A Practical Framework by Using Active M&A Strategy for Corporate Growth in China

by

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M.E., Management Engineering
Zhejiang University, 1994

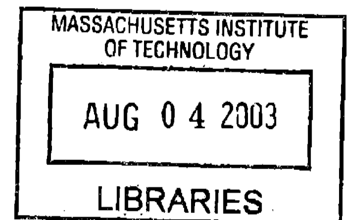
Submitted to the Alfred P. Sloan School of Management in Partial Fulfillment of the Requirement for the Degree of

Master of Science in Management of Technology

at the

Massachusetts Institute of Technology

June 2003



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ABSTRACT

As China becomes more global, Mergers & Acquisitions (M&As), have been increasingly attracting the attention of China. This thesis investigates M&A theories and practices of valuation and integration in China on the basis of the analysis of the current trends of M&A market in both the US and China. Some related studies are reviewed to identify the research gap and applications in the Chinese context. A practical framework of using an active M&A strategy for corporate growth is presented, along with a case study.

Thesis Supervisor: S.P. Kothari

Title: Professor of Economics, Finance & Accounting

To my wife, Weihua and my son, Edward
For your endless love and support

To professor, S.P. Kothari
For your invaluable encouragement and advice

Contents

Abstract......2
Acknowledgements......3
Contents......4

Chapter One: Introduction and Summary 6

1.1 Objectives of the Thesis 6
1.2 Focus and Methodology 6
1.3 Conclusions 7
1.4 Recommendations 8

Chapter Two: Theoretical Principles and Research Review of M&As 9

2.1 Introduction 9
2.2 Fundamental Principals of M&As: 10
2.3 Research Review 12
2.4 Remaining Questions and Research Focuses......18

Chapter Three: New Trends of M&As at the Time of Post-Dotcom Bubble 20

3.1 Post-Dotcom Bubble M&A Overview 20
3.2 Factors Affecting the Current M&A market: 26
3.3 New trends in Post-Dotcom Bubble Era 28

Chapter Four: Mergers and Acquisitions in China 32

4.1 Introduction 32
4.2 Historical Perspective of China M&A Activities 33
4.3 Current Key Issues in China M&A Market 36
4.4 Cross-Border M&As Issues in China......40

Chapter Five: Gap the Valuation Framework and M&A Reality in China 44

5.1 Fundamental Valuation Framework 44
5.2 Basic Issues for DCF valuation 47
5.3 A Practical Way in Valuation of Chinese Company 49
5.4 Case Analysis: Valuation of China Mobile 53

Chapter Six: Adding Value through Successful Integration 60

6.1 Integration Process and Metrics 60
6.2 Managing the Key Issues of Integration Process......63

6.3 Strategic Fits 64
6.4 Effective Communication..65
6.5 Human Resource Issues 66
6.6 Cultural Issues 69

Chapter Seven: Conclusions of the M&As Framework and A Case Analysis of Corporate Growth through Active M&As in China 73

7.1 A Systematic Approach for M&As 73
7.2 Case Analysis: China Netcom (HK) Acquires Asia Global Crossing 74

References...78

Chapter One: Introduction and Summary

1.1 Objectives of the Thesis

As China becomes more global, Mergers & Acquisitions (M&As), the vehicles commonly used by companies in western countries as a growth strategy, have been increasingly attracting the attention of China. Especially since the fade out of dotcom bubble in 2000, the Chinese M&A market is becoming a hot zone for investors.

However, questions still exist concerning the practices in this field. For example, what are the new trends in the US and China M&A market? Where is the next opportunity in acquisition? How are the Chinese companies priced for foreign investors? How is the cultural conflict in the integration process managed? How to fit the classic valuation approaches into the Chinese context? How to increase the odds of the post-merger integration puzzle?

This paper is intended to respond to the above questions and develop a framework to bridge the theory and practice of M&As in China.

1.2 Focus and Methodology

The paper focuses on three areas:

- Current trends of M&A activities in the US and China
- Tailoring the valuation approaches to Chinese companies
- Effectively managing the integration process in China

The methodologies used in the paper vary from section to section.

