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A Pocket Guide to Chinese Cross-Border M&A

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Content

Making sense of Chinese outbound M&A

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The past year saw Chinese companies spend $227.0bn on acquiring foreign companies – 6x what foreign companies spent acquiring Chinese firms. These ‘outbound’ M&A volumes have grown at 33% p.a. for the past five years though regulatory controls on foreign exchange have slowed growth in 2017. Chinese companies were amongst the ten largest deals worldwide in 2016 (e.g. current ChemChina/ Syngenta acquisition going through regulatory approval process), and were involved in some of the most controversial transactions of the year, such as Anbang Insurance’s high-profile battle for Starwood Hotels & Resorts, which added $0.4bn to the price that Marriott eventually paid, and Chemchina’s $47bn acquisition of Syngenta.

Despite all the media attention, a number of myths around Chinese outbound acquisitions persist. Let’s discuss them one by one.

First myth – the ‘wave of money’

China, the theory runs, is awash with cheap capital, and that is now fueling a global shopping spree. It has almost $3 trillion in foreign reserves, the world’s 2nd largest sovereign wealth fund, and four of the world’s largest banks by assets – all of which are extremely well-capitalized. Chinese companies therefore have almost unlimited firepower for overseas acquisitions, and that makes them willing to pay unrealistically high prices for high-profile megadeals.

It’s important to put this supposed wave of money into context. The total amount of China outbound acquisitions has grown dramatically, from

We are still at the beginning of a long growth trend, and the persistent myths surrounding these deals reflect this. Chinese companies will in time be an important part of global cross-border M&A, and that means levels of activity substantially higher than what we have seen to date. This will require some adaptation on both sides. However Chinese companies need the brands, channels, technology and relationships that these transactions can bring; and the investee companies benefit from access to the rapid innovation, scale and cost advantages of the China market. In the long run, everyone gains from China's participation in the global deal market.

Chinese outbound M&A: the decade in review

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We are now a decade past Lenovo's acquisition of IBM's PC division – the first major outbound acquisition by a Chinese company. Since then, over six hundred and fifty deals of greater than $100m have taken place. Chinese investors, financial and strategic, have gone from being rarities in the international deal market, to regular participants in major auctions.

In the post-2008 era, there has been considerable discussion of the impact of outbound Chinese investment. However this analysis mostly considered the impact on sellers – whether this new source of capital is bidding up asset prices, and whether host governments should fear Chinese buyers – or looks at the role that capital outflows play in China's broader economic development. While these are relevant questions, more important is the experience of the buyers themselves. Were the investments successful? Did they create value for companies? If not, why not?

In this article we take a hard look at the experience of the past decade. The track record has been mixed. A majority of deals did not clearly accomplish their original objectives. The most significant reason for this was simply bad timing, something that no company can fully guard against. But in large part it is also due to what Chinese companies did – or did not do – after closing deals.

Historically, many Chinese acquirers had limited ability to manage acquisitions post-deal. This affected their ability to extract synergies: genuine operational integration was often not possible. With the emergence of a pool of Chinese management capable of operating internationally, that no longer has to be the case. More companies are taking a hands-on approach to integration, recognizing the importance of actively managing their acquisitions while appreciating the real differences in culture and operating model. We expect that in the coming years this will become the norm, rather than the exception.

Assessing the track record[1]

Evaluating the 'success' of an acquisition is always subjective. The experiment has no 'control' – we never know what both sides would have done if the deal hadn't been done. Looking at short-term share price reactions to deals tells you whether the market liked the concept when it was announced, but says nothing about execution. To really assess the success of a deal, we have to go back to the original objectives, and look at whether they were met.

By this standard, the results of the past decade look less than impressive. Around 60% of outbound investments by Chinese companies, close to three hundred deals of almost three hundred billion dollars, created little or no value for acquirers.

The resource curse

The deals with the worst success rate were the resource acquisitions of the late 2000s. The decade preceding 2008 had seen the price of China's resource imports rise by 18% CAGR on average across 10 years. This was rightly seen as a threat to chinese companies' international competitiveness, and as a national security issue.

