

China's Global Challengers

THE STRATEGIC IMPLICATIONS OF CHINESE OUTBOUND M&A



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MAY 2006

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About This Report

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Acknowledgments

The authors would like to acknowledge the contributions of BCG's global experts in corporate finance and strategy and in the specific industries discussed in this report:

Kees Cools, an executive adviser in BCG's Amsterdam office and the global leader of research and marketing for the Corporate Finance and Strategy practice

David Dean, a senior vice president and director in BCG's Munich office and the global leader of the Technology and Communications practice

Gerry Hansell, a senior vice president and director in BCG's Chicago office and the leader of the Corporate Finance and Strategy practice in the Americas

Heino Meerkatt, a vice president and director in BCG's Munich office and the leader of the Corporate Finance and Strategy practice in Europe

Richard Peters, a senior vice president and director in BCG's Houston office and the global leader of the Energy practice

David Pitman, a vice president and director in BCG's Sydney office and the leader of the Corporate Finance and Strategy practice in Asia-Pacific

Daniel Stelter, a senior vice president and director in BCG's Berlin office and the global leader of the Corporate Finance and Strategy practice

The authors would also like to thank the members of the Chinese outbound M&A research team: **Brian Han** (Shanghai), **Roy Kwan** (Hong Kong), and **Alfred Shang** (Hong Kong); **Robert Howard**, for his contributions to the writing of the report; and the following members of the BCG editorial and production staff: **Barry Adler**, **Gary Callahan**, **Kim Friedman**, **Sean Hourihan**, and **Thomas Teal**.

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Preface

In recent years, Chinese companies have burst onto the global mergers-and-acquisitions (M&A) scene. High-profile deals such as the 2003 purchase of Thomson's television business by Chinese television manufacturer TCL, and the 2004 acquisition of IBM's personal-computer business by the Chinese computer company Lenovo, have introduced the world to a new generation of Chinese companies with aspirations to be global competitors. Even unsuccessful mergers such as Haier's failed bid for Maytag (eventually bought by Whirlpool) and the attempt by energy giant China National Offshore Oil Corporation (CNOOC) to buy Unocal (which foundered on political opposition in the United States) reflect the increasing frequency with which Chinese companies are turning to M&A to penetrate global markets and acquire global scale.

So far, the value of these Chinese "outbound" acquisition deals remains relatively small. We estimate that since 1986, Chinese companies have invested some \$30 billion in non-Chinese companies, nearly a third of it in 2004 and 2005 alone. This amount is significantly less as a percentage of GDP than the equivalent amounts for other rapidly developing economies such as India and South Africa. And it pales in comparison with the more than \$60 billion per year of foreign direct investment currently flowing *into* China. Nevertheless, we believe that the recent flurry of M&A activity on the part of Chinese companies is only the beginning of a powerful long-term trend.

A new generation of aggressive Chinese companies wants to break out of the Chinese home market. Financing is plentiful. The Chinese government is aggressively creating national champions that are strong enough to compete globally. For at least some of these Chinese companies, often the most dynamic

and entrepreneurial, acquisition is becoming a preferred strategy for reaching global scale quickly. What's more, there is an increasing supply of deals as established global companies review their portfolios and decide to divest from noncore sectors.

To understand the strategic implications and managerial challenges of Chinese outbound M&A, The

Boston Consulting Group studied some 500 deals involving Chinese companies that took place over the past 20 years.¹ We also analyzed the performance of a cross-industry

sample of 16 transactions between Chinese and non-Chinese companies that have taken place since 2001. (To our knowledge, this analysis is the first attempt to evaluate the stock market performance of recent Chinese deals.) Our study produced five key findings:

The current wave of Chinese outbound M&A is intensifying—and there is plenty of room for growth. Despite the recent activity, China still lags significantly behind the rate of M&A in other rapidly developing economies such as India and South Africa. Relative to GDP and levels of foreign trade, Chinese outbound M&A would have to increase more than tenfold to reach current levels of M&A in the United States.

So far, Chinese companies have proven to be better investors than acquirers. Roughly two-thirds of the Chinese acquisitions in our sample created value in the first year after the announcement of the deal. However, there are substantial differences between the performance of strategic investments (where the Chinese acquirer buys only a minority stake) and the performance of outright acquisitions (where the Chinese acquirer buys 100 percent of the target and integration synergies are needed to create value). Some outright acquisitions have actually destroyed value.

The recent flurry of M&A activity by Chinese companies is only the beginning of a powerful long-term trend.

1. The initial results of our study were first published in Chinese in 2005. See *Xiang shijie wutai majin: zhongguo qiye de duiwai binggou* (向世界舞台迈进: 中国企业的对外并购), BCG report, December 2005.

Most Chinese acquirers lack world-class M&A capabilities. For Chinese companies with global aspirations, acquisition is an important way to become major players in the world economy. But in order to succeed, they must overcome a significant obstacle—their lack of managerial expertise in executing large-scale cross-border mergers.

A new organizational model may be emerging. In response to this weakness, a new type of deal may be emerging: temporary partnerships, in which acquisition by a Chinese partner is accompanied by a time-limited joint venture between acquirer and

target. These partnerships allow Western targets to transfer capabilities to their Chinese acquirers. So far, these partnership mergers have outperformed outright acquisitions.

For Western incumbents, Chinese outbound M&A represents a potential threat—but also an opportunity. Established companies need to prepare for the possibility that a low-cost Chinese player may upset competitive dynamics in their industry. At the same time, selling to a Chinese acquirer may be an effective way for established companies to exit sectors of their business.

The Growth in Chinese Outbound M&A

Although Chinese outbound M&A has only recently come to the business world’s attention, it is not a new phenomenon. Chinese companies have been investing in foreign companies, both inside and outside China, for 20 years. We have identified four major waves of investment. The most recent wave is driven by powerful forces that are likely to intensify in years to come.

