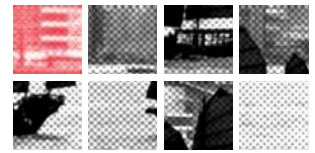


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## Due Diligence Factors of Success in M&A

by **Stephan Haagmans and Robert Partridge**<sup>i</sup>

For European investors seeking to participate in China's M&A opportunities, due diligence is a critical step, not only for risk reduction but also as a process hurdle — the great majority of Letters of Intent (LOI) never close.

*Due diligence is a critical step, not only for risk reduction but also as a process hurdle — the great majority of Letters of Intent (LOI) never close*

Many state-owned enterprises (SOEs) and other companies are still operating in a business environment and system that is radically different from enterprises in western economies, raising numerous issues for foreign acquirers

One common issue encountered by potential acquirers of SOEs, and most other Chinese companies, is that land is owned by the state, not companies or individuals. Questions related to the transferability of land-use rights often arise in due diligence and sometimes have significant financial implications as the state may require payments for the land use rights before allowing a transaction to close.

In addition, most SOEs in China operate as “social communities”. It is common to see acquisition targets that maintain employee housing hospitals schools, restaurants, and even roads on their books. As these are carved out from a target entity, foreign investors may be expected to continue to provide these social services post-closing.

A lack of good tax compliance is another common issue. Many companies often maintain inappropriate books in order to defer or avoid taxes, particularly value added tax which is typically the largest form of taxation. In many cases, income tax may be insignificant due to historic or potential tax holidays.

### Successfully Closing Deals

With the right preparation, expectations and process, it is possible to successfully close deals in China despite the pitfalls. We believe there are a few basic suggestions to maximize your chances of deal success:

#### 1. Early involvement of advisors:

- Engaging advisors prior to a Letter of Intent helps increase a target's transparency, thereby accelerating the timeline to LOI execution. It is important not to intimidate the Chinese party by characterizing advisor involvement as “due diligence” because when translated into Mandarin this term means “investigation” which has a negative, even frightening connotation in any language. It is better to refer to an “initial data gathering” process that is designed to “facilitate” the potential transaction.

*“Due diligence” sounds intimidating to the Chinese party, better use the expression “initial data gathering” process that is designed to “facilitate” the potential transaction instead*

#### 2. Understand there are significant differences between conducting due diligence in Europe and China:

- Entering into the due diligence process with the right expectations is a critical success factor for European investors. The quality of financial statements, financial infra-

*A lower quality of financial statements, financial infrastructure and business processes result in more risk areas and more time for due diligence*

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structure and business process will be lower than western investors are accustomed to, resulting in the need to explore more risk areas and take more time for due diligence. Some of the differences between due diligence in Europe and China are illustrated below.

**Table 1:**

*Conducting Due Diligence: Europe vs. China*

<b>Conducting Due Diligence: Europe vs. China</b>		
	Europe	China
1. Level of transparency in financial information	High	Low, if any
2. Normal duration of due diligence	1-8 weeks	3-12+ weeks
3. Preparation time required by target company before due diligence	Minimal	May require extensive assistance
4. Basis of financial statements	US GAAP or IFRS	People's Republic of China (PRC) GAAP, at best
5. Audited financial statements	By reputable standards	Typically not reliable from a US GAAP or IFRS perspective
6. Extent of related party transactions	Varies, typically fully disclosed	Usually extensive; inadequate disclosure
7. Disclosure of contingent liabilities	Usually transparent	High risk area and rarely disclosed
8. Reliance on computerized accounting systems	Typical	Evolving; large dependence on manual processes
9. Reliability of representations and warranties	Normally reliable	Untested
10. Enforceability of indemnification claims	Strong; backed by courts	Untested; may need to consider "holdbacks"

- In addition to general deficiencies in the accounting records the local accounting rules are as well different to standard true and fair accounting rules and have to be understood by investors. One of the easiest accounting illustrations to understand is how allowances for doubtful accounts under Chinese GAAP often do not adequately provide for old receivables (see table below). In almost every industry Chinese com-**

panies receivables are aged by years, not months. For this reason, accounting due diligence should focus on identifying these types of issues early and evaluate the quality of earnings and working capital implications that result.

### 3. Listen for the word “no”:

- Asian culture is less direct in some respects than Western culture, which often leads to misunderstanding in the business milieu. Western investors rarely hear their Chinese counterparts say “no,” even though they do not mean “yes.” Do not be drawn into a false (and drawn-out) process of assuming cooperation by the other side without defined actions and deadlines. When discussing potentially contentious items, reduce discussions to writing (English and Chinese) and agree on dates, if appropriate.

### 4. Manage internal expectations:

- Closing a deal in China too often becomes the goal in and of itself and companies lose sight of the business rationale. Corporate development officers say that one of their biggest challenges is managing their company’s internal expectations. Start managing internal expectations early and do not over-commit to the potential of a Chinese investment without fully considering the valuation shortcomings that may be found during due diligence.