In the trend analysis, a large amount of data and charts are used to evidence the current direction of the M&A market in the US and China. In addition, the factors that may have a major impact on M&A activities are developed in detail.

In the valuation section, through an in-depth comparison of different valuation approaches, the framework for the effective valuation of M&A in China is developed and tested by using a simple case study.

In terms of managing integration, the paper uses a survey of Chinese practitioners in the M&A market to reveal some key issues such as culture, communication and incentives cycling the success of integration. Further, the paper presents recommendations for successful M&A integration in China.

The final chapter discusses a case on how Chinese companies are using active M&A as a sustainable growth strategy.

1.3 Conclusions

The paper presents the following perspectives:

- In general, M&A fundamentals are applicable to China but some modifications are necessary to precisely manage the process.
- Globally, the M&A markets in the US and EU are still in a down wave trend as a result of a poor economy, high stock market volatility, tight bank credit, and strict regulation. However, the use of some old vehicles such as LBOs and stock splits come to the way.
- China has been experiencing its unprecedented opportunities in M&As since 1999. With the help of continuing reform and WTO re-entry, the evolving trends include industry deregulation and consolidation, the acceleration of privatization in many sectors, prosperous management buyouts (MBOs), the popularity of cross-border M&As for foreign and domestic companies, and the advancement of M&A legal framework.
- Discount Cash Flow (DCF) is the foundation for M&A valuation. To use the three main approaches, DCFWACC, ECFE, and APV, derivatives from DCF, a detailed comparison of their unique applications as well as how to apply this framework to the valuation of M&A in China are very important.
- The Chinese macro economy has its specialty that differentiates it from many emerging market in terms of sustainable GDP growth, a stable political system, a relatively fixed

exchange rate, continuously increasing of FDI, and the on-going privatization although it is still in the emerging phase. This paper recommends using a combination of two methods: 1) DCF with probability-weighted scenarios only for the micro situation, and 2) The adjusted cost of capital that highlights the risks or uncertainties of the macro economy.

- The integration is viewed by experts in China as a more and more important chain for a successful acquisition. The key determinants of successful integration include strategic fit in finance, marketing and technology, human resource issues, effective communication, and cultural issues.

1.4 Recommendations

In this new century, China opens a window for M&A activities. As investors, establishing a LBO fund to participate in MBOs, and restructuring SOEs, presents a very lucrative opportunity. As entrepreneurs, using an active M&A strategy for corporate growth creates the excellent opportunities in almost every industry sectors in China.

Chapter Two: Theoretical Principles and Research Review of M&As

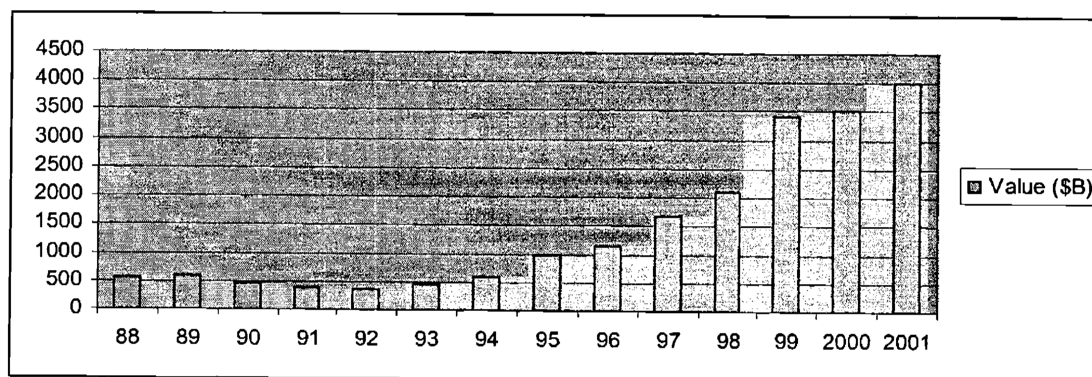
2.1 Introduction

The first wave of mergers and acquisitions (M&As) emerged at the beginning of 20th century, characterized by horizontal consolidation. Since then, the M&A activities have remained a growing part of the business landscape with different characteristics by a number of major waves.