Four Waves of Investment

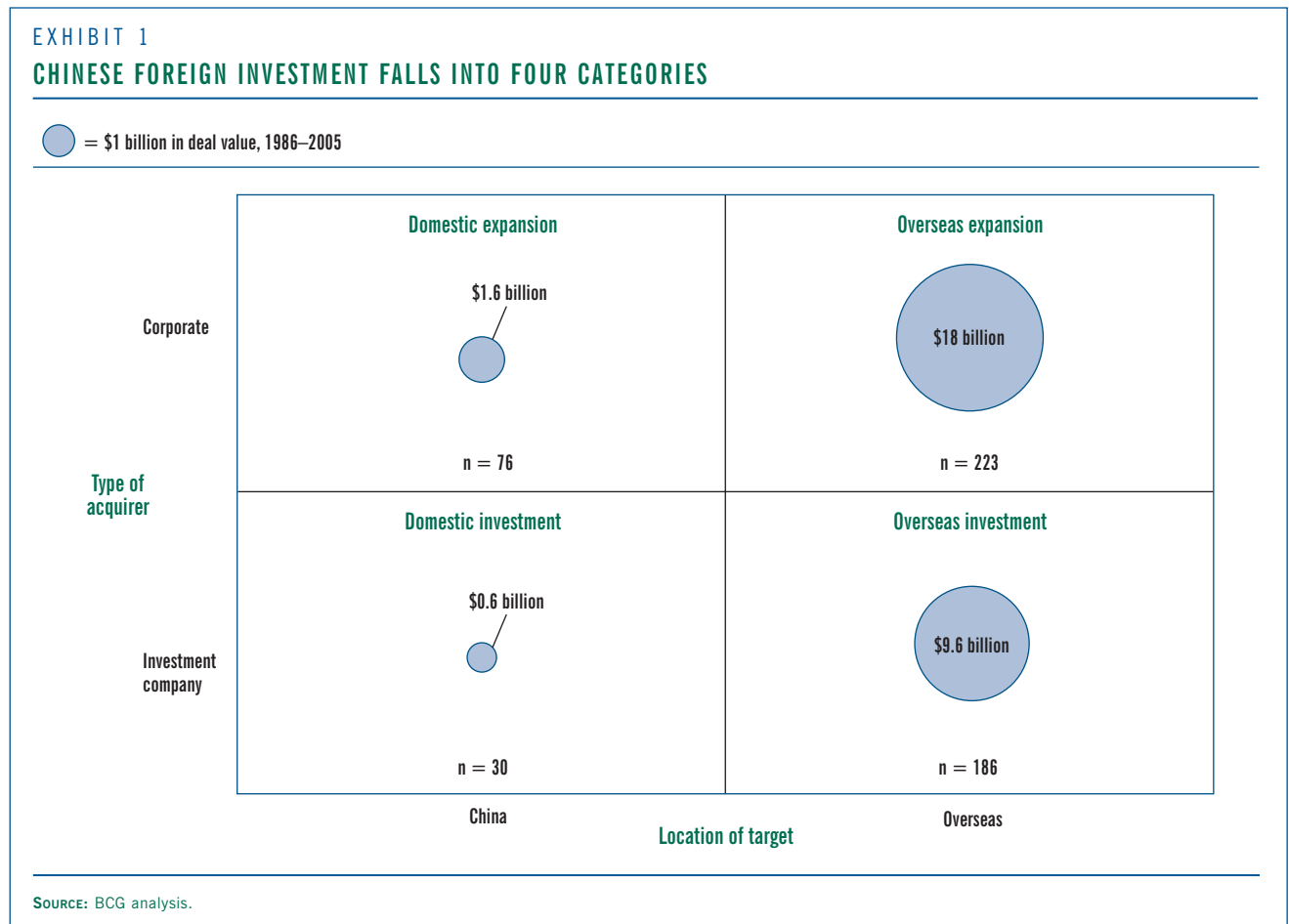
To get a sense of the patterns of investment by Chinese companies in non-Chinese operations, we categorized 515 transactions since 1986. We differentiated these transactions along two critical dimensions:

- *The Nature of the Chinese Acquirer.* Was the acquirer a corporation trying to expand its operations or was it a financial-investment company primarily seeking financial returns?

- *The Location of the Target.* Was the target outside China or was it a subsidiary or joint venture owned by a foreign company inside China?

These criteria define the two-by-two matrix in Exhibit 1. By far the largest category, in both the number and the value of deals, is *overseas expansion*, in which a Chinese company has acquired operations in order to expand its business beyond the Chinese market. A classic example is Lenovo’s recent acquisition of IBM’s personal-computer business. There have been 223 such deals since 1986, with a total value of about \$18 billion.

The second largest category is *overseas investment*, in which Chinese investment companies or private-equity firms invest primarily for the sake of financial return—for example, the acquisition of a 12 percent stake in Hong Kong Telecommunications by CITIC Pacific, a subsidiary of state-owned China International Trust and Investment



Corporation, in 1993. There have been 186 such deals since 1986, with a combined value of some \$9.6 billion.

The two final categories in our matrix are considerably smaller. In *domestic expansion* deals, Chinese companies buy out their foreign joint-venture partners or take over foreign assets in China. For example, in 2003, Shanghai Bright Dairy & Food bought Guangzhou Danone Yogurt from Groupe Danone. The 76 deals in this category since 1986 are valued at only \$1.6 billion. Finally, in relatively rare *domestic investment* deals, Chinese investment companies make passive investments in foreign assets in China. For instance, in 2002, the Liaoning Development Group purchased a 10 percent stake in Jinbei GM Automotive, a joint venture between General Motors and Jinbei Auto. But there were only 30 such deals between 1986 and 2005, valued at \$600 million.

Exhibits 2 and 3, on page 10, chart the growth of Chinese investment in foreign companies from 1986 through 2005, first in terms of the number of deals and then in terms of deal value. The number of deals grew at an average rate of 11 percent per year, and deal value grew annually by 22 percent.

Exhibits 2 and 3 also show four major waves of investment. The first wave, lasting roughly a decade from 1986 to 1996, focused on overseas investment, as Chinese investment firms began to search the world for attractive financial returns. During this period, there were relatively few deals of low value. A second wave, lasting from about 1996 to 1999, was triggered by the return of Hong Kong to China, as money from mainland China flowed into Hong Kong and Chinese companies took control of strategically important assets in the city. The number of deals per year grew during this period. What's more, the highest annual deal value to date came in 1997, the year of the Hong Kong handover.

Starting around 2000, a third wave characterized by domestic expansion took shape as many joint-venture contracts came to an end and Chinese companies began to buy out their foreign partners. Almost simultaneously, a fourth wave began to

emerge when China joined the World Trade Organization in late 2001. Deal activity in this latest wave has covered a far broader range of industries and target countries. Deal sizes are also larger, with some in excess of \$1 billion. One sign of this recent growth in deal size: although the number of deals in 2005 decreased from the 2004 peak, the value of those deals actually increased to the highest level since 1997. And while all deal types showed increasing activity during this fourth wave, overseas expansion has clearly been dominant, accounting for roughly 50 percent of the deals and 75 percent of the value since 2001.

*The latest M&A wave
began when China
joined the World Trade
Organization in late 2001.*

The vast majority of the deals in this fourth wave—approximately 80 percent of the top transactions since 2001—are

in two sectors of the economy: technology and communications, and natural resources. (See Exhibit 4, page 11.) Technology and communications is an integral part of a modern industrial infrastructure, and the many deals in this sector reflect the rapid growth of the Chinese economy. In addition to the much publicized Lenovo-IBM deal, Beijing-based BOE Technology Group, a manufacturer of computer monitors, acquired a stake in TPV Technology, a Taiwan-based monitor vendor, and bought the thin-film-transistor LCD business from Hyundai's semiconductor unit in South Korea. Meanwhile, China Netcom Group, an \$8 billion Chinese telecommunications company, teamed up with partners to buy Asia Global Crossing.

