysis should also be careful to avoid counting overhead for unused capacity as a part of actual inventory value; overhead for unused capacity largely represents waste and should be removed from inventory numbers for valuation purposes.

As indicated above, use of sales and net assets multiples for the relevant industry is one widely-accepted method in China. When using multiples, it is useful to bear in mind that, if the existing market in China is weak or non-existent relative to the comparables, then the result will be an inflated number. Due to wide acceptance in China of industry multiples of sales and net assets for valuation, it will likely be easier to use them as a communication tool. This is true even if your company is actually employing a different method altogether—a DCF number, for instance, can simply be expressed as a multiple.

For deals in which sales are highly uncertain and are dependent on one or a few major events, including blockbuster R&D projects and abstract, long-term, strategic “we cannot afford not to establish a beachhead in China” projects, a valuation utilizing real option methodology may give a clearer picture of the risk and opportunity.

Discounted cash flow methodology is, in most cases, the best tool. As noted above, however, DCF, useful internally, has limited currency in China and is usually an extremely hard sell. In addition, the discount rate must be meticulously built-up by a party with extensive, China-specific micro- and macro-economic acumen. One of the biggest mistakes strategic buyers make is they assume the discount rate is the same as their company’s cost of capital. This is a very dangerous assumption as that rate, even if the industry is the same, does not reflect sovereign and currency risk.

Conclusion: Negotiating the Minefield

While daunting, good China due diligence is quite rewarding, as it allows a company to snatch up bargains and back away from lemons—both are abundant in Chinese M&A and JV deals. Having conducted thoughtful analysis of the kind that the Chinese side might well be unequipped to perform itself, quality diligence can be a source of a powerful informational advantage. However, diligence of the sort outlined above remains, above all, a necessary risk-mitigation technique for an environment that lacks guarantees often taken for granted in the West.

From the initial “logical audit,” which examines the validity of the value proposition, to the exhaustive identification and narrowing-down of potential partners/ targets, to grassroots business intelligence, to in-depth examination and analysis of the business, each phase of the diligence process is a necessary step to avoiding

catastrophe and capturing value. They are arranged roughly in order from less-expensive to more-expensive, so as to avoid as much as possible wasting precious resources investigating Potemkin villages.

About the author

James Boyle, "Jay," has lived and worked in China since 1996 in numerous financial roles for industry and is the Managing Partner of Expat-CFO Services, a boutique financial consultancy providing transaction advisory for pre- and post-acquisition.

For further info see <http://www.expat-cfo.com> or contact Jay at jay.boyle(AT)expat-cfo.com

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