Issues Related to Foreign Chemical Acquisitions in China, and How to Deal with Them

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Foreign chemical companies historically considered China a complicated environment to do businesses but believed it was worth the effort when taking into account China's market potential and growth prospects. In many cases, foreigners had guidance from JV partners (in refining/basic petrochemicals, cooperation with a local JV partner was a legal requirement), making the whole experience easier. However, as Beijing promotes increased openness for foreign direct investment, it is generating renewed interest from potential foreign investors in the chemicals industry. Some of the reasons include:

- China's new foreign investment law (effective January 1, 2020) with attractive provisions, including the protection of intellectual property for foreign investors and companies
- Considerable consolidation is expected within China's domestic chemicals industry – offering foreign investment as a strategic alternative
- Global chemical M&A is slowing, prompting some dealmakers to look at China for investment
- Some foreign companies consider China's current situation as providing a window of opportunity to expand local control of operations, as the issues involving trade between the US and China give China an incentive to prove its openness to foreign investment.

For existing JVs in China, some of the world's largest chemical companies will eventually be impacted by the new foreign investment law and may trigger either additional investment or divestment. For example, foreign firms that currently control their ventures may want to strengthen direct governance (e.g. secure director consents, amend company articles, inject capital, etc.), then pursue "bolt-on" acquisitions. On the other hand, in JVs where the Chinese partner has majority interest and wants to gain greater control, the foreign partner may prefer to sell the JV share and subsequently either exit China or start over on its own. Some companies may choose a mixture of these options depending on the nature of the business and the location. For example, BASF plans to establish a 100% foreign owned petrochemical Verbund site in Guangzhou, something that previously would not have been legally possible. At the same time, BASF will only have a 25% share in the newly built cracker in the Nanjing JV with Sinopec but a 50% share in the Nanjing downstream plants.

Regardless of the situation, successful M&A requires foreigners to pay attention to the various nuances, on-the-ground risks, an accurate assessment of market conditions, knowing the customer base, and a proper evaluation of issues and risks (e.g. knowledge of environmental regulations for individual chemical companies). These issues and risks are best examined by deal phase, with the pre-deal phase, the transaction phase and the post-deal phase each meriting a separate analysis (see Fig. 1).

Issues and risks: pre-deal phase

- Foreigners are overly transaction oriented whereas China places importance on relationship building. Foreigners interested in an acquisition need to take this into account – for example, while they may want to start a relationship with a business meeting, the Chinese side may prefer to start with a dinner
- Chinese sellers may require a longer lead times to prepare (e.g. legal structure consolidation, audited accounting records, official documentation of asset ownership and other preparations) - in our work, we have experienced delays of several months due to incomplete accounting on the Chinese side
- Legal and accounting improvements prior to starting a sales process can be seen unnecessary, costly or overwhelming for the Chinese side but can greatly improve deal success at the best possible valuation, which is a point that needs to be made clear to Chinese sellers of companies to avoid frustration
- If this advice is not heeded, the potential consequence for a Chinese seller is that the foreign buyer may conduct a forensic-type audit that can be highly intrusive and expensive for both the buyer and seller
- Opaqueness of shareholding structures can complicate a deal (e.g. nominee shareholder agreements where person A wants to invest in a company but for various reason is hidden from public disclosure and instead an investment is made and registered in the name of person B who appears on public records)
- Related-party transactions can also complicate a deal when an agreement is entered by at least two entities, where one has control over the other for various reasons (e.g. injection of assets, cross guarantees and loans, privatization and sale of assets, etc.)
- Chinese sellers will need to prepare a "Data