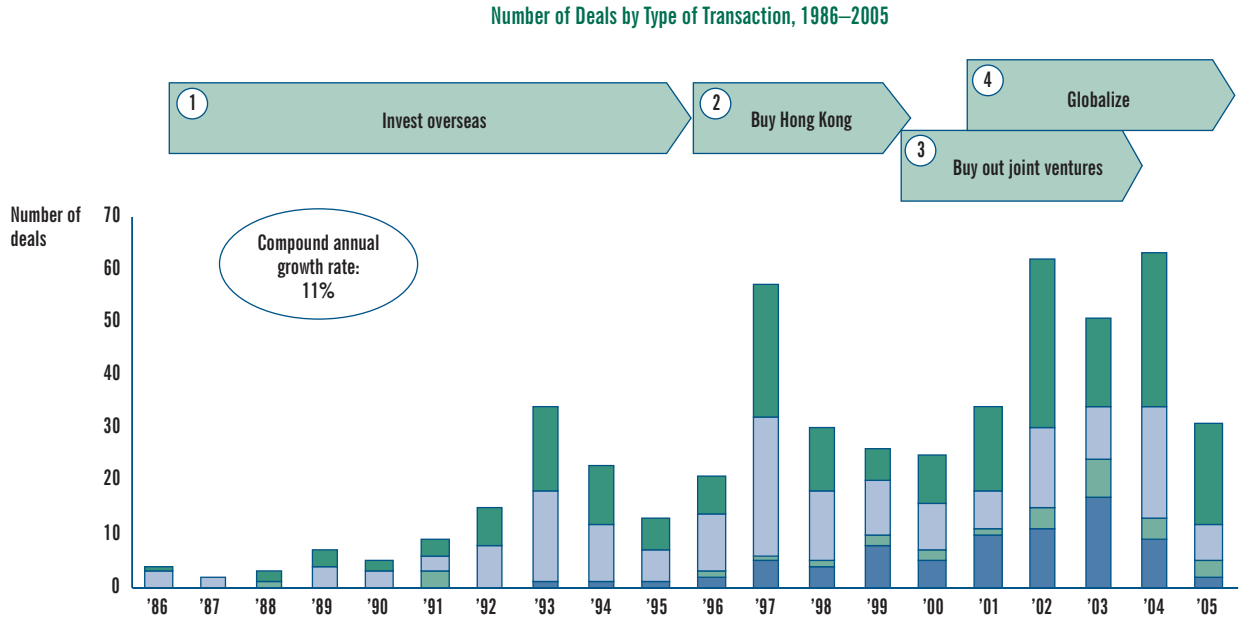
The natural-resource deals are driven by China's quest for sufficient supplies of energy and other natural resources to fuel its rapid development. For example, in 2002, China's state-owned energy company CNOOC successfully acquired the Indonesian assets of Repsol Exploración, a Spanish energy company. Similarly, PetroChina, a subsidiary of the China National Petroleum Corporation (CNPC), bought the Indonesian oil and gas assets of U.S.-based Devon Energy Corporation. And in 2005, CNPC itself acquired the North Buzachi oilfield in Kazakhstan through its purchase of the Canada-based PetroKazakhstan.

But the predominance of these two sectors does not mean that other industries have not become increasingly active as well. In automobiles, for

EXHIBIT 2

THERE HAVE BEEN FOUR WAVES OF CHINESE OUTBOUND M&A (I)

Overseas expansion Overseas investment Domestic investment Domestic expansion

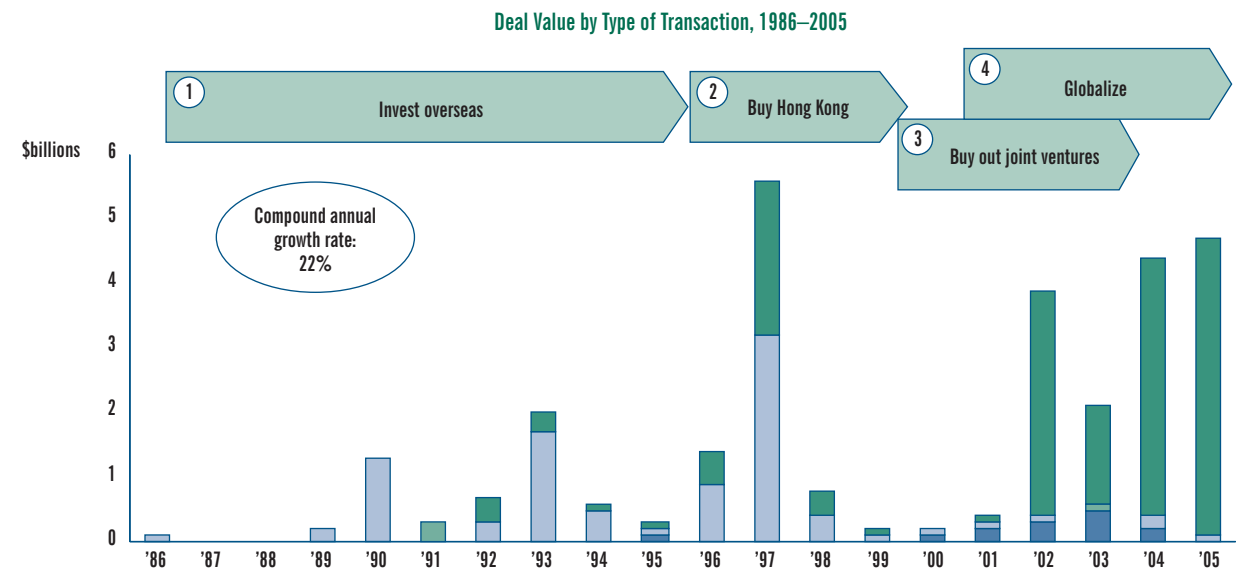


SOURCES: Thomson Financial; BCG analysis.

EXHIBIT 3

THERE HAVE BEEN FOUR WAVES OF CHINESE OUTBOUND M&A (II)

Overseas expansion Overseas investment Domestic investment Domestic expansion



SOURCES: Thomson Financial; BCG analysis.

NOTE: We have estimated the value of private deals, for which the value of the transaction has not been disclosed, by averaging the lower third of disclosed deals for the equivalent transaction type in the relevant industry.

example, Shanghai Automotive Industry Corporation (SAIC), one of China's big three automakers, has purchased a controlling stake in South Korea's SsangYong Motor Company; and Nanjing Automobile has bought the insolvent MG Rover Group. In the utility sector, Huaneng Power International has acquired a 50 percent stake in the Australian power-generation company OzGen.

Chinese Global Challengers

Three major forces are driving the current wave of Chinese outbound M&A. Each is likely to intensify.

The first is the emergence of a new generation of Chinese companies determined to become players in the global economy.² These companies have been successful in the Chinese market and are rapidly working to establish themselves globally as well.

