Chinese Outbound Acquisitions of Foreign Chemical Companies

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As strong players gradually develop in the Chinese domestic market for chemicals, these companies increasingly have ambitions to go overseas, preferably via acquisitions. There are several reasons for this trend. Larger Chinese players realize that many segments of the chemical industry, particularly those at the higher end, are fairly global in nature and thus cannot efficiently be served in only one country or region. The Chinese government generally supports the creation of strong national players and also promotes the acquisition of technology overseas, giving domestic chemical companies an additional incentive to acquire companies overseas. Finally, big as the Chinese chemical market is, its growth rate is slowing down, leaving expansion into new markets outside of China as an interesting alternative for future growth.

However, despite a strong rationale for acquiring overseas chemical companies, so far in reality not many such transactions have happened. By number, only 1.1% of all Chinese outbound transactions were in the chemical sector (10 transactions in total), though due to the larger average size of these transactions, the chemical sector accounts for 6.4% of the total transaction volume during the same period. Why is that?

According to our analysis, the issues complicating such transactions can be grouped into three main categories:

- Lack of or insufficient strategy and strategic rationale for the acquisition
- Competition from Western buyers (both strategic and private equity)
- Transactional complexity specific to Chinese buyers

Strategic issues:

In our experience, Chinese chemical companies often lack a clear strategy – one that can be implemented and operationalized in an unambiguous way. Needless to say, such a strategy needs to be much more specific than just phrasing a version of the old “buy cheap, sell high” nugget, or an updated version of it (“focus on innovative, fast-growing, profitable companies”). The key aspect of this strategy needs to be the consideration how and why the new owner can add value to the acquired assets in a way that is specific to this owner. Yes, this is about synergies. What kind of synergies could this include?

- Acquisition of multiple companies in order to combine them to a bigger unit
- For a new Chinese owner, this will be particularly relevant if he can add Chinese activities in this chemical segment. This may mean targeting a complementing domestic acquisition (or several ones) along with the overseas one
- Opening the Chinese market via sales channels already existing for the new owner
- Achieving cost savings by optimizing the location of the different value chain steps between China and the overseas locations

Indeed, a lack of a clear strategy may be the current biggest obstacle to overseas acquisitions by Chinese chemical companies. As a consequence, companies primarily pursue acquisitions opportunistically based on what is or might be on offer abroad, rather than based on creating long-term value.

Competition from other bidders:

In the past, many of the acquisitions made by Chinese chemical companies overseas were in areas that are regarded as relatively unattractive due to commoditization and declining margins. However, currently the focus of acquisitions seems to have shifted to areas regarded as more attractive – i.e., areas with higher margins, more innovative products etc. This puts Chinese buyers in direct competition with Western bidders, for example with global specialty chemicals companies also wanting to expand in areas such as food ingredients, electronic chemicals and branded/formulated products. In such a situation, it is very likely the Chinese bid will be too low as the competing Western bidders are willing to pay a strategic premium. Chinese bidders will only be able to match this premium if they have a strong strategic rationale for their acquisition themselves (see above).

Transactional complexities for Chinese bidders

While most Chinese companies across all sectors have had their difficulties with outbound acquisitions, chemical companies with limited M&A experience face even greater challenges:

- Experience in Formalized Western Style Investment Processes – Chinese companies have generally relied on informal relationship building and "on the job" learning over rigorous due diligence. Western sellers usually expect an adherence to procedures, timelines and commitments. Examples include commitments to Letter of Intent (LOI), Memorandum of Understanding (MOU), or other binding and non-binding agreements. Not adhering to such protocols from Chinese companies was tolerated, including late bidding but, due to too many failed transactions, it is now far less acceptable by sellers and as result the sellers are increasingly requiring breakup fees that can range from 0.5-3.0% of transaction value – making the strategic planning process highly important.

• Quantifying Valuations and Synergies – Foreign chemical companies, in particular specialty chemicals, have experienced a "sellers market" over the last 2 to 3 years with double-digit EBITDA multiples that requires harmonizing business plans and financial model assumptions. Furthermore, as competition for specialty companies has become fierce, full valuation and sharing synergies with the sellers is often a prerequisite. Quantifying synergies and willingness to share can vary between buyers and sellers but is a primary reason some Chinese bids are lost to Western firms. Buyers need to be diligent about quantifying potential synergies, both revenue enhancements and cost savings, and consider the amount that they are willing to share as part an offer (e.g. LOI).

• Justifying Non Quantifiable Soft Factors – Buyers need to be relevant to "stay in the game" due to competitive bidding process and to ensure that a solid business case is made on why a buyer is the best positioned for the seller. If the buyers valuation is competitive, such a solid business case will differentiate the bidding and help define why the proposed transaction is optimal for the seller and other stakeholders, including regulators. Deal success for chemical companies is highest when buyers keep close to their core business and either build scale or expand to a new geography as an extension of the buyers corporate growth strategy rather than an opportunistic standalone transaction.

• Concerns of Foreign Political Backlash – Increasing anxiety in host countries about potential Chinese takeovers is having a material effect on acquisitions. Chinese control over strategic and seemingly non-strategic assets is attracting national security concerns (e.g. US, Germany, and other-EU), and many of these countries are developing investment review processes specifically targeting Chinese investment. In addition, there may be informal barriers on a business level. In one case we were involved with, a US target refused to consider a potential Chinese buyer for fear of losing business with the US military.

• Integration Planning – Most Western countries have well developed approaches to integration via a Transition Services Agreement (TSA) that is based on local laws and regulations of the host country. In addition, speed of integration is usually critical for capturing synergies or realizing financial model/valuation assumptions.

• Post Close Operating Environment – Challenge is usually in establishing the key management team and resources for "Day 1". Developing a cadre of managers with experience in both operating abroad and in integrating acquisitions often requires deep functional experience (e.g. subject matter experts to support technical matters, marketing teams to support selling, operational and accounting to manage and report).

• Opportunity Readiness – If the buyer is analyzing a company for sale for the first time, the buyer is already at a disadvantage to competing Western bidders which have continuously followed the market. Analyzing a list of potential targets and synergies prior to companies being brought to market will greatly improve buyer readiness and success for an acquisition. Dedicated deal teams and streamlined decision-making are also highly important. While there are many good reasons why strategic buyers are unable to have a full deal team, it is critical to understand best practices and the importance in leveraging strategic advisors with the prerequisite skills, knowledge and experience.

What does this mean for Chinese chemical companies seeking to successfully acquire companies overseas? While the answer obviously depends on the specifics of the company, a few general pointers can be given:

• Develop a clear strategy first, and derive your acquisition targets from this strategy

• Search widely based on companies existing, rather than just on companies currently openly for sale

• Be aware that the more attractive a chemical segment is, the stronger the competition from other bidders will be. So only focus on highly attractive segments if you are truly willing to pay a premium

• Look for synergies that will allow you to pay such a premium

• Establish clear responsibilities and functions for M&A activities within your team

Particularly for larger Chinese chemical companies with the long-term ambition to become a global player, these points will be vital for successful acquisitions overseas. ■