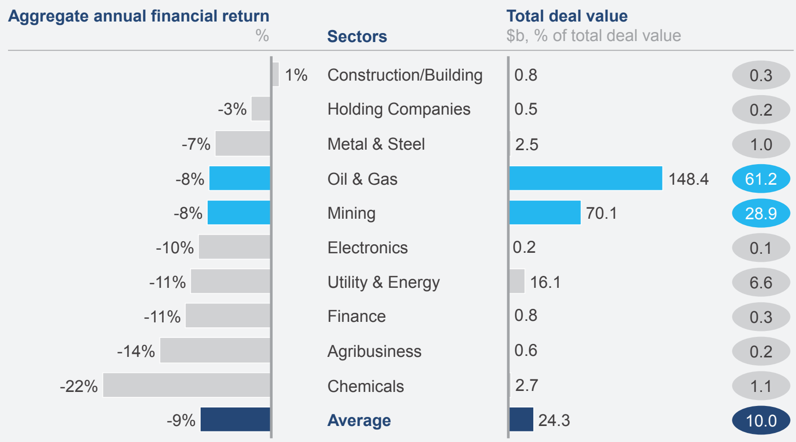
As a result, 43% of the deals done in the past decade (217 deals, representing 56% of total outbound investment value) – involved natural resources. 80% of this happened during the run-up in commodities prices, before they peaked around the time of the financial crisis; the remainder happened in the three years following, when a dip in prices appeared to present a buying opportunity. However commodity prices in most cases

1 For our analysis, we screened out those deals where little or no public information was available on acquiror or target, leaving slightly over 500 transactions.

remain below the price at which these deals were done. In 84% of the deals we reviewed, representing 89% of deal value, these deals did not create value for the acquirer, losing on average around 10% of the initial.

EXHIBIT 1

Investment mix for resource deals



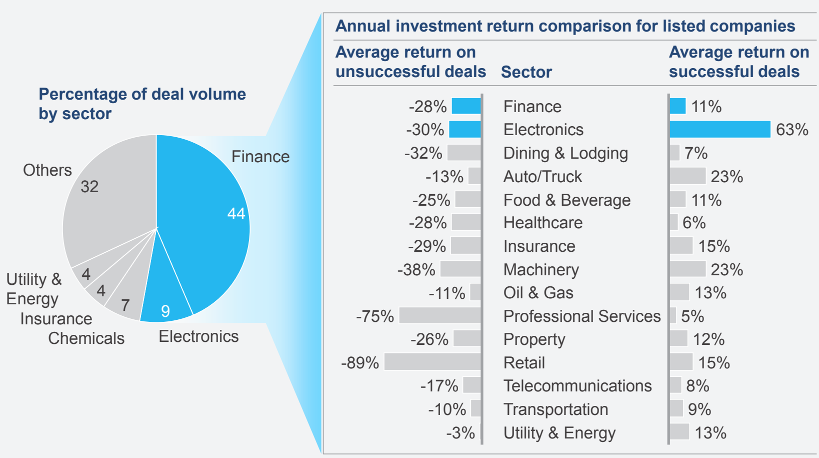
Financial diversification and relationship-building deals

A second group with low success rates are investments into listed companies that remained listed post-deal, primarily motivated either by financial diversification or to build a relationship with the target – 24% of the deals done (119 deals, worth 18% of total value) had this profile. These targets generally kept a high degree of independence after acquisition. While this kind of investment had been successful domestically, not so abroad. On average, the companies invested lost ~7% of their value per annum from the date of investment to today. If we included the opportunity cost – making a similar minority investment into domestic Chinese equities, which have risen on average 15% per annum since 2008 – the track record would look considerably worse. Bad timing again played a major role here: the majority of these deals were concentrated in financial services and computers & electronics, each of which lost around 30% of their initial investments on average. The hardest hit sectors were retail and professional services: the investments made there lost on average more than 70% of the initial investment.

Majority investments into listed companies did slightly better than minority investments. On average, the share prices of these deals lost ~2% per annum since investment; however, the range around this was wide, with more than half of the deals yielding positive returns. There is also more evidence of synergies being captured by the acquirers in their core business in majority control deals – bringing technology or products into the China market, and creating genuine growth in the acquirer's profits.