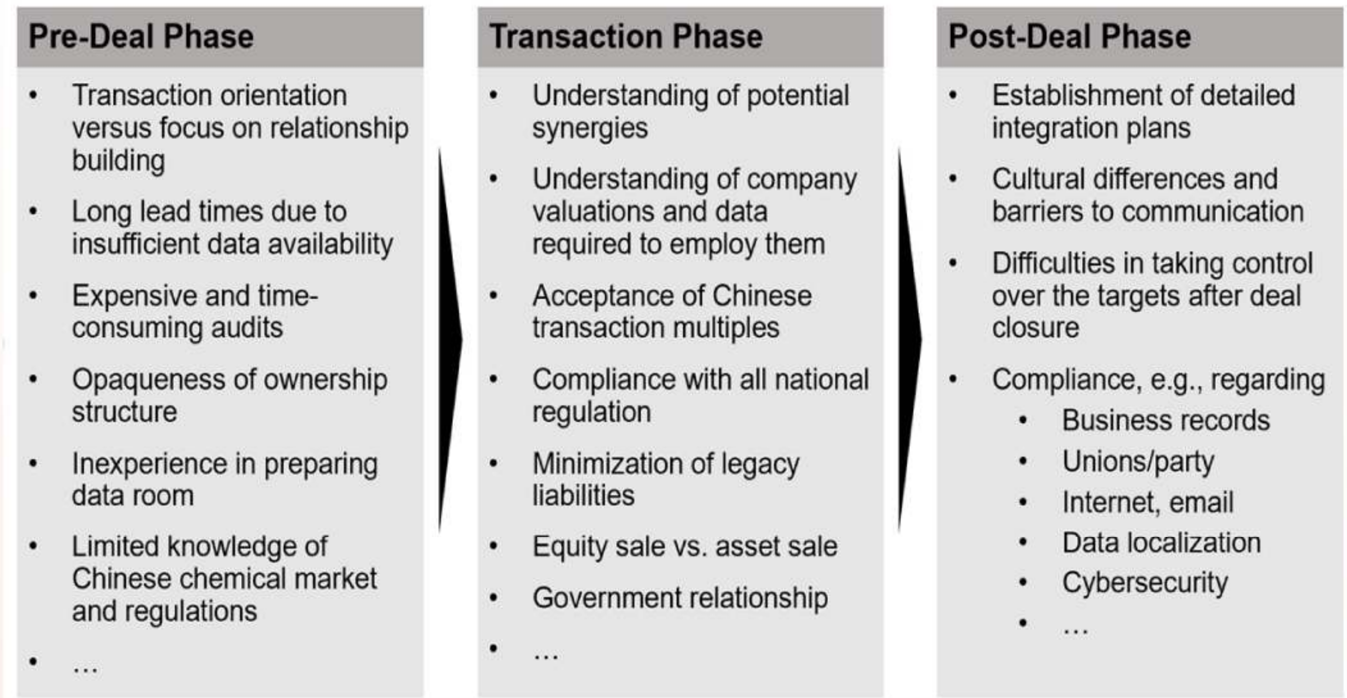

Fig. 1: Examples of Issues and Risks of Overseas M&A Transactions in China by Project Phase

Room" that usually includes the previous three years financial statements, operational details, personnel information by function (including pay and benefits), land, factory equipment / fixed assets, customer information, marketing and other relevant materials that are highly confidential and will need to be properly managed. As most Chinese sellers are doing these activities for the first time in their life (after all, most of them spent their lives establishing a chemical company rather than in accounting), they need detailed advisory support in this

• Foreigners may have insufficient knowledge about the markets and businesses they wish to operate (e.g. domestic and/ or export business, production and/or distribution), and need to get this knowledge within a short period of time

Issues and risks: transaction phase

• Foreign and Chinese companies need to work together to understand potential synergies covering both revenues (e.g. leveraging distribution channels, sales teams and other economies of scale) and costs (e.g. streamline operations and eliminate redundant expenses)

• Small and medium sized Chinese chemical companies have an insufficient understanding of the various valuation methodologies (e.g. comparisons, discounted cash flows, sum-of-the parts, etc.). Consequently, they may not have prepared the relevant documents related to these valuation methods, such as detailed business plans describing future sources of growth

• Foreign buyers may have to accept valuations (e.g., EBITDA multiples) that are higher than those typically paid outside of China if there is to be a successful deal

• Most Chinese sellers may not realize they are not fully compliant with national and local regulations (e.g. taxation, pension payments, asset registration, etc.) that may only be triggered during a sale process or "change in control". Most Foreigners do not understand the rules and regulations

• Foreign buyers are concerned about limiting their exposure to undisclosed and unknown liabilities and minimizing taxes before a deal closure

• Chinese sellers generally prefer equity sales for tax and nontax reasons. One of their main objectives is to minimize the taxation exposure from a sale

• Foreigners may experience difficulties in maintaining positive and effective communications with local government after change in control (e.g., chemical company's dependence on passing environmental inspections may be critical to the ongoing operations)

• Chinese and foreign parties need to collectively understand the importance of a Transaction Service Agreements and leverage relationships to solve problems

Issues and risks: post deal phase

• Lack of a detailed and comprehensive integration plans, including an understanding on how chemical production assets are utilized

(e.g., for production of the existing local portfolio or also for the localization of some import products)

• Cultural differences and communication barriers (e.g., high versus low context communications, building trust, methods of decision making and solving disagreements)

• Difficulties in taking control over the targets promptly after deal-close (e.g. legal agreements versus relationships)

• Other important considerations (e.g., business records compliance, union/party compliance, Internet and e-mail server compliance, data localization, and cybersecurity law compliance.

Given this multitude of potential issues and risks, it is worthwhile anticipating them and proactively providing solutions. This can be done via a number of tools including strategic planning, choosing the deal team executive, optimizing project management, as well as by ensuring that the right advisory support is available.

Strategic planning

Any foreign buyer of chemical production in China will most likely not leave the new unit as a stand-alone operation but to have it cooperate with existing operations overseas (or even in China, if the company already has operations there). Integrating the new unit thus requires diligent strategic planning. The first step is to decide which role the newly acquired Chinese operations are to have in the foreign entity as a whole. What will be the main functions and objectives, e.g. production for the local Chinese market, production for export, development of locally adapted products, etc.? Subsequently, resources need to be allocated accordingly. For example, if the acquisition is aimed at increasing local market share in China, it may make sense to develop localized products, which in turn requires R&D resources. Another consideration is whether the newly acquired unit can also take over some functions previously done elsewhere (e.g. local distribution, sourcing of chemicals in China, etc.).

Deal team executive

Choosing the right deal team executive is an important part of a successful transaction, as the execution of cross-border deals needs the assistance of an executive negotiator who has the technical skills and experience to manage such transactions, and who understands Chinese and Western ways of doing business. Among the differences of the latter is that while the Chinese process starts off slow during relationship building, it is then executed quickly. In contrast, Western-style negotiations typically start off aggressively and and then slow down as specialists such as lawyers and accountants get involved. The deal team executive needs to communicate these differences in process speed to both sides.

Project management

Running projects without a dedicated manager significantly increases execution risk. Ideally this person will not be the person to manage the acquisition after change in control. The skills of an intermediary experienced in changing the company versus the ultimate manager experienced in running the company are different. In addition, the intermediary tends to be more experienced when recommending and communicating unpleasant decisions such as job redundancies, and less reluctant in implementing them due to his more temporary role. Requirements for leading M&A project management include knowledge of due diligence, valuation methodologies, legal structuring, accounting and time management.

On the level of business line managers, some existing pre-M&A projects will need to be accelerated while others will need to be delayed or stopped. Deciding what this means for each individual project requires self-assessment of skills, resources and returns, for example with regard to questions such as "What is the best use of existing chemical equipment?", "Which projects will create the most value for the company?", etc. Ideally, this planning should not be too rigid and detailed. Rather, it is advisable to define a top-down high-level plan and then adjust it via detailed bottom-up planning of the individual projects – allowing the organization to manage day-to-day operations.

Advisory support

Given the complexities described above, we strongly suggest getting advisory support when considering a chemical acquisition in China. This is true even if the initial project progress is good, as in the process the focus gradually shifts from relationships ("who you know") to detailed process expertise ("what you know"). Unfortunately, global investment banks so far have limited experience in China and are likely a generation away blending international skills with local cultural considerations while many Chinese investment bankers still look to Hong Kong, New York and London for developing their cross border M&A skills, so even if the banker is from China, their exposure to mainland business practices is limited. Experienced M&A managers recognize that M&A projects have many sub-projects and know how to best manage this complexity during a relatively short timeframe, from initial management meeting to deal signing and close, adjusting support accordingly.

Conclusion

Chemical cross border M&A is a complex activity that requires a strong commitment from senior management and hiring the right combination of accounting firms, law firms, assets evaluation specialists and investment banks or other intermediaries to manage all of these various activities in the most efficient way. In particular, the right intermediary will not only manage the M&A process but effectively communicate the issues, risks and resolution in order to complete a transaction. ■