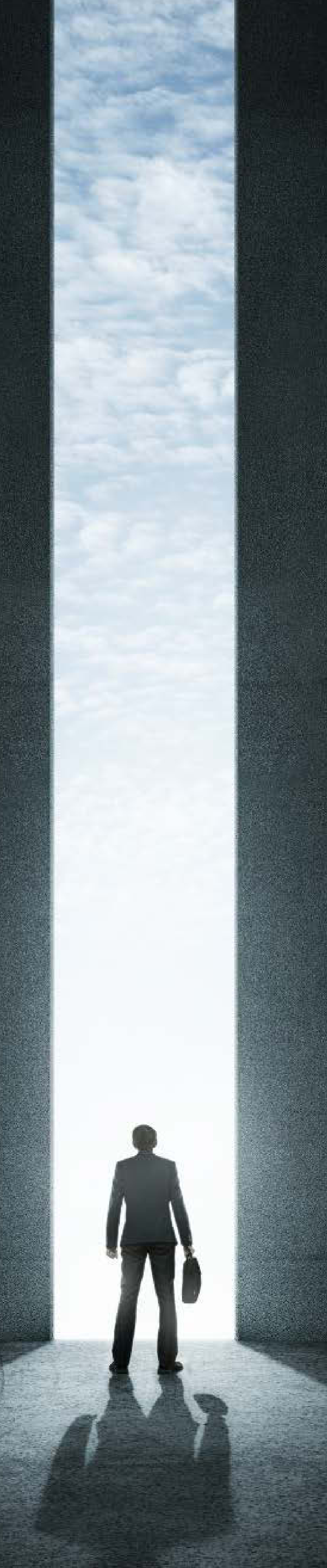
Chinese A-share Companies: Outbound M&A Update

Second Edition

September 2017



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Executive Summary

Outbound mergers and acquisitions (M&A) are a key part of the growth strategies of Chinese listed companies as they continue to expand their global footprint.

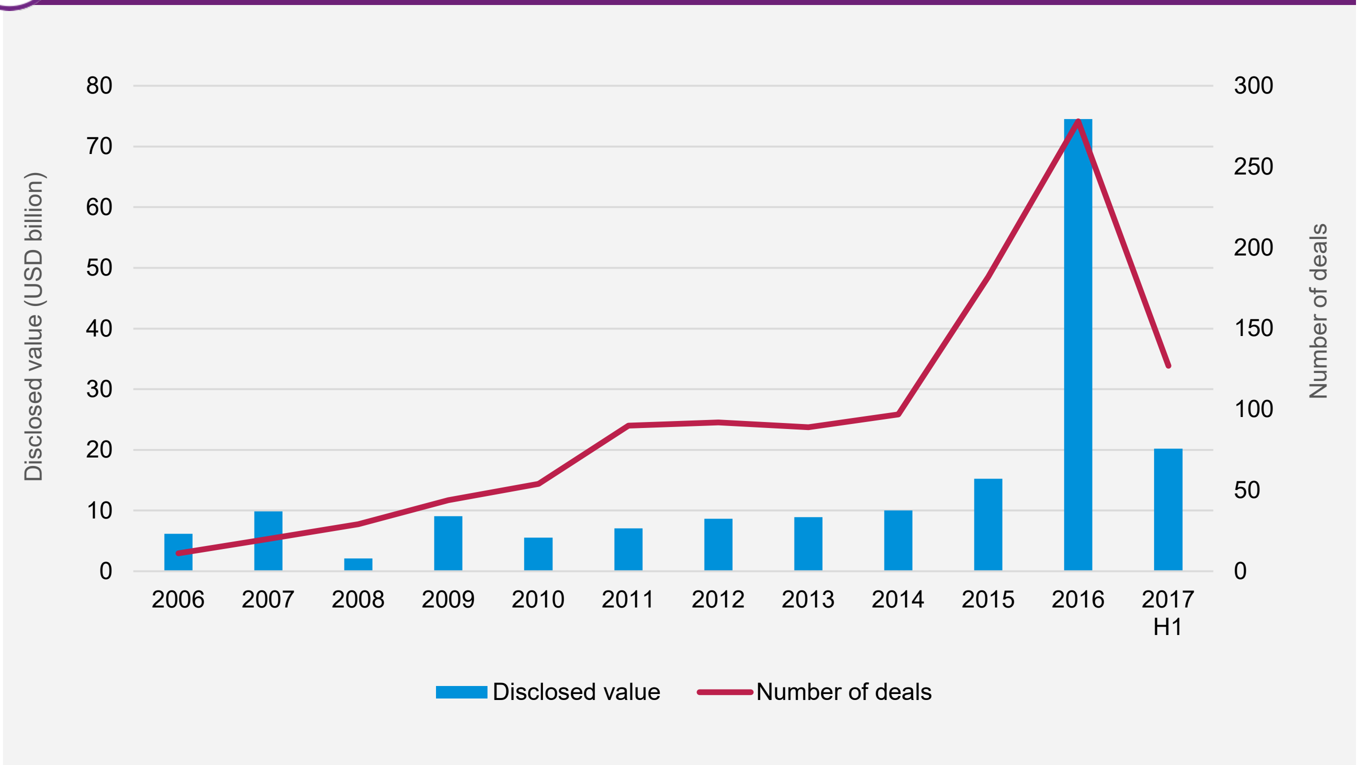
The Computers and Electronics sector was a key target of Chinese investors and accounted for nearly 25 percent of the total number of deals in 2017 H1. Meanwhile, the Healthcare sector ranked second in terms of the number of M&A transactions. The majority of transactions in the Healthcare sector focused on pharmaceuticals, medical instruments, and analytical systems.