For the moment, these Chinese global challengers benefit from some distinctive competitive advantages. The enormous size of the domestic Chinese

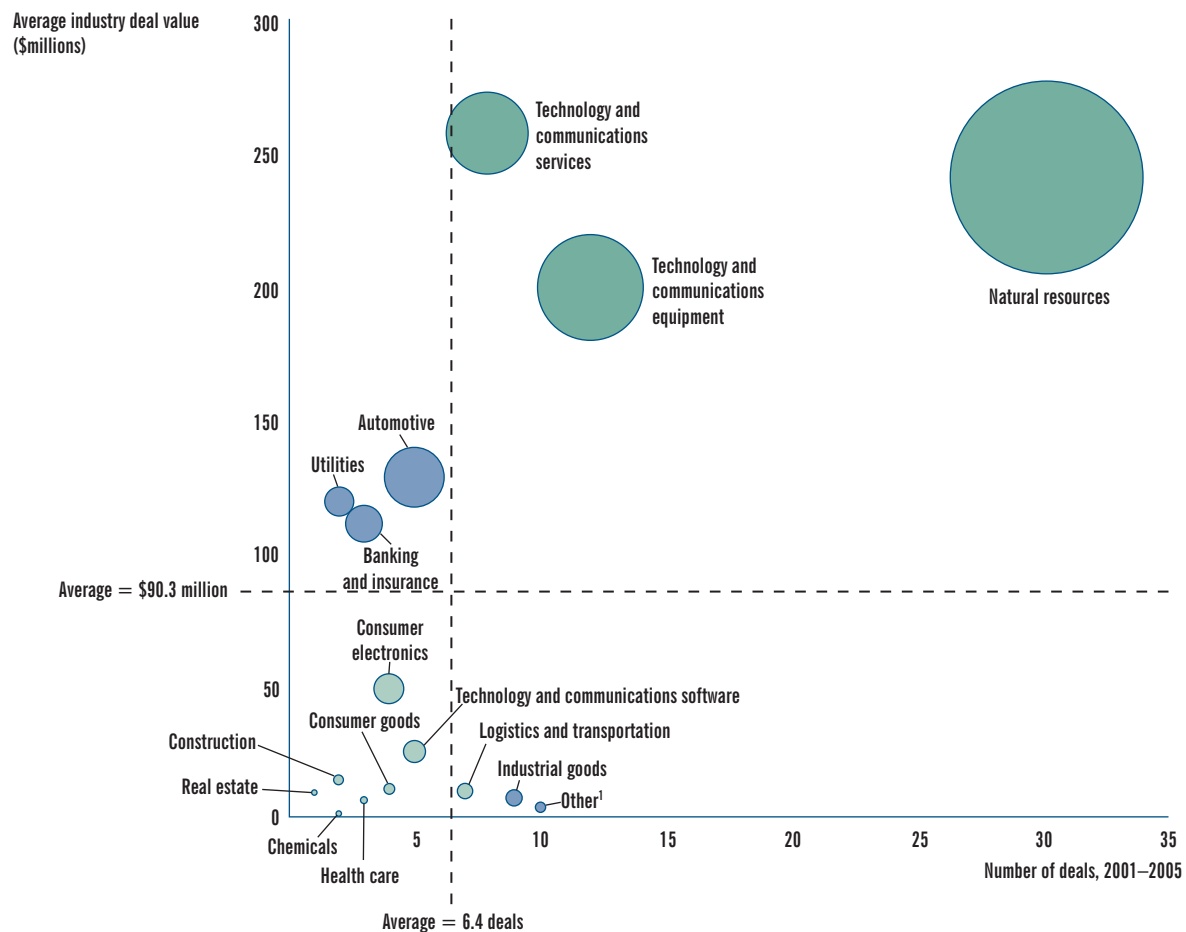
2. This trend is not limited to China. It can be found in all rapidly developing economies. See *The New Global Challengers: How 100 Top Companies from Rapidly Developing Economies Are Going Global—and Changing the World*, BCG report, May 2006.

EXHIBIT 4

NATURAL RESOURCES AND TECHNOLOGY AND COMMUNICATIONS LEAD THE RECENT M&A WAVE

Total industry deal value

○ = \$1 billion ● Most active industries ● Moderately active industries ● Emerging industries



SOURCES: Thomson Financial; BCG analysis.

¹Includes agriculture, services, and media and entertainment.

market gives them significant scale advantages. For example, China is already the world's largest market for television sets and mobile phones. And China's low labor costs not only give Chinese companies a substantial cost advantage but also allow them to pursue a highly flexible production model that is significantly less asset intensive than that found in most industrialized countries. The growing dynamism of the Chinese market has also put Chinese companies at the forefront of product innovation in some sectors—for instance, mobile phones. What's more, many of these aspiring global players from China have gained invaluable operating experience by working with multinational companies in joint ventures that were originally intended to serve the domestic Chinese market.

Of course, many of these local advantages will disappear in time. As Western investment continues to flow into China, global multinationals will eventually create a platform for low-cost manufacturing in China and gain the benefits of serving the fast-growing Chinese market.³ But in the meantime, the Chinese global challengers have a significant strategic opportunity to leverage their strengths and use them to break out of their home market and acquire the economies of scale, distribution channels, marketing and sales capabilities, intellectual property, brand awareness, and other advantages that will allow them to compete globally over the long term.

For at least some Chinese companies, acquisition is rapidly emerging as the quickest and most efficient way to achieve this goal. The capital to fund acquisitions is readily available. Many Chinese companies have considerable cash reserves (especially in heavy industries such as steel, which have recently benefited from high prices due to soaring demand from China's own economic expansion). And with Chinese foreign reserves likely to reach \$1 trillion by the end of 2006, cheap financing is easily available from state-owned banks. What's more, international private-equity firms are

becoming increasingly active in Chinese deals. For example, three major U.S. private-equity firms—Texas Pacific, General Atlantic, and Newbridge Capital—played a central role in the Lenovo-IBM acquisition.

Strong State Support

The global ambitions of Chinese companies are reinforced by strong support for global expansion from the Chinese government. China has a clear national interest in expanding its businesses abroad. Since 2001, the Chinese government has had an explicit policy of internationalizing Chinese businesses and creating national champions through industry consolidation. And because China's foreign-exchange reserves are heavily regulated by the state, the government is a key enabler of cross-border deals.

The fact that China's biggest companies are, to a large extent, state-owned companies greatly magnifies the state's role. For example, the Chinese government's State-owned Assets Supervision and Administration Commission (SASAC), charged with restructuring China's most important state-owned companies, is the world's largest portfolio manager, overseeing some 170 companies with combined revenues in excess of \$500 billion. SASAC's portfolio includes leading companies in major industries such as telecommunications, energy, automobiles, and steel. SASAC's mission is to turn the companies under its shield into highly competitive industry leaders, in part by aggressively consolidating them. It has decisive authority when it comes to overseas M&A, either driving or approving transactions.

An Increasing Supply of Deals

Finally, China's appetite for outbound M&A has received a further boost from the simultaneous willingness of multinational companies to review their portfolios and shed underperforming business units, making more acquisition targets available. As

With Chinese foreign reserves likely to reach \$1 trillion by late 2006, cheap financing is easily available.

3. See *Organizing for Global Advantage in China, India, and Other Rapidly Developing Economies*, BCG report, March 2006.