In the new century, we are again just over the fifth wave (See Gaughan 2002 pp51-54) which is the largest in history and is being driven by globalization, technological change and deregulation. Unlike the conglomeration movement of the 1960s or leverage buyouts (LBOs) of 1980s, the latest wave appears to be quite strategic. Companies are attempting to become global, and are doing so by acquiring new technologies, products and services, increasing geographic presence and consolidating within the markets they compete or hope to compete in. Critical to the success of these deals is management's ability to integrate the combining companies, especially in cases where the prices paid were based on synergy values.

The pervasiveness of M&As is best reflected in the fact that, in the peak time of year 2000, there were 9,566 domestic deals announced, worth $1.326 trillion in the US (Mergerstat Review, 2001), which reflects a double in the number of deals since 1990. Worldwide, the number and value of cross-border deals has consistently increased from 1990 to 2000 (See Figure 2.1).

Figure 2.1 Value of M&A Transactions Worldwide (1988-2001)



Source: Thomson Financial Securities Data.

Although this unprecedented wave was ended since the broken of dotcom bubble, the sluggish economy and some unexpected events from 2000 on, the successful stories of companies like GE and Cisco by using active M&A as the sustainable growth strategy have created some miracles and set up the benchmark for the business community. Now, more CEOs than ever are enthusiastic in growing companies by acquisition rather than organic growth.

This paper is interested in how to implement active M&A strategy for corporate growth in China based the fundamental principles in this discipline. The paper centers on two aspects: valuation and integration, which are critical to the success of M&A activities in the Chinese environment.

The first chapter has two sections:

1. Fundamental of M&A.
2. Research review.

2.2 Fundamental Principals of M&A:

Types of Mergers

Mergers are often categorized as horizontal, vertical, or conglomerate mergers. A horizontal merger occurs when two competitors combine. If a horizontal merger causes the increase in market power that will have anticompetitive effects, the merger may be opposed on antitrust grounds. Vertical mergers are combinations of companies that have a buyer-seller relationship. Conglomerate mergers occur when the companies are not competitors and do not have a buyer-seller relationship or not in a industry-based value chain. Clearly, these companies are in very different lines of business.

Reasons for M&As:\

- Expansion: acquiring a company in a line of business or geographic area can be a quicker way to expand than internal expansion.
- Synergy: an acquisition of a particular company may provide certain synergistic benefits which include technology, market and talent.

- Diversification: an acquisition may be part of a diversification program that allows the company to move into other lines of business.
- Financial factors: some M&As are driven by the foreseeable financial factors such as the undervalued targets or the overvalued acquirer.
- Tax motives: tax credit or tax shield also play a role in an acquisition decision.

Merger Financing:

Deals may be structured by all cash, all securities, or a combination. Securities include stock and other securities such as debentures. In US, stock transactions may offer the seller certain tax benefits that cash transactions do not provide. However, securities transactions increase the volatility of the value.

Stages of the M&A Process:

- Preparing buy or sell: What the buyers look for varies from what sellers look for in this phase. For example, a few items for buyers to prepare include the legal structure, the financing and operational plans.
- Locking target: The buyer locks the target in the metrics such as revenue range, geographic location, market share, reputation, distribution channels, technology, corporate culture, industry, publicly traded or privately held, and management team.
- Due diligence: A review of legal structure review, ownership and capitalization structure, IP rights and technology, and financial performance. Detailed marketing and sales evaluation of the customer base.
- Arranging financing and structuring the deal.
- Negotiating and signing the agreements.
- Post-merger integration by buyer.

Typical Intermediaries in the M&A:

- Accounting firm and accountants
- Law firm, M&A attorneys, and tax attorney
- Key members of management team for both parties
- Investment bankers

- Consultants for strategic planning through the M&A process.

Transaction Cost:

Fees for intermediaries are typically based on the Lehman formula:
5% of first million, 4