### 5. Be prepared to go the distance:

- In any good investment market, deal success requires a certain degree of diligence and patience. This is particularly true in the case of China, a market which tests investors’ stamina and where only 20 percent to 30 percent of LOIs ultimately close. There are three primary reasons for deals failing to close in China: quality of earning issues; lack of transparency in the due diligence process; and a timeline from LOI to closing that stretches from 6 to 18 months or more.

### A staged approach

We strongly suggest conducting due diligence investigations in different phases. A typical approach would be to define certain tasks in order to be able to sign a LOI. Such tasks could include the following:

Table 2:

Typical PRC Accounts Receivable Aging.xls

Typical PRC Accounts Receivable Aging		
	Amount	%
< 1 year	5500	55
1-2 years	1000	10
2-3 years	4500 - 1000	10
> 3 years	2500	25
Total	10000	100%
Allowance	-50	=0.5%
Net	9950	

Clearly defining actions and deadlines and reducing discussions to writing (English and Chinese) reduces the risks of cultural misunderstandings

Start managing internal expectations early and do not over-commit before you fully understood the results found during due diligence

The three main reasons for deals failing to close in China are:  
 1) Quality of earning issues  
 2) Lack of transparency in the due diligence process  
 3) Too long time between LOI and closing

**Table 3:***Possible Pre-LOI Initial Data Gathering*

<b>Possible Pre-LOI Initial Data Gathering</b>	
<b>Possible Tasks</b>	<b>Objectives</b>
1. Screen historical auditor's report	Understand key business drivers, quality of earnings and related issues, working capital requirements, etc
2. Evaluate key accounting policies	Identify potential risky/sensitive areas that need additional attention in due diligence, valuation and structuring.
3. Perform high level overall analytical review	Assess integrity and quality of financial data
4. Assess financial/accounting environment	Understand the limitations of the current accounting software, set expectations of the extent of financial data available for further analyses.
5. Review internal management reports	Identify useful business statistics that are instrumental to in-depth analysis.
6. Understand business and their financial impact	Determine impact on valuation and identify areas for further detailed due diligence.
7. Develop a comprehensive /Information Request List for detailed due diligence	Ensure sufficient information and data are available to facilitate appropriate analyses.

After having signed the LOI we propose continuing the investigation in two stages:

**Table 4.1:**

*Typical Post-LOI Due Diligence Procedures*

Typical Post-LOI Due Diligence Procedures	
Possible Tasks	Objectives
Stage I	
1. Review audit workpapers	Identify risky areas that need special attention.
2. Raise asset/liability questions	Validate the book value of assets/liabilities and assess the impact on future earnings.
3. Analyze income statement fluctuations	Understand the /seasonality of the business, assess quality of earnings, etc.
4. Identify potentials pro forma adjustments	Ensure the historical /profitability of the acquired business in truly reflected.
5. Assess stand-alone matters	Evaluate the /hidden costs of the NewCo.
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence.

Fairly often the findings of stage 1 lead our client to reconsider their M&A projects: on the one hand prices are lowered, on the other hand deal opportunities are aborted due to reassessment of the risks. If, however, the /investigation should continue we suggest analyzing the following issues in more depth:

**Table 4.2:***Typical Post-LOI Due Diligence Procedures*

<b>Typical Post-LOI Due Diligence Procedures</b>	
<b>Possible Tasks</b>	<b>Objectives</b>
Stage II	
1. Evaluate profitability by product/segment/geography	Develop in-depth understanding of the business, assess the quality of earnings.
2. Analyze correlation between price and volume	Same as above.
3. Identify key cost drivers and expenses variability	Same as above.
4. Review capital expenditure history	Determine impact on valuation.
5. Analyze working capital sensitivity and seasonality	Determine impact on valuation and buyer's financing needs.
6. Analyze projections versus history	Assess the practicability of the projections and profitability of the NewCo.
7. Evaluate the human resources and benefits issues	Determine impact on valuation.
8. Quantify pro forma/EBITDA	Same as above.
9. Finalize due diligence report	Summarize key findings and observations, raise alerts, if any, to facilitate client's purchase decision making.
10. Develop representations and warranties for /purchase agreement from a financial perspective	Assist client in minimizing the /investment risk.

## Conclusion

*Approach acquisition opportunities with a system of well-defined steps that consider internal opportunity costs as well as external advisory fees*

Foreign companies aiming to invest in China are faced with language barriers, cultural differences and unfamiliarity with local business rules. For these reasons, we advise our clients to approach acquisition opportunities using a system of well-defined steps that consider both internal opportunity costs as well as external advisory fees. In addition, China is undergoing a dual transition from a centrally planned economy to a market economy and from an emerging economy into an industrialized economy in which the business environment is in constant change. As an example, the accounting profession in China has recently undergone a period of rapid development but we estimate that currently only about 10% of the final /number of accountants required have already been trained. Understanding some of the main cultural differences, potential pitfalls and due diligence success factors will help you to

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approach investing in China with greater confidence as well as to determine when greater investigation and the assistance of a professional advisor are needed.