Our findings show that Chinese companies are starting to focus more on post-acquisition activities. This includes improving their ability to integrate different businesses in order to realise synergies from their acquisitions.

Introduction

Following the explosive growth in Chinese M&A activity last year, there was a moderation in outbound activities during the first six months of 2017. The disclosed transaction value in 2017 H1 by Chinese A-share companies totalled USD 20.2 billion, down 49 percent from the same period last year. Despite the slowdown from last year, the disclosed value in the first half of 2017 is still more than full year 2015, indicating that Chinese companies' appetite to invest overseas remains.

Chinese A-share companies: Outbound M&A transactions (2006 - 2017 H1)



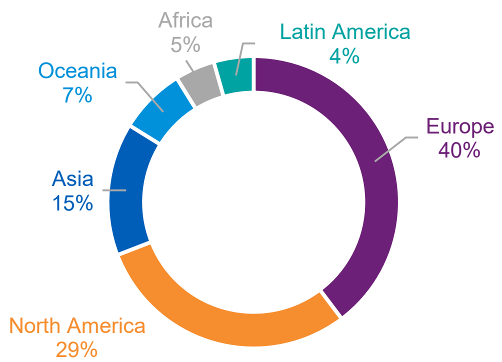
Source: Dealogic. KPMG analysis is based on all announced M&A deals by Chinese A-share companies.

Note: In this report, all M&A data was obtained from Dealogic on 1 September 2017. Data does not include any alteration or cancellation of subsequent transactions unless otherwise indicated. Outbound transactions of targets in Hong Kong, the British Virgin Islands and the Cayman Islands are excluded from all statistics in this publication, unless otherwise stated.

Analysis of Chinese A-share companies: Outbound M&A transactions

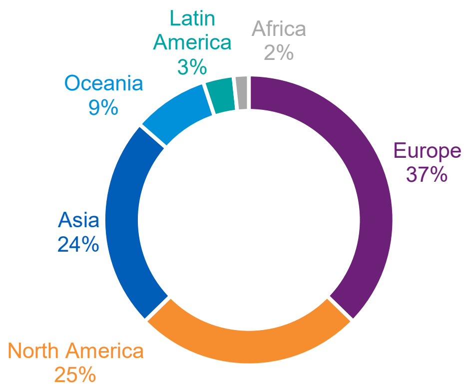
Geographical distribution (No. of transactions)

No. of transactions by region - 2017 Q2



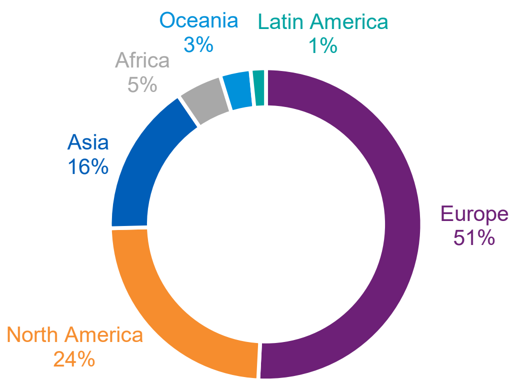
Source: Dealogic, 1 September 2017

No. of transactions by region – 2017 Q1



Source: Dealogic, 1 September 2017

No. of transactions by region - 2016 Q4

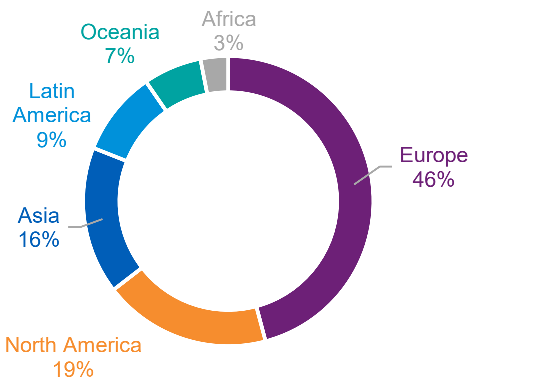


Source: Dealogic, 1 September 2017

Europe was the leading investment destination for Chinese A-share companies, taking the top position in each of the three quarters as shown above. North America was second, followed by Asia.

