

FORETHOUGHT GLOBAL STRATEGY

Making M&A Fly in China

by Mike W. Peng

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The first wave of foreign direct investment in China, in the 1980s, mostly took the form of joint ventures. A second wave followed in the 1990s in the form of greenfield wholly foreign-owned enterprises (WFOEs). Now a third wave of foreign direct investment—cross-border mergers and acquisitions—is gaining strength.

Consider the forces driving this third wave. China has a massive appetite for foreign direct investment; it is the world's largest FDI recipient. Yet M&A accounts for only 10% to 15% of FDI flowing into China, compared with the 60% to 70% of FDI outside of China that takes the form of M&A. One reason for this disparity is that, until China joined the World Trade Organization in 2001, national regulations often encouraged (or required) foreign entrants to form joint ventures or set up WFOEs, while explicitly discouraging M&A. But China has since gradually loosened the regulations that govern foreign takeovers of Chinese assets, especially state-owned enterprises (SOEs), and has made explicit moves to attract foreign M&A. In many industries, including financial services and manufacturing, constraints on M&A are just now being lifted. At the same time, Chinese firms are increasingly engaging in cross-border M&A of their own, as evidenced by their recent bids for Unocal, Maytag, and IBM's personal computer division. To the extent that the Chinese government supports this outbound M&A, it must in most cases clear the path for inbound M&A, according to international norms of reciprocity.

Given this environment, how should foreign companies proceed? In many ways, strategies for M&A in China overlap with those for M&A elsewhere. But my recent research has uncovered some idiosyncrasies that are specific to acquisitions in China.

First, Chinese SOEs are rife with organizational slack. Government agencies have restructured some SOEs to reduce underutilized resources and to make the SOEs more attractive M&A targets for foreign firms. While slack usually indicates inefficiency, in certain firms, some slack—such as unabsorbed cash flow in

the form of depreciation funds, reserve funds, and retained earnings—may indicate the potential for increased performance, actually enhancing the target's attractiveness.

Second, it's well known that many Chinese SOEs maintain three sets of books: one set that exaggerates performance, to show to administrative superiors; one that underreports performance, for tax purposes; and one that is fairly accurate, for managers themselves. Acquisition targets are likely to show foreign negotiators the bragging books initially. As a result, foreign firms need to be aggressive in conducting due diligence to uncover an accurate picture of targets' assets and resources. This is particularly relevant when investigating slack.

Finally, most Western firms launching joint ventures and WFOEs in China have believed that ethnic Chinese managers—those from overseas Chinese economies, such as Hong Kong and Taiwan, who are well versed in the local language—were the best choice for running their operations in China. Meanwhile, they have presumed that Western managers would be less effective because of language and cultural barriers. But evidence from my research and others' suggests the opposite: Using surveys, interviews, and other tools, researchers are finding that ethnic Chinese managers hired by Western companies to run these businesses are, on average, less effective than their non-Chinese counterparts, as measured by the length of their tenures and attainment of performance goals. How could this be?

One reason appears to be that ethnic Chinese managers often struggle with an ambiguous managerial identity: Western corporate headquarters views them as "us," while local Chinese employees also expect them to be "us." When these managers favor headquarters on issues where headquarters and locals conflict—such as whether Western employees and locals should receive equal compensation or whether chopsticks or forks should be used at company banquets—local employees may regard them as traitors of sorts. That corrodes employees' trust, ultimately undermining per-

formance. On the other hand, employees give Western managers the benefit of the doubt. They expect these managers to behave differently, to commit cultural errors, and to show allegiance to the parent firm. This tolerance by local employees of Western managers' differences can enhance these managers' confidence and performance.

Of course, not every non-Chinese manager outperforms every ethnic Chinese manager. It is clear, however, that managerial effectiveness in China does not depend on one's ability to use chopsticks. This point is crucial

as more M&A flows into China and more acquiring companies staff their target firms' management.

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