EXHIBIT 2

Sector mix of listed company deals



1 Others include sectors has less than 4%: Auto, Dining & Lodging, Food & Beverage, Forestry, Healthcare, Holding Companies, Leisure, Machinery, Oil& Gas, Professional Services, Property, Transportation

SOURCE: Team analysis

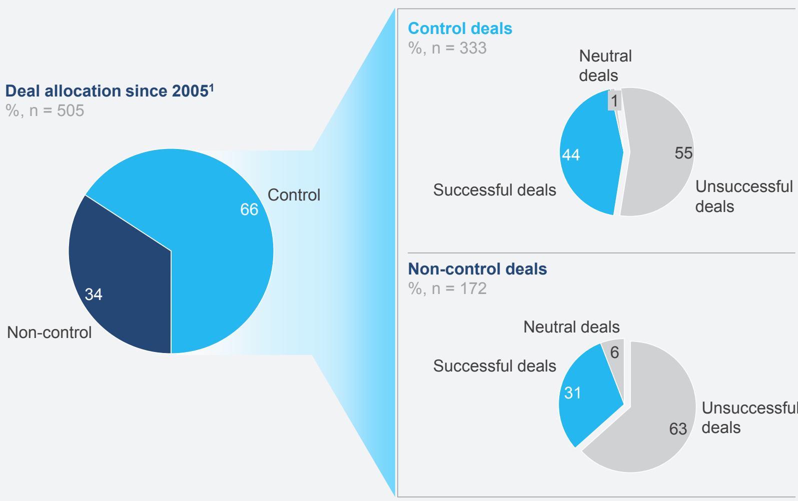
Identifying the successes

For the slightly over a quarter of the deals done that do not fall into either of the above categories, we analyzed the stated objectives of each deal – product, technology, or cost – and looked at whether these had been achieved subsequently. We found that ~70% of these deals clearly did achieve their objectives. For control deals, that success rate rises to 75%, vs. 60% for the non-control deals.

Looking across the full set of deals, level of control does matter. 34% of the total 505 deals was non-control investments, of which only ~30% was successful. For the control investments, the success rate rises to around 45%.

EXHIBIT 3

Non-control investments generally did worse than control investments



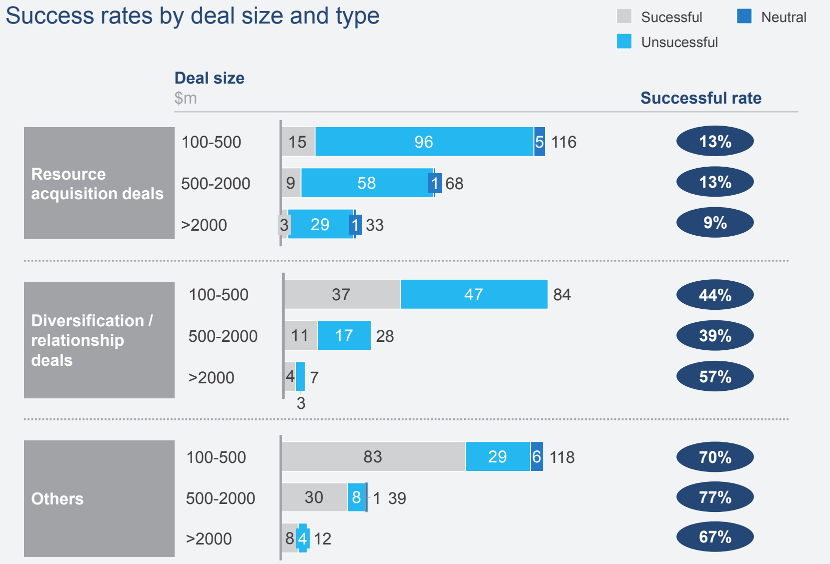
1 Others include sectors has less than 4%: Auto, Dining & Lodging, Food & Beverage, Forestry, Healthcare, Holding Companies, Leisure, Machinery, Oil& Gas, Professional Services, Property, Transportation

Note: We define control as having >50% share ownership in target company.

SOURCE: Team analysis

EXHIBIT 4

Success rates by deal size and type



SOURCE: Dealogic; expert interviews; McKinsey analysis

This paints a stark picture overall. Of 505 deals and $432bn of deal value, only 200, worth $146bn, have achieved their objectives. Moreover this happened at a time when M&A was, in fact, creating value for most companies. In the post-2008 period, when money became historically cheap, equity markets were encouraging companies to acquire for the first time in decades, to convert cheap funding into productive assets. Asian acquirers in particular were rewarded richly by their investors for acquiring. For example, the market more consistently rewarded Asian acquirers, on average, than Western acquirers for the value their deals were expected to create.