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KPMG China, Deal Advisory

# Negotiating letters of intent in China

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Charting a successful long-term course in China for new entrants can be a challenge at the best of times. Even more so for entities with scant deal experience seeking a foothold via M&A, given a tendency by some to cling to business models or strategies that may have met needs historically in home markets, but which fail to factor in the scope or intricacy of considerations inherent in China.

Lately, we've seen a new wave of companies – of which an increasing portion are family owned or small to mid cap entities – seeking to enter China. Many of these companies are non-serial deal makers, and many, in our experience, have embraced steep learning curves in the PRC when it comes to one of the most critical pre-deal elements in a M&A: the letter of intent (LOI).

However, LOI effectiveness can easily be reduced if certain locale-specific steps are skipped. While LOIs are usually not legally binding, they can be central in terms of confidentiality, exclusivity and cooperation. But crucially, disparate expectations (especially in China given potentially opposing cultural influences) can lead to unnecessary waste of time, funds and resources.

A prime area where expectations can collide is the justification and process each party – say party *α* from the West and party *β* from China – adopts to arrive at their respective notion of equitable deal price. Party *α* might typically use a multiple (x) of EBITDA (earnings before interest, tax, depreciation and amortization) to formulate deal price. In contrast, party *β* might typically expect a hard-coded deal-price figure (in mind from the outset) as the formal deal price, regardless of any multiples or earnings adjustments presented by party *α*.

Specifically, the Western method of using quality of earnings adjustments to arrive at deal price may bear little weight in China in some scenarios, given a pre-disposition by some PRC business owners to place greater emphasis on historical cost or less quantifiable (or less comparable) facets – such as what a friend's business sold for, or the consensus/outlook of a local industry body.

In principle, an argument could be made for either the Western or Chinese approach, and the conflict can be exacerbated given no – or very limited – public access to accounts and databases (e.g. tax accounts) via which data for multiples might be available.

To counter such potentially opposed expectations in the PRC – and more so lately regarding the prior-mentioned new entrants (some with little or no experience with LOIs) – we're increasingly initiating 'rapid assessment' (RA) due diligence (DD) for clients on targets before LOIs are formulated, in order to gain a 'sense of smell' of key issues. The RA can take form as simple as a few key interviews from a high-level accounts perspective; this can identify a vast majority of the issues impacting on valuation and/or on the likelihood of consummating a transaction. These issues can then be more effectively addressed in LOIs and subsequent DD if proceeding further, saving costs.

Another issue is potential disparity between data and figures provided by a target, often a result of substandard financial reporting and controls, making it difficult for the foreign company to determine valuation.

Further, deal structure – whether an asset or equity deal – can have significant bearing in respect to inheriting (or not) historical liabilities, in addition to subsequent regulatory compliance. This aspect can be especially pertinent to small and mid-sized targets in China, and must be factored in.

Besides enhanced cooperation from the target to root out actual figures, and thus a more representative historical performance, other benefits that can flow from such RA and tailored LOI include:

- enhanced access to management and appropriate personnel given a clearer agenda
- avoidance of protracted negotiations given clearer terms from the outset
- identification of key due diligence issues making subsequent due diligence phases more efficient.

All up, a pre-deal rapid assessment can be a relatively simple step with potentially strong benefits that any company – regardless of size or deal experience – should consider as part of any M&A-related DD.

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