KPMG

Our view

KPMG China, Deal Advisory

July 2017

Partnering with SOEs – a new path for growth?

A renewed interest among both multinationals (MNCs) and state-owned enterprises (SOEs) in China to form joint ventures could be emerging given Beijing's recent explicit encouragement for private companies to participate in the nation's ongoing SOE reform[1]. Such notion is supported by comments from China's State-owned Assets Supervision and Administration Commission (SASAC) in April regarding private companies being more market-conscious – and thus faster to react to issues such as overcapacity – than SOEs[1].

With more than 20 provinces and cities stating SOE reform would be a priority this year[2], in addition to SASAC recently reiterating SOE reform would be a focus for 2017[3], a more concerted effort seems in the works to improve capital allocation, lessen production overcapacity, and make SOEs leaner and more efficient.[2] Currently, China has about 150,000 SOEs, employing some 30 million people and holding more than CNY100 trillion (USD14.69 trillion) in assets.[4]

While market access, scale, and growth prospects – all potential benefits from teaming up with an SOE – would constitute an attractive proposition for many MNCs, China's complex landscape (varying provincial rules regarding SOE reform, need for SOE control, restricted sectors etc.) among other challenges around MNC-SOE JVs conceivably might also dampen enthusiasm for some.

However, viable arrangements are attainable. Two major recent examples include the strategic partnership between Sanofi and China Resources Sanjiu that would focus on consumer healthcare products and opportunities in China[5], and the JV between Imperial Brands (formerly Imperial Tobacco) and state-owned China National Tobacco, incorporated earlier this year as Global Horizon Ventures Limited.[6]

Key challenges in dealing with SOEs would typically center around their need for majority control, compliance matters, valuations, transaction experience, access to information, cashflow/ funding and agreement on the future business operating model, to name a few.

SOEs generally require control (i.e. more than 50% ownership). Likewise, MNCs would also have concerns over control, particularly in respect to home-country or headquarter jurisdiction compliance matters.

Options to resolve such potential impasse can include the forming of a 'twin JV', while a JV agreement wherein the MNC has minority share rights to full audit and access to information systems might also be considered.

Source: 1) *SOE reforms prove profitable*, english.gov.cn, 14 April 2017; 2) *Central SOE mixed ownership reform to get green light soon*, chinadaily.com.cn, 25 April 2017; 3) *Better management set for SOEs' assets*, chinadaily.com.cn, 10 March 2017; 4) *Shanghai to shake up state enterprises ownership*, chinadaily.com.cn, 17 February 2017; 5) *Sanofi joins forces with China Resources Sanjiu*, otctoolbox.com, 6 December 2016; 6) *Imperial Tobacco Follows the Well Trodden Path to China*, blog.euromonitor.com, 15 February 2017. Credit: Nick Lindsey (Editor, KPMG China)

The twin JV option, for instance, could comprise say a production entity and a commercial entity with ownership allocated at inverse proportions – i.e. the SOE owns 51% of the production entity (MNC owning 49%) while the MNC owns 51% of the commercial entity (SOE owning 49%). This can allow the MNC to control aspects regarding key business relations, distribution networks and IP, while simultaneously satisfying SOE control requirements.

And for valuations, a pivotal deal make-or-break aspect, pre-valuation discussion in terms of highlighting possible sticking points can be key. A typical challenge might be when one party, say the SOE, contributes fixed assets and land use rights, while the other party, in this case the MNC, contributes more intangible aspects such as IP. The MNC's intangible assets (in particular know-how) can be difficult to value under China Valuation Guidelines, especially as often there may be little to no comparable transactions or comparable JVs/companies in the marketplace to support what either party considers fair value.

Treatment of IP in particular can be a complex and lengthy process entailing significant discussions given potentially differing appreciation for IP valuation between the Chinese and Western cultures. Often, the Western party might tend to want an upfront fee and subsequent royalties in addition to the capital contribution from the Chinese party or SOE. However, to reach an agreement, less focus on the technical calculations often used in Western valuation methods to value IP might be needed in place of discussion on how to actually use the IP for commercial purposes, to demonstrate and quantify the value.

Also, transactions involving SOEs in China require a statutory valuation, which must be done by a local, government-appointed valuation firm. In such circumstances, it can be worthwhile for the MNC to still conduct its own independent valuation for comparison or negotiation purposes as needed. Monitoring the statutory valuation process from the outset can also assist.

Sustainability of any beneficial government arrangements (e.g. subsidies, preferential tax treatment, or related-party transactions) should also be assessed, given discontinuance of some or all such arrangements post-deal could have significant ramifications.

Coupled with this is the need to determine the SOE's existing financial commitments and ability to fund future JV growth. While prevailing mindset among SOE management might be inclined towards an assurance the government would step in regarding any future funding needs, the reality might likely differ once the JV becomes operational. Clarity on financial strength and future funding sources is crucial.

Further, underestimation by the SOE as to depth of assessment needed by the MNC – in addition to the necessary access to information or time-investment needed regarding operating model going forward – means initial framework agreements must be negotiated to clarify the requirements of both the MNC and SOE, especially where complex carve-outs are involved. Such agreements can facilitate due diligence momentum, reduce bureaucracy and help determine suitability regarding strategic fit and feasibility of realizing a workable roadmap.

Finally, retaining talent – in addition to securing the commitment of SOE senior management to the JV from the get-go given a perception career path may be in jeopardy – are also issues that can be addressed via early intervention and a clear integration plan to put minds at ease.

Contact us

Linda Chen
Partner, Valuation & Modeling
+86 (21) 2212 3660
linda.l.chen@kpmg.com

Mark Harrison
Partner, Deal Advisory
+86 (21) 2212 3620
mark.harrison@kpmg.com

kpmg.com/cn