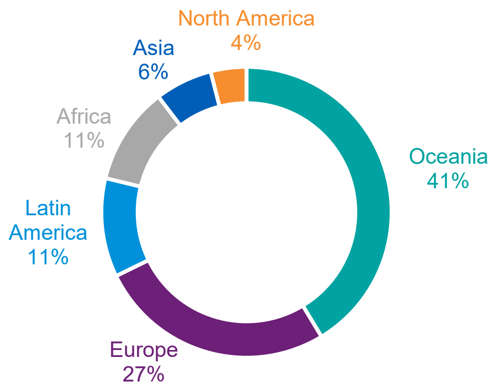
Geographical distribution (Deal value)

Deal value by region - 2017 Q2



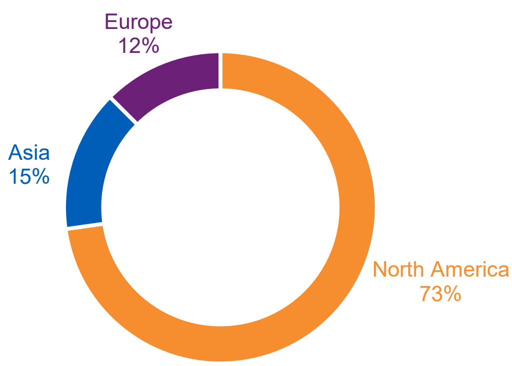
Source: Dealogic, 1 September 2017

Deal value by region - 2017 Q1



Source: Dealogic, 1 September 2017

Deal value by region - 2016 Q4



Source: Dealogic, 1 September 2017[1]

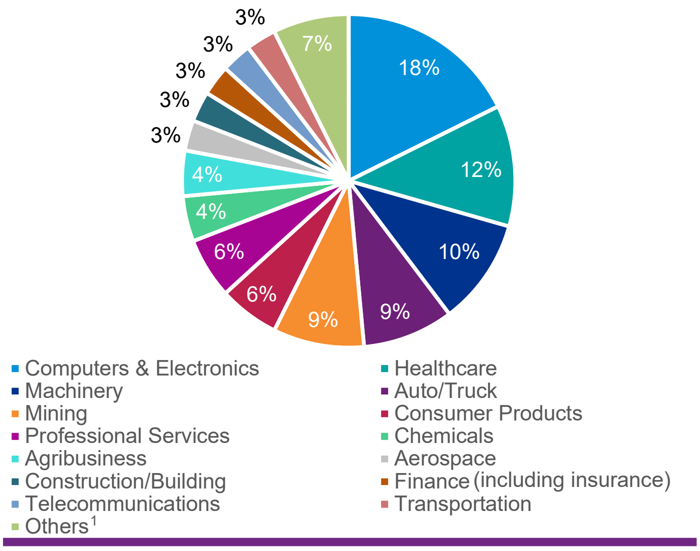
In terms of deal value, Oceania and Europe were the top two destinations in the first half of 2017. Some of the key transactions announced in this period include:

- Yanzhou Coal Mining's USD 3.1 billion acquisition of Coal & Allied Industries Ltd, an Australian mining firm
- Ningbo Joyson Electronic Corp's USD 1.6 billion acquisition of Takata Corp[2], a Japanese automotive airbag manufacturer
- Yinyi Real Estate's USD 1.2 billion acquisition of Ningbo Dongfang Yisheng Investment Co Ltd., a holding company focused on manufacturing automotive gearbox and transmission parts in Belgium.

[1]The deal values of Oceania, Latin America and Africa in 2016 Q4, which were 0.20%, 0.07% and 0.04%, respectively, were not large enough to reflect in the chart.
[2]The acquisition does not include the assets of PSAN business.

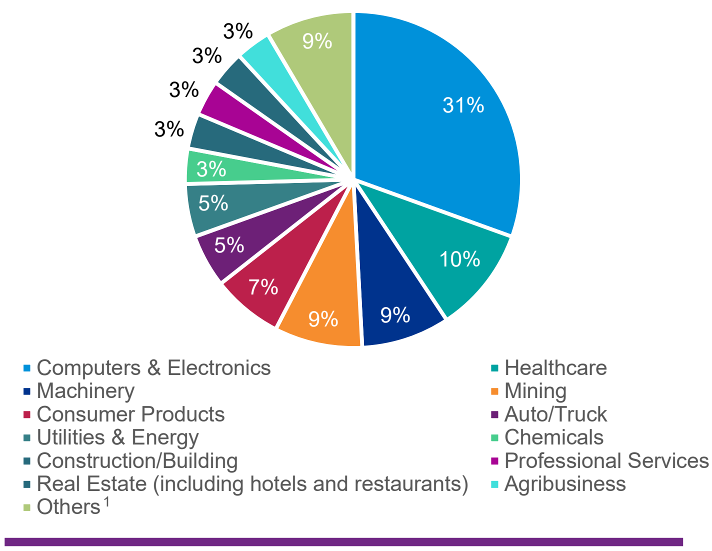
Industry breakdown (No. of transactions)

No. of transactions by industry – 2017 Q2



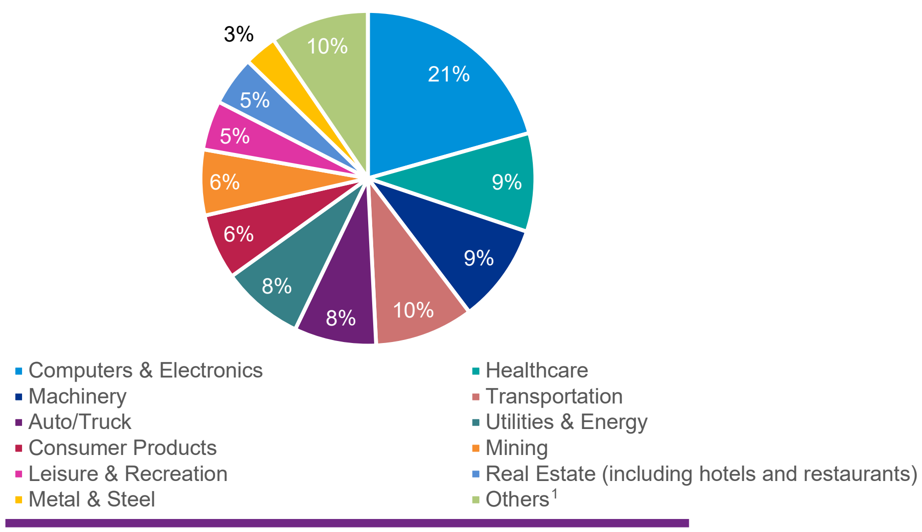
Source: Dealogic, 1 September 2017

No. of transactions by industry – 2017 Q1



Source: Dealogic, 1 September 2017

No. of transactions by industry – 2016 Q4



Source: Dealogic, 1 September 2017

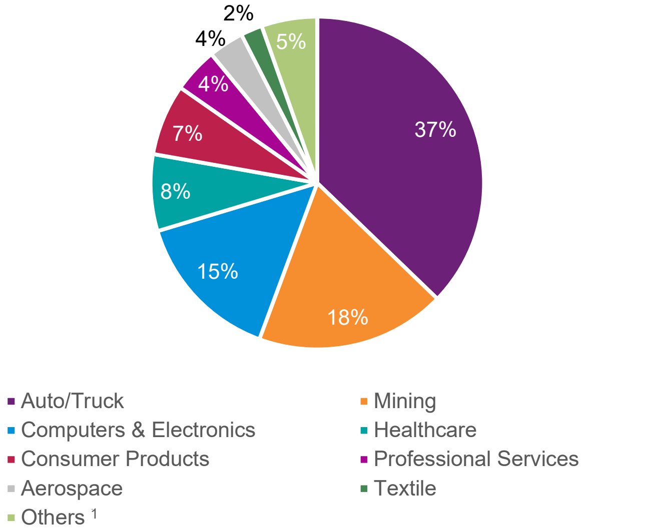
Industry breakdown by number of transactions:

- The Computers and Electronics sector came first in all three quarters. It accounted for nearly 25 percent of the total number of deals in 2017 H1 with 30 transactions. Chinese investors were mostly attracted by companies focusing on software development related to online business such as mobile gaming and medical diagnostic platforms. This reflects their efforts in growing the digital economy.
- The Healthcare sector has also seen continued investment from Chinese A-share companies and was second in terms of the number of M&A transactions. The majority of transactions in the Healthcare sector focused on pharmaceuticals, medical instruments, and analytical systems.

[1] "Others" included those sectors whose share in the total transaction number is below 3%.

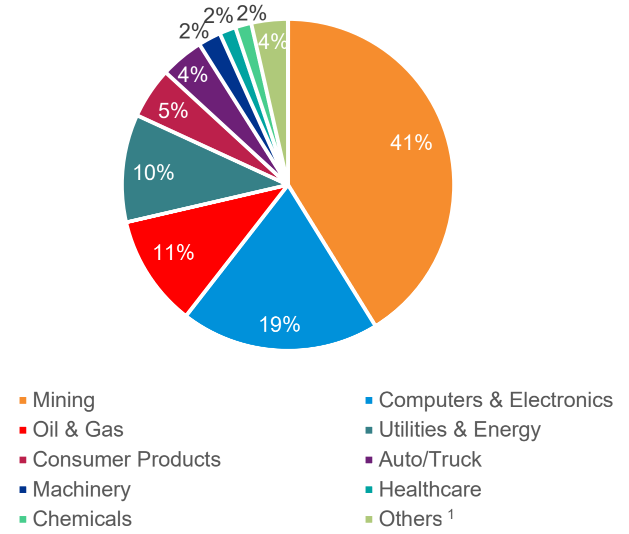
Industry breakdown (Deal value)

Deal value by industry - 2017 Q2



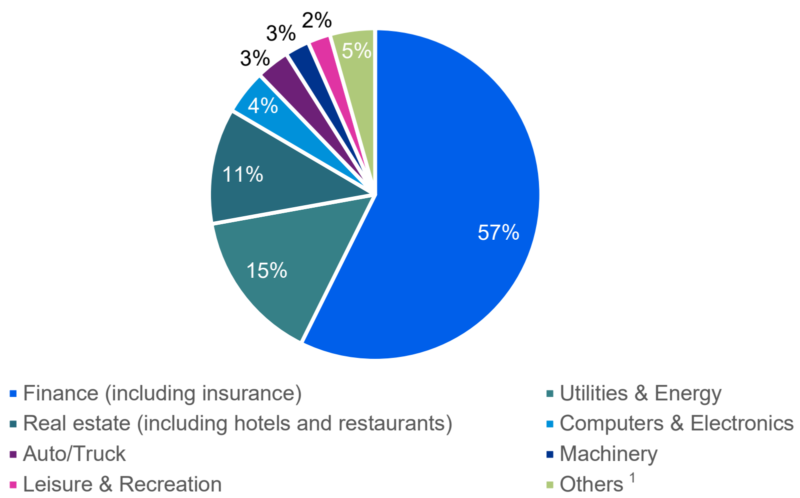
Source: Dealogic, 1 September 2017

Deal value by industry - 2017 Q1



Source: Dealogic, 1 September 2017

Deal value by industry - 2016 Q4



Source: Dealogic, 1 September 2017

Industry breakdown by deal value:

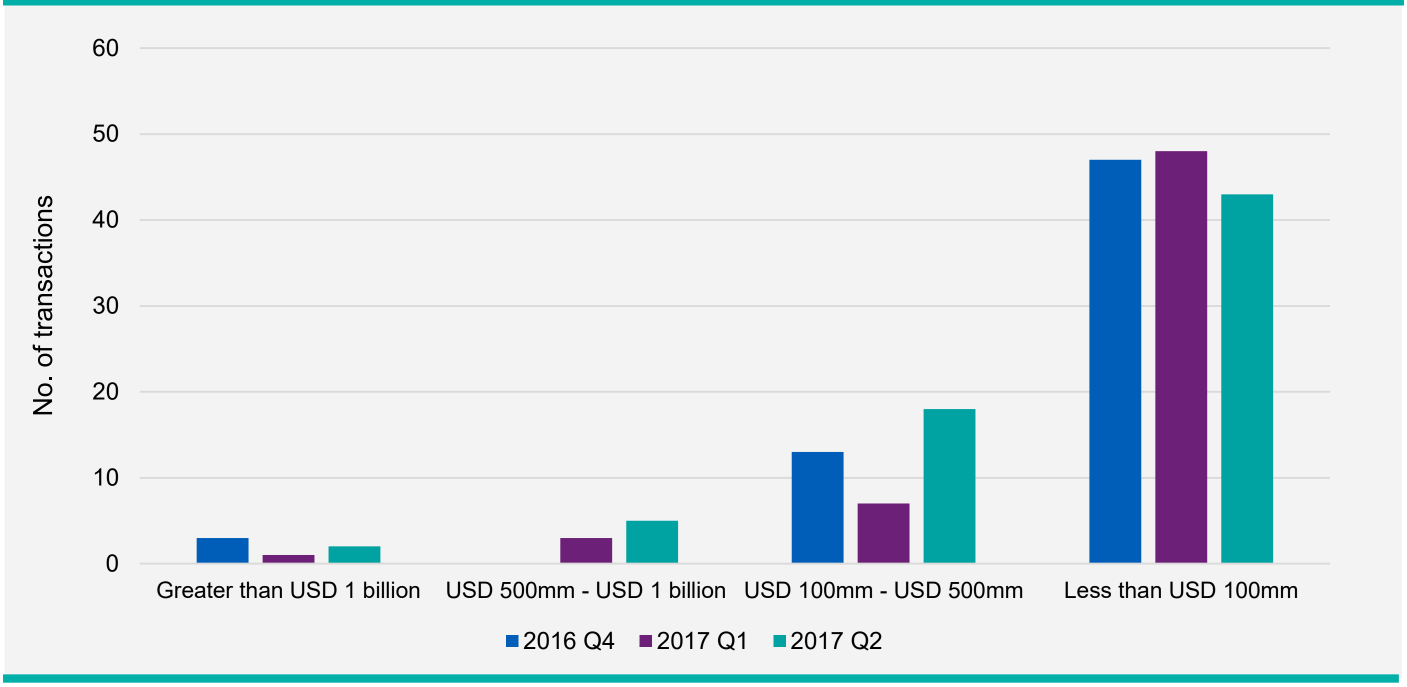
- In the first half of 2017, the Mining sector came first with disclosed value of USD 5.6 billion. While Yanzhou Coal Mining's acquisition of Coal & Allied Industries Ltd was a big contributor, transactions were also supported by Chinese investors' increasing appetite to acquire overseas gold mining businesses.
- Following closely behind the Mining sector was the Auto/Truck sector with total disclosed deal value of USD 4.8 billion. A major focus of the acquisitions was on auto parts and equipments, driven by Chinese auto companies' desire to access advanced technology and expertise in order to move up the value chain.
- The Computer and Electronics sector was third with USD 3.4 billion, with 17 percent of the capital investing in semiconductor-related businesses and 53 percent investing in software-related businesses.

[1]"Others" included those sectors whose share in the total transaction value is below 2%.

Analysis of Chinese A-share companies: Outbound M&A transactions

Deal value range

Deal Value Range - 2016 Q4 & 2017 Q1 & Q2



Source: Dealogic, 1 September 2017.

Post-M&A Integration and Management

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Chinese companies have been actively engaging in outbound M&A activities in recent years as part of their global expansion plans. The increased activity has highlighted the importance of post-transaction planning and proper investment oversight – areas that regulators are increasingly keeping a close watch over. As a result, the core challenge faced by senior management has evolved from originating and executing deals to the post-M&A integration and management of acquired companies. Consequently, their attention has also shifted towards achieving synergies, which are not limited to just financial gains. In this new environment, the ability for companies to identify synergies early, validate it before a deal close, as well as prudently manage and monitor business risks have become critical in order to maximise investment returns.

The growing scale and variety of deals, along with increasingly complex deal structures, are some of the key challenges when it comes to post-M&A integration.

Main deal complexities

- **Diversified investment patterns including M&A, green-field, JVs etc.**
- **Rapid & simultaneous geographic expansion into developed and developing economies.**
- **Flexible corporate structures can lead to ill-defined roles and responsibilities over time.**
- **Rapid & simultaneous expansion into adjacent or non-core industries.**

Key integration challenges

- **Shortage of talent and immature management processes during early stages of global expansion.**
- **Inability to effectively apply existing corporate governance standards to overseas subsidiaries.**
- **Corporate cultural differences lead to barriers and frictions between teams.**
- **Fragmented and disjointed management processes as a result of the "build-as-you-go" approach.**

This growing complexity meant that more companies are beginning to seek advice on post-M&A management before a deal closes. The key questions to consider are 'what', 'how' and 'to what extent' can the acquirer exercise control and accelerate value creation. In this report, we have highlighted a series of key observations and developments for companies to consider when it comes to post-M&A integration.

How Chinese companies are managing overseas acquisitions

Chinese companies tend to adopt one of three main approaches when it comes to managing their overseas acquisitions. Each approach comes with its own strengths and limitations.

1. **Dispatching a management team:**

A typical approach is to dispatch a management team or a number of key staff to help with the running of the acquired company. This usually involves taking on the CFO role or other administrative positions. The newly appointed Chinese management team can then act as the bridge between the acquired company and the acquirers. It also promotes better communication and interaction with shareholders, which can help create an element of trust during the post-acquisition transitional period.

In practice, however, companies adopting this approach face many challenges:

Selecting the appropriate managers – The management team dispatched to the acquired company needs to be familiar with the business cultures of both sides. They also need to be capable of implementing their integration strategy quickly, and be able to build an element of trust with the local staff. In addition, they have to possess deep industry knowledge in order to have the credibility to make decisions, and communicate with group company from the perspective of the acquired party or vice versa.

Managers equipped with such a diverse skillset are rare and many Chinese companies are finding it difficult to find the right candidates within their ranks.

Defining the management roles – The roles, responsibilities and reporting lines can often be unclear following a merger. It is common for managers who did not participate in the initial M&A negotiations to be tasked with post-M&A integration matters.

In such instances, the dispatched team have limited direction in terms of their job scope or level of authority. More often than not, these staff end up becoming 'messengers', serving as a communications channel rather than actively managing the business to drive value creation.

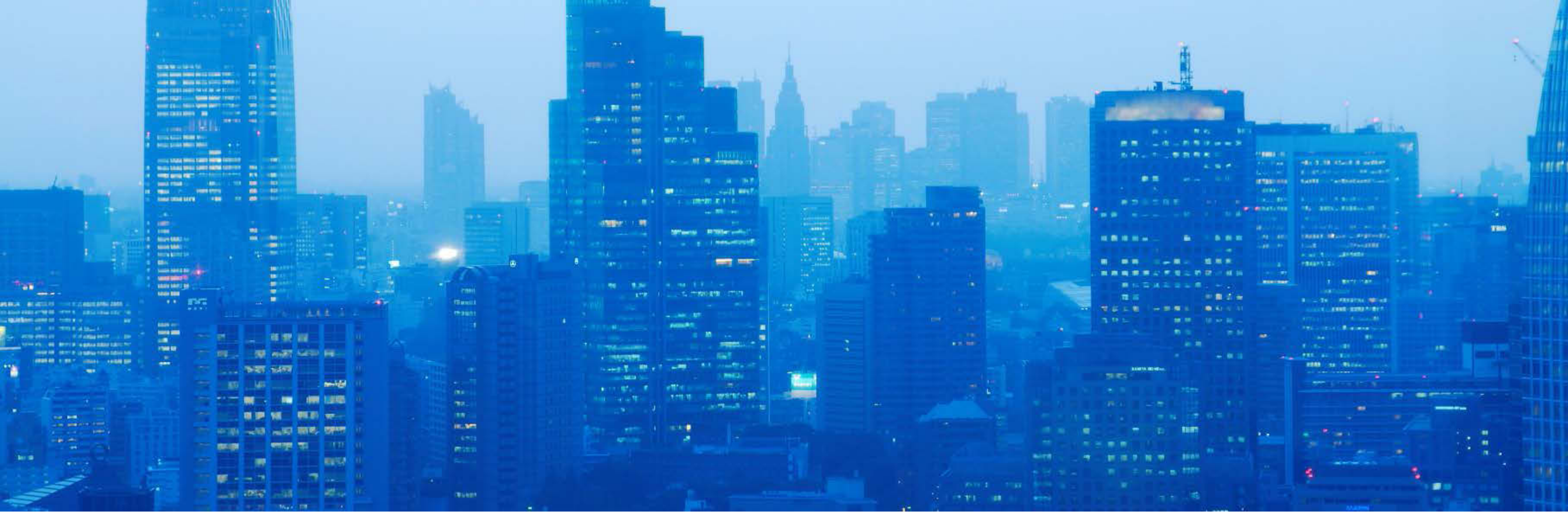
Complicating the situation further is how the relationship with the acquired firm's management team is being handled. This can be a delicate task as the acquired firm's existing members may be disenchanted if they believe the new staff are not adding value to their business or if demands from the group company are deemed unreasonable. This could potentially undermine the collaboration between the two sides and hamper the ability to achieve the acquisition's intended goals.

Managing the dispatched managers – Staff dispatched by the acquirer are often sent out to deal with specific problems. This 'one issue, one solution' approach can reflect a lack of planning and understanding of human capital issues that are likely to hinder their ability to extract value from the merger (Incentive plans and performance management). This approach yielded results when Chinese companies first started expanding overseas many years ago. But as the scale and complexity of M&A deals continues to increase, there is a need for companies to improve their ability to integrate different businesses or explore opportunities to collaborate with professional organisations that possess the required expertise.

Key observation: Dispatching a team to run an acquired subsidiary is effective only if the management structure of the company, together with the roles of these personnel, are clearly defined.

2. **Corporate governance:**

The corporate governance structure of an acquired company typically comprises of the shareholders (the new owner), board of directors and the supervisory board.



How Chinese companies are managing overseas acquisitions

Standardising corporate governance standards is another popular approach adopted by Chinese companies to promote post-merger integration. In many cases, such a move is driven by local corporate governance laws and regulations.

This approach makes sense for private equity investors from a portfolio management perspective. However, this may not be an effective method for corporate investors with an operational agenda. Strategic buyers looking to realise business synergies quickly might find this approach slow to implement. For instance, the board of directors might approve the adoption of a collaborative procurement plan, but the acquired company may be slow to formulate the relevant bargaining strategies or build the procurement platform.

In addition, companies often neglect the design and implementation of the governance structure. Instead, excessive emphasis is placed on the role of the shareholder (the group company). This neglect of the roles played by the board of directors and the supervisory board can result in an ineffective management structure.

Those relying on a rigid governance approach can also be slow to detect and react to post-investment risks.

Key observation: This approach needs to be combined with a detailed integration implementation roadmap for strategic buyers to realise synergies.

3. Functional management:

If the acquired company already has an established functional structure (including finance, human resources, and investment management), further integration between the two companies can be achieved by combining the corresponding departments of both entities. This will require the clear definition of roles and responsibilities along functional lines, well-defined processes and efficient operations.

However, operational challenges can occur during the implementation process:

- A lack of coordination and communication across functions can lead to repeated requests and slow decision-making, especially when multiple departments are involved.

- Lack of cooperation between staff from the group company and the subsidiary can lead to inefficiencies and even conflicts.

- Management requirements can vary across functions. This can lead to confusion in the subsidiary, higher operational costs, and impede the realisation of economic benefits.

- The investing party might try to manage the acquired overseas subsidiary in the same manner as a domestic subsidiary. This management style can appear rigid, particularly if the acquired company is relatively established.

Key observation: Companies should consider both the vertical and horizontal aspects of business functions. There needs to be an appropriate balance between the various functions to reduce friction and communication costs.

Key takeaways from the experience of successful multinational corporations

The integration challenges faced by companies in their journey to go global are not unique to Chinese companies. Some similarities can be drawn from the experience of overseas companies entering the Chinese market in the early 21st century. The examples of how some of these companies react to the setbacks they encounter can provide useful insights:

- **Create a post-deal management team:** A professional management team with the experience and expertise to deal with the challenges of post-deal integration should be established. This team can focus on both the 'micro' and 'macro' integration issues, and serve as the conduit between the acquirer and the acquired company.

- **Develop a detailed integration plan:** Companies should create a '100-day implementation plan' before an acquisition is completed, which details how the acquired company will be managed. The plan should contain a clearly defined organisational structure, personnel allocation strategy and communication mechanisms.

- **Establish effective two-way communication channels:** Promoting effective two-way communication is a vital component of post-merger integration. In particular, a strong relationship between the core management teams of the two parties is crucial so as to ensure geographical, cultural and regulatory differences do not lead to issues. The acquirer needs to set an appropriate tone in its communications with the subsidiary.

- **Ensure compliance with regulatory requirements:** The acquirer needs to have a deep understanding of the acquired company's local legal requirements in order to ensure they operate in accordance with these law and regulations. Strict monitoring of the legal and regulatory environment should be a key part of the management's post-deal operations.

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Based on our extensive experience supporting Chinese companies, KPMG recommends a two-pronged approach to integration that incorporates both 'hard' and 'soft' power.

1. Enhancing 'hard power'

a) Be in clear control

The approach taken to manage the acquired company is dependent on the acquisition's aims, the size of the deal and the intended level of collaboration between the two parties.

There are four factors to consider:

- **Financial control:** The investing company needs to track the business and financial performance of the acquired company, whose management team has authority over all strategy and business decisions.