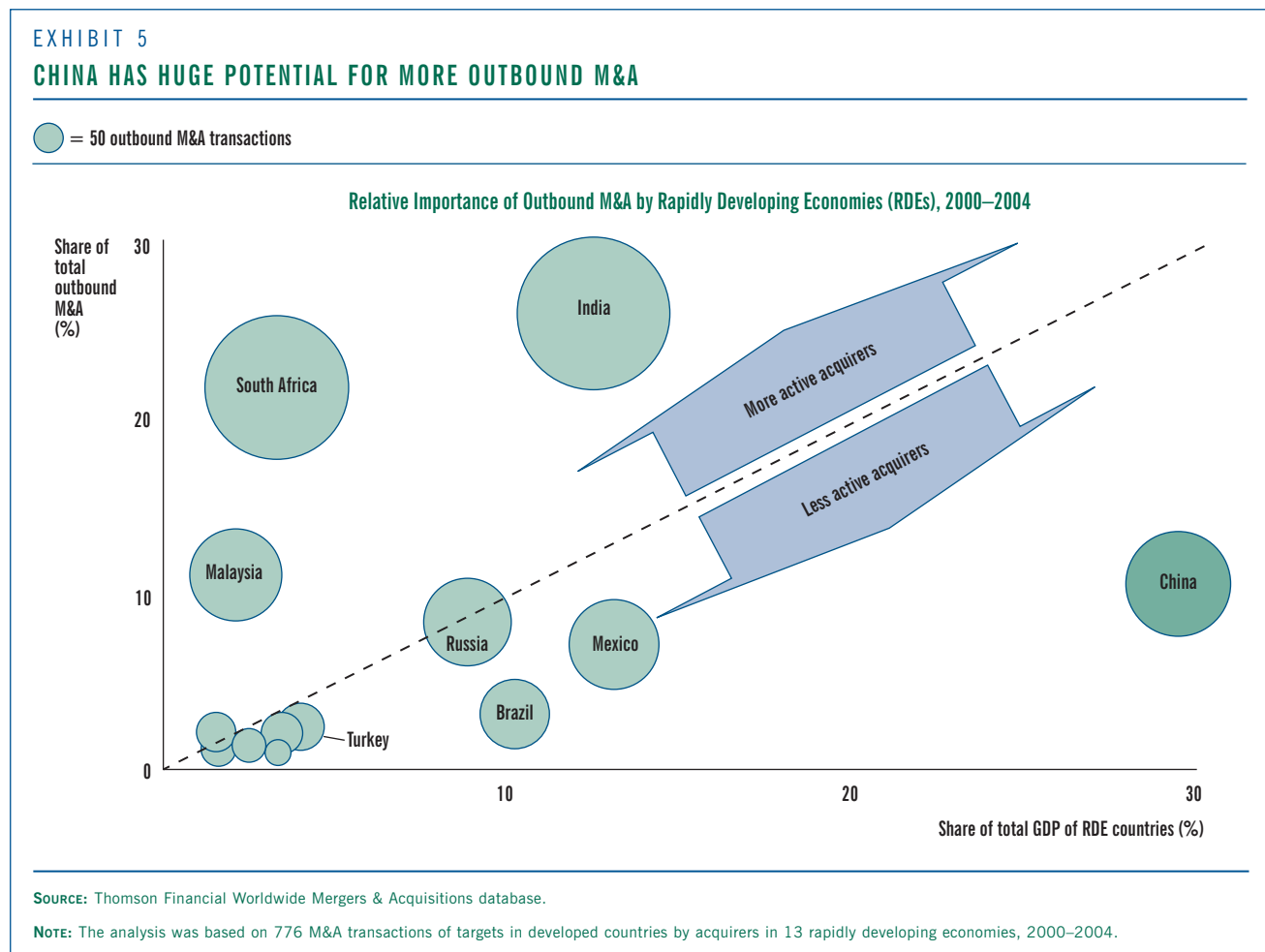
foreign companies restructure and consolidate, they are increasingly willing to sell divisions and units outside of their core strength. Unattractive financials, second-in-class operations, lagging market position, or a generally challenging market environment often make exit a sensible option. In many cases, these business units have assets—for example, patents, strong brands, and established sales channels—that make them more valuable to a Chinese acquirer.

All these trends will intensify the wave of Chinese outbound M&A in the years ahead. How large might it become? Macroeconomic data suggest that there is plenty of room for further growth. Despite recent high-profile deals, China remains a relatively small player on the world M&A stage. For example, China represents roughly 30 percent of the total GDP of the world's rapidly developing economies, but it takes part in only 11 percent of the cross-border M&A deals emanating from those economies. (See Exhibit 5.) China's outbound M&A—in relation to its GDP and foreign trade—would have to

increase tenfold to reach current levels in developed countries such as the United States and the United Kingdom.

It is highly probable that within the next few years, deal activity will expand over a much broader base, including the full range of industries in which Chinese companies already have strong exports. What's more, big players like Haier and CNOOC, whose first forays into major M&A have failed, are likely to reenter the acquisitions game. (See the sidebar "Six Predictions for Chinese M&A," page 14.)

But even as the trend intensifies, Chinese companies will have to overcome a major obstacle. Despite their growing experience overseas, most Chinese management teams are still relatively weak when it comes to effectively executing large cross-border mergers. In order to succeed in their goal of achieving global scale through acquisition, the Chinese global challengers must significantly improve their M&A managerial capabilities.



SIX PREDICTIONS FOR CHINESE M&A

- 1. Big players will return to the global M&A stage.** Despite some early failures, the appetite for global expansion on the part of major Chinese companies remains strong. They see M&A as an increasingly important tool for becoming global competitors, and they are actively looking for deals. In the future, however, they will avoid takeover battles in favor of deals with willing sellers.
- 2. Deals will take place on a much broader industry and ownership base.** Look for more M&A activity in strong export sectors such as consumer electronics, home appliances, automotive, and shipping, as well as from companies in China's fast-growing private sector.
- 3. Private equity will play a leading role.** International private-equity firms will actively bring new deals to Chinese acquirers.
- 4. Developing world-class M&A and integration capabilities will be key.** For Chinese companies, organic growth alone will not be sufficient. To succeed at M&A, they must address the challenge of effective execution.
- 5. The most successful deals will be win-win.** To bridge the capability gap and increase the probability of success, Chinese acquirers will increasingly use partnerships in which the acquirer benefits from the management and integration capabilities of the divesting company and the seller realizes superior value through ongoing revenue streams and the potential for later capital gains.
- 6. Everyone will be looking to make a "China play."** The drive for global scale will require any company with global aspirations to consider a possible cross-border M&A transaction involving China.

The Performance of Chinese Outbound M&A

To evaluate the recent performance of Chinese outbound M&A, we analyzed 16 transactions that have taken place since 2001.⁴ We measured the relative total shareholder return of the acquiring companies at five days before the announcement of the deal and at five days, six months, and one year after the announcement.⁵ Given the small sample size, the brief time period studied, and the inefficiencies in the Chinese stock markets, the results of this analysis are in no way definitive. Still, they do suggest some intriguing potential trends that are worthy of additional research.

Superior Average Performance but Considerable Divergence

Nearly two-thirds of the deals in our sample created value in the first year after announcement. (See Exhibit 6.) Given the industry rule of thumb that roughly two-thirds of mergers typically destroy value, this finding suggests that Chinese outbound M&As have, on average, delivered superior performance.

A closer look at the data, however, reveals considerable divergence in performance, depending on the degree to which the deal in question required the

integration of the two operations. We divided our sample into two groups. We looked at eight deals in which the need for integration was comparatively low. These were either strategic investments, in which the Chinese company bought a minority stake and the foreign owner remained in control of operations, or they were acquisitions to gain access to natural resources or stand-alone assets. We also looked at eight deals in which value depended on realizing synergies and the need for integration was high.

