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"Our view"

KPMG China, Deal Advisory

VDRs in China M&A: boots on ground a virtual necessity

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In the space of about 15 years, the virtual data room (VDR) industry has grown from (virtually) nothing to a USD3.5 billion sector[1] that's refashioned the way many professions conduct engagements involving sensitive documents and data. And for M&A due diligence (DD), VDRs – which provide access to a repository of data from anywhere with online access – have undoubtedly brought major efficiencies and cost savings. Regardless, in terms of VDR-related DD in China, various hurdles can still arise that are worth considering.

Since being introduced around the new millennium, VDRs have generally lived up to their promised benefits (centralized data, security features, convenient access, travel savings, less disruption to the target and/or deal teams, to name just a few). Indeed, a sizable portion of our M&A engagements in China utilize a VDR to varying degree. But in our experience, VDRs are not a substitute for on-site DD when it comes to China-related inbound or domestic M&A DD.

Typically, especially regarding small privately owned enterprises in China, issues around substantive testing and veracity of data can arise, which can drag out the DD process and lead to higher costs if not planned for. Quality and relevance of data supplied in a VDR, regardless of initial specific requests at the outset, can often deviate from that needed to draw sufficient conclusions from the VDR alone to make a binding offer. Often this is a consequence of poor historical bookkeeping, a not uncommon issue among local China-based companies.

Technical issues can also arise (in terms of VDR preparation) regarding speed and quality of internet access at client sites – particularly in tier-2 or -3 cities or more rural locales – delaying the DD process or, as is often the case in our experience, necessitating subsequent on-site fieldwork.

Similarly, China's State Secrets law restricts the transmission of information containing "state secrets" outside of China, but does not precisely define what constitutes a "state secret". With physical server location of the majority of VDR service providers likely to be outside of China – in addition to considerations regarding accessing certain information from outside China even if the server was within the PRC – a VDR may breach State Secrets law. Where potential issues arise, we would seek in-house legal counsel.

That said, we do not advocate the abandonment of VDRs in respect to inbound or domestic China-related M&A, but rarely have we seen such deals conclude in China via VDR alone given the above factors which invariably arise. In contrast, for outbound M&A (from China), the benefits of VDRs are typically more definitive and assured.

In China, we generally recommend a dual approach where certain aspects of the DD are done to the extent possible via VDR, but nearly always followed up by on-site fieldwork to reconcile and test the figures and claims. While this might seem counter-productive to deploying a VDR in the first place, in our view on-site visits are a necessary backstop enabling a more surgical fieldwork (having prepped via VDR as to specific concerns or red flags) and which ultimately benefits all parties in an M&A deal.

In our view, reliance solely on VDR DD is unwise – though with a tailored approach that incorporates and plans for anticipated hurdles, ultimately outcomes acceptable to all deal parties can be had. Besides stipulating to target companies the specific data requirements needed to best avail of a VDR, we advise our China M&A clients to be cognizant that:

- on-site substantive testing is nearly always needed
- timelines can be drawn out (compared with similar M&A in developed countries) given volume and often poor state of raw data
- pre-deal client-seller 'ice-breaking' liaison can assist in direct requests to seller to clean up data.

Source: 1) Intralinks Holdings' CEO Ron Hovsepian on Q1 2016 Results, seekingalpha.com (accessed 13 June 2016). Credit: Nick Lindsey (Editor, KPMG China)

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