- **Strategic design:** The investing company is responsible for the overall strategic direction, while the acquired company is responsible for business planning within the stipulated context. The management team of the acquired company would

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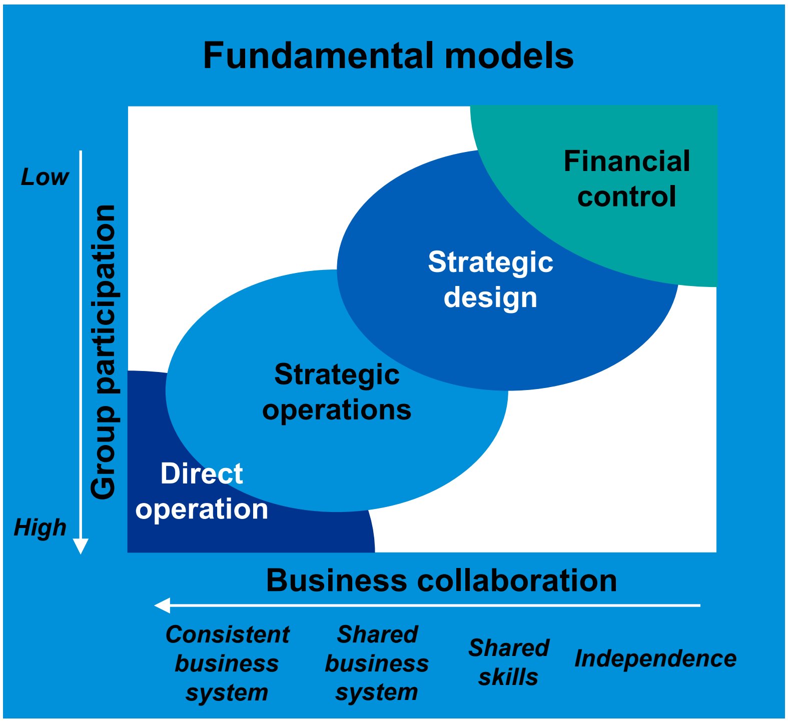
have to submit annual budgets and major investment plans to group company for approval in order to ensure activities are in line with the strategic goals set out by the group. The group company provides support in the form of resource coordination, but is not involved with day-to-day operations.

- **Strategic operations:** The group company offers top-down strategic direction in addition to working alongside the subsidiary to make business decisions. The subsidiary then implements those decisions under the supervision of the group company.

The subsidiary's daily business operations are subject to the guidance and supervision of the group company.

- **Direct operation:** The group company sets the strategic direction, and is also responsible for its direct implementation. Management decisions are centralised and the group company is intimately involved in the core value chains (Production, R&D, logistics and other business units). The subsidiary's daily operations are executed in-line with the group requirements.



It can be difficult to have a clear distinction of the four models in practice as most relationships tend to sit between the different approaches. Companies should customise and adjust the way they manage their subsidiaries based on the their individual needs as well as the market environment they operate in.

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b) Secure appropriate control via five key enablers

There is no one-size-fits-all solution for the effective control and management of a subsidiary. Instead, a combination of management techniques across five key dimensions are usually adopted:

Corporate governance structure

- Structure of board of directors
- Establishment and daily management of committees
- Regulations on shareholders' discussion and decisions
- Assessment and evaluation of board members

Construction of vertical function systems

- Overall control principles and strength
- Functional controlling fields
- Control methods and means
- Control implementation

Management of key staff

- Appointment of executives and key staff
- Remuneration of executives and key staff
- Performance of executives and key staff
- Equity options for executives and key staff

Performance tracking

- Formulation and decomposition of long-term strategic objectives
- Financial operation analysis and tracking
- Management reports / core performance systems
- Annual targets and budget formulation, decomposition and tracking

Improvement of services and operation

- Improvement of financial management capabilities
- Improvement of information systems management capabilities
- Improvement of human resource management capabilities
- Improvement of strategies and synergies
- Internal control and corporate governance
- Tax planning
- Core business process optimisation

It is not possible to execute all these control measures at once, which highlights the importance of prioritisation. The success of post-M&A integration hinges on choosing the most suitable approach based on the needs of the various parties involved.

2. Enhancing 'soft power': Understanding cultural differences and importance of effective communication

Companies should identify cultural differences in the early stages of a M&A transaction. This would allow both parties to understand the inherent business culture of one another, which forms the base for a successful integration process. It is also advisable for companies to establish a two-way communication platform dedicated to integration activities and processes so that information can be exchanged in a timely manner. Soft power can be promoted through the following methods:

- Identify cultural differences and mitigate any communication and management risks as early as possible in order to accelerate the integration process.
- Recognise and understand the challenges faced by the dispatched management teams
- Support the practical (actionable) implementation of corporate governance processes. Ensure that corporate governance is not simply a box-ticking exercise and is instead an integral part of the integration strategy.
- Reduce management costs and enhance the efficiency of decision-making processes.
- Reduce non-systematic risks in post-deal management such as poor communication or lack of understanding between the two sides.

KPMG has made every effort to verify the accuracy of the data and information presented in this report.

All M&A data was obtained from Dealogic on 1 September 2017. The data does not include any alteration or cancellation of subsequent transactions unless indicated otherwise.

KPMG China has accumulated extensive and practical engagement experience in outbound M&A transactions across various industries and regions. We have successfully assisted many large enterprises with their outbound M&A transactions, with acquisition targets located in Europe, the Americas and other regions. Leveraging the support of KPMG‘s global network, KPMG China is able to provide efficient and effective professional services in all aspects of an outbound M&A transaction.

Feel free to contact us if you require any assistance or have any questions regarding outbound M&A.

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