The low-integration deals performed considerably better than the high-integration deals. (See Exhibit 7, page 16.) The deals requiring minimal integration delivered approximately 15 percent in additional value, whereas the deals requiring substantial integration actually destroyed value. (The passive strategic investments created even more value—nearly 30 percent. See Exhibit 8, page 16.) This finding seems to suggest that while investors are in favor of international expansion, they are skeptical about the capacity of Chinese acquirers to successfully integrate foreign acquisitions.

Obstacles to Success

They are right to be skeptical. On the basis of our experience advising Chinese companies, we believe that the greatest weakness of many Chinese acquirers is their lack of a world-class M&A capability. At the strategic level, Chinese acquirers typically do not have a clearly defined view of the role of M&A in their globalization strategy and, as a result, they tend to respond opportunistically to deals as they become available. They are relatively inexperienced at managing a portfolio of businesses across diverse markets. They often lack a deep understanding of customers, competitors, distribution structures, and the regulatory environment in their target markets. And their management information systems, governance structures, managerial skills,

4. All the acquirers are listed on the Hong Kong, Shanghai, or Shenzhen stock markets. None has completed any other transactions in the period under study.

5. Relative total shareholder return compares a company's total shareholder return to the relevant market index.

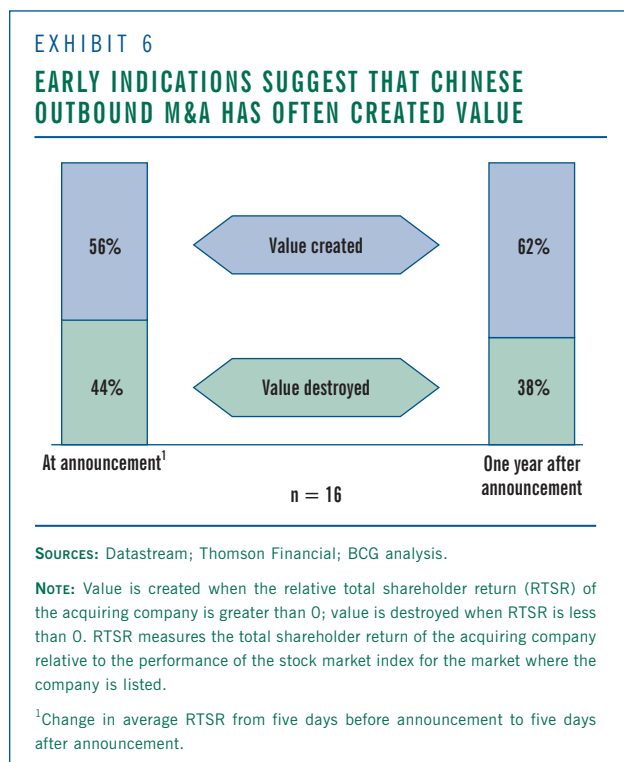
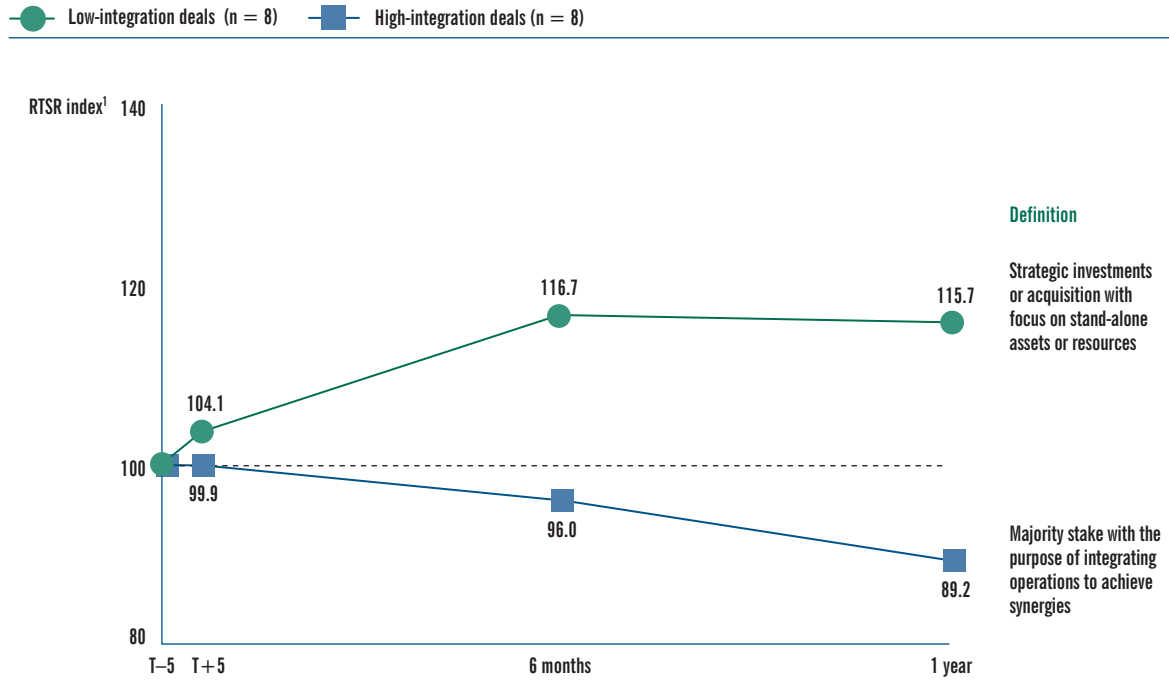


EXHIBIT 7

CHINESE COMPANIES ARE BETTER INVESTORS THAN ACQUIRERS

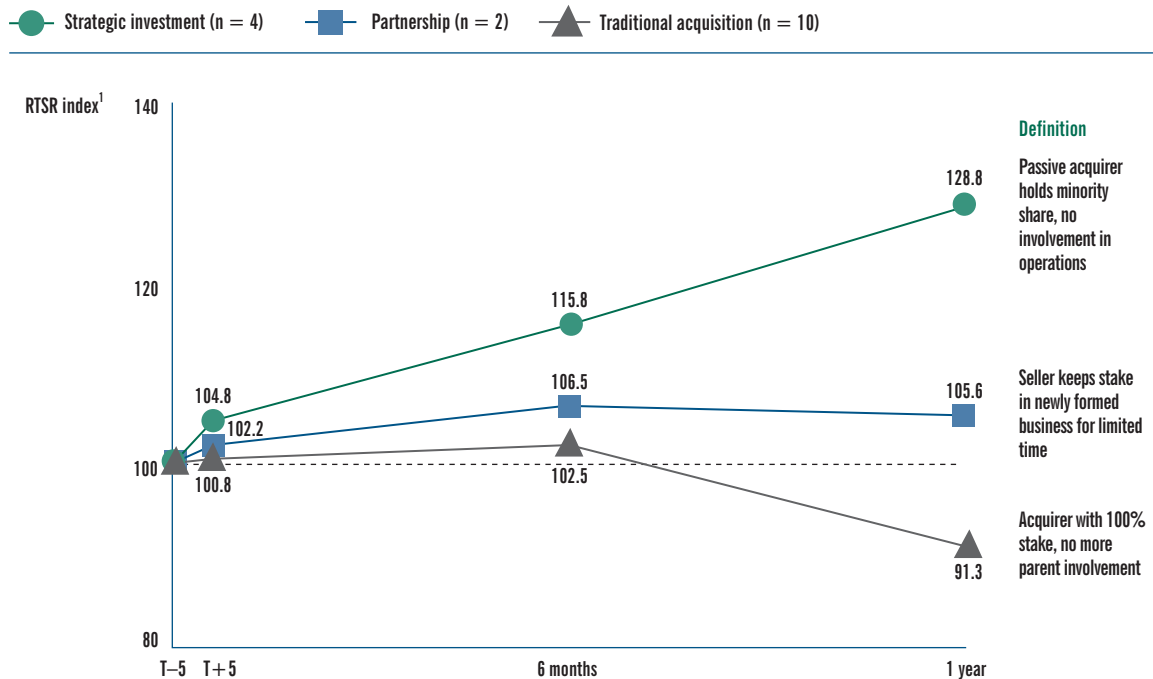


Sources: Datastream; Thomson Financial; BCG analysis.

¹The index measures the total shareholder return of each acquiring company relative to the performance of the stock market index in the market where the company is listed. The share price five days before the announcement date (T-5 on the horizontal axis) equals 100.

EXHIBIT 8

PARTNERSHIPS MAY IMPROVE THE CHANCE FOR SUCCESSFUL INTEGRATION



Sources: Datastream; Thomson Financial; BCG analysis.

¹The index measures the total shareholder return of each acquiring company relative to the performance of the stock market index in the market where the company is listed. The share price five days before the announcement date (T-5 on the horizontal axis) equals 100.

and corporate processes are less well developed than in large global firms.

At the operational level, they have yet to develop effective processes for target identification, valuation, and postmerger integration. They do not generally possess best-in-class operations that could easily be transferred to their targets. Nor are they experienced in eliminating duplications and waste in newly combined operations. As a result, they find it difficult to achieve the kinds of synergies that generate most of the value in an acquisition.

Chinese companies also face major cultural barriers when it comes to integrating a non-Chinese acquisition. To be sure, any postmerger integration must navigate often

subtle differences in the cultures of the merged entities. But the differences between how Western companies and Chinese companies operate are extensive. Chinese companies tend to be highly entrepreneurial. Often, they are run by a small group of owner-managers who create a strong patriarchal culture characterized by personal loyalty. They make decisions quickly without a lot of analysis. They also lack process discipline, and their management processes tend to be disorganized. Integrating this kind of corporate culture with the more professionalized managerial cultures of most Western companies requires an even higher than normal degree of sensitivity, determination, and flexibility. (See the sidebar “A Checklist for the Chinese CEO,” page 18.)

Finally, these obstacles are exacerbated by the fact that, in many cases, Chinese acquirers are taking on especially difficult deals—where the target company is either losing money or has already gone bankrupt. This is due partly to their inexperience, partly to their sense of urgency about achieving global scale, and partly to the fact that political opposition frequently prevents them from winning the most attractive deals. (Witness the negative political reaction to CNOOC’s proposed acquisition of Unocal.) It is hard enough for a Chinese acquirer to manage a U.S. or European company. It is even more difficult when the challenge is to turn around a failing enterprise that local managers have been unable to revive.

Emergence of the Temporary Partnership Model

To overcome these managerial obstacles, some Chinese companies have embraced a hybrid integration model that combines an outright acquisition with a temporary partnership between the Chinese acquirer and the Western seller. These partnerships sometimes take the form of a joint venture in which the acquirer holds the majority stake but the seller retains a minority interest. Additional agreements ensure access to jointly used assets like sales channels and to intellectual property such as patents and brands. Both the joint-venture agreement and any subsidiary agreements are typically limited in time.

One example of this kind of partnership between

buyer and seller is TCL’s acquisition of Thomson’s television business. The two parties established a joint venture, known as the TTE Corporation, in which TCL has a 67 percent share and Thomson the remaining 33 percent. The joint venture includes Thomson’s R&D centers in Germany, Singapore, and the United States; production facilities in Mexico, Poland, and Thailand; and approximately 9,000 former Thomson employees. It also has a long-term license to use Thomson’s brands (Thomson in Europe, RCA in North America) and a license to use Thomson’s patents (with the right to negotiate further use for a fee after the license expires). Thomson receives a royalty based on TTE’s earnings before interest and taxes. After 18 months, Thomson also has the option to swap its equity in TTE for equity in TCL.

Lenovo’s IBM deal is also structured as a temporary partnership. As part of the acquisition, IBM took an 18.9 percent equity stake in the Chinese company and signed a five-year cooperation agreement. Lenovo took outright ownership of IBM’s R&D centers in Japan and North Carolina and its ThinkPad factory in Shenzhen and thus became the employer of some 10,000 former IBM employees. Lenovo also licensed the IBM brand for five years. Lenovo products will be supported by IBM’s sales-and-marketing organization, and IBM’s service organization will be the preferred supplier of Lenovo leasing, warranty, and maintenance services. In exchange, IBM receives licensing fees for use of its sales channels

Chinese companies find it hard to achieve the synergies that generate most of the value in an acquisition.

A CHECKLIST FOR THE CHINESE CEO

- **Ensure that strategy drives opportunity.** Don't just react to the latest deal your investment bankers bring you. Define the role of M&A in your globalization strategy and start evaluating potential acquisition candidates now.
- **Don't be afraid to get your feet wet.** Start by expanding organically to better understand overseas markets and, in parallel, start building or acquiring M&A capabilities.
- **Do robust due diligence.** Often ignored factors such as intellectual property rights, local labor laws, and environmental standards can turn out to be deal breakers. Make sure you give them sufficient attention before making a commitment.
- **Create win-win transactions.** The best deals are those in which both parties achieve their goals. Design a structure that gives the seller incentives to help the merged entity succeed.
- **Be sensitive to cultural differences.** Typically, Western companies have explicit processes for delegation, accountability, and transparency. Make sure you design the organizational structure and communications practices of your integrated operations accordingly.
- **Retain key people in the target organization.** They will play a central role in transforming the new entity into a global competitor. Make them your allies.
- **Define and communicate clear synergy targets.** Creating value through integration requires explicit revenue and cost synergies. Define them in advance and then use them to drive the post-merger integration.
- **Drive the integration process aggressively.** Make sure to use proven postmerger-integration processes and techniques.

as well as commissions on any leads that IBM personnel generate for Lenovo.

The temporary partnership model is attractive to both sides. From the perspective of the Chinese acquirer, such partnerships help smooth the integration of a major acquisition by ensuring the continuity of key management and technical personnel and, over the long term, by transferring Western management capabilities to the Chinese company. They also provide a way for the Chinese company to benefit from valuable assets, such as brands and intellectual property, that the Western partner is unwilling to sell. From the point of view of the Western company, partnerships can be a way to exit an unattractive business while still participating in

ongoing revenue streams with minimal business risk. In some cases, the acquirer may even be an attractive partner for the seller in penetrating the Chinese market.

When well structured, temporary partnerships give both partners an incentive to make the deal work.⁶ Although the sample size is far too small to draw general conclusions, we note that the two joint-venture partnerships in our sample do outperform the more conventional acquisitions. Whereas the passive strategic investments in our sample created the most value—nearly 30 percent—the temporary partnerships also created value. By contrast, conventional acquisitions requiring significant integration destroyed value.

6. For more detail on the strategic and managerial challenges of corporate partnerships, see *The Role of Alliances in Corporate Strategy*, BCG report, November 2005.

Strategic Implications for Western Companies

For Western companies, Chinese outbound M&A is a potential competitive threat—but also an opportunity. On the one hand, the entry of an aggressive low-cost Chinese competitor into an established global industry or market may change fundamentally the competitive dynamics of an industry. On the other, a Chinese acquirer may be the best candidate when it comes to exiting a business that is no longer attractive. To assess the precise strategic implications, we suggest a three-step process.

Understand the Impact of Chinese Global Players

For starters, every Western company needs to develop a detailed understanding of how its industry will be affected by new competitors from China. A good grasp of the competitive strengths and weaknesses of potential new Chinese players—by industry segment, by region, and by growth strategy (organic versus acquisition)—is indispensable. Who are these likely new entrants, and what are their expansion strategies? Which steps of the value chain will be affected?

Rethink Long-Term Strategy

Once a company understands the specific market segments and geographies that Chinese challengers are likely to attack, it is in a position to make fundamental decisions about where it wants to compete in the long run and how it wants to respond to the new entrants. It needs to identify the deepest and fastest-growing profit pools, and it needs to figure out where the company's value proposition, capabilities, and innovation power will be most relevant. The company must also make sure that its cost structure is in line with that of potential Chinese competitors and that it has an effective intellectual-property strategy for protecting its most profitable assets from low-cost competition.

Reassess Strategic Options

Once a company has made fundamental decisions about which markets to focus on, a hard look at rel-

evant Chinese global challengers should also inform decisions on how to implement the long-term strategy. This is partly a question of improving the company's competitiveness *against* its new competitors. But even more important, it also means assessing opportunities to *cooperate* with Chinese companies in order to achieve one's own fundamental goals. For many companies, collaboration with a Chinese partner or full divestiture to a Chinese acquirer can be an effective way to minimize business risk or to completely exit sectors that are no longer profitable or not vital to a company's competitive strategy.⁷

Even when an incumbent's management team decides to retreat from a market segment, partnership with a Chinese player can be the right strategy for staging this exit. In the case of an outright sale, a Chinese company may be willing to pay more for a business than a domestic competitor, because the deal involves exactly the sort of assets—intellectual property, brands, distribution channels in mature markets—needed to offset the Chinese company's current weaknesses. As discussed above, a temporary partnership might in many cases create more value than an outright sale. (For more on this subject, see the sidebar “Some Questions to Consider Before Divesting to a Chinese Acquirer,” page 20.)

* * *

Far from being a short-term fad, Chinese outbound M&A is only one part of an even broader phenomenon: the transformation of the global economy by a new generation of competitors from rapidly developing economies. The arrival of this new generation of global players is perhaps the most important of the trends that will shape the world economy in the years to come.

To take their place on the global stage, however, Chinese competitors will have to significantly improve their M&A capabilities—in particular, their ability to integrate new acquisitions effectively. And Western incumbents need to start now to assess both the opportunities and the threats that Chinese outbound M&A represents for them—and to adapt their corporate strategies accordingly.

7. For more on divestiture, see “The Right Way to Divest,” BCG Opportunities for Action in Corporate Finance and Strategy, November 2004.

SOME QUESTIONS TO CONSIDER BEFORE DIVESTING TO A CHINESE ACQUIRER

A Western company thinking of selling a business to a Chinese acquirer needs to answer three questions: Does it make sense to sell to a Chinese company? Should the deal take the form of a temporary partnership? Who is the most appropriate partner?

Should we sell to a Chinese company?

- Do we have an established brand, intellectual property, sales relationships, or other assets that might be valuable to a Chinese company?
- Is the deal likely to cause domestic political opposition—and if so, how will we manage it?
- Is there additional value in partnering with a Chinese acquirer by bundling products or services with the M&A deal?
- Will a relationship with a strong Chinese partner help us gain access to the Chinese market?

Should the deal take the form of an alliance?

- What is the potential for generating a continuous revenue stream from licensing fees for brands or intellectual property, sales commissions, or fees for back-office support?
- Is the newly established business worthy of continued investment?

- Does the Chinese partner need the incumbent management in order to succeed?
- Is a strong partner in the divested business important to the success of our remaining core businesses?
- Would the absence of an alliance substantially decrease the value of the sold business in the eyes of investors?
- If we do decide to partner, what is our long-term exit strategy?

Who is the most appropriate partner?

- Is the acquirer a viable player with products of international quality and a leading position in the Chinese market?
- Does the acquirer have a clear vision and strategy for the merged business?
- Does it have the ability to leverage—and not damage—the brand?
- Can we contain the risk of the acquirer becoming a competitor in our remaining businesses?
- Do we and the acquirer have a shared view of how to govern the partnership effectively?

The Boston Consulting Group has other publications on China, globalization, and M&A that may be of interest to senior executives. Recent examples include:

The New Global Challengers: How 100 Top Companies from Rapidly Developing Economies Are Going Global—and Changing the World

A report by The Boston Consulting Group, May 2006

Organizing for Global Advantage in China, India, and Other Rapidly Developing Economies

A report by The Boston Consulting Group, March 2006

The China Rip Tide: Threat or Opportunity?

A white paper by The Boston Consulting Group, January 2006

A Game Plan for China: Rising to the Productivity Challenge in Biopharma R&D

A Focus by The Boston Consulting Group, December 2005

“Successful M&A: The Method in the Madness”

Opportunities for Action in Corporate Finance, December 2005

Balancing Act: Implementing an Integrated Strategy for Value Creation

The 2005 Value Creators Report by The Boston Consulting Group, November 2005

The Role of Alliances in Corporate Strategy

A report by The Boston Consulting Group, November 2005

“Spurring Innovation Productivity”

Opportunities for Action in Industrial Goods, November 2005

“The New Economics of Global Advantage: Not Just Lower Costs but Higher Returns on Capital”

Opportunities for Action in Operations, July 2005

“Winning in Today’s Chinese Automotive Market”

Opportunities for Action in the Automotive Industry, June 2005

“Globalizing R&D: Knocking Down the Barriers”

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“Avoiding Supply Chain Shipwrecks: Navigating Outsourcing’s Rocky Shoals”

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Navigating the Five Currents of Globalization: How Leading Companies Are Capturing Global Advantage

A Focus by The Boston Consulting Group, January 2005

“The Right Way to Divest”

Opportunities for Action in Corporate Finance, November 2004

Growing Through Acquisitions: The Successful Value Creation Record of Acquisitive Growth Strategies

A report by The Boston Consulting Group, May 2004

Capturing Global Advantage: How Leading Industrial Companies Are Transforming Their Industries by Sourcing and Selling in China, India, and Other Low-Cost Countries

A report by The Boston Consulting Group, April 2004

“What Is Globalization Doing to Your Business?”

Opportunities for Action in Industrial Goods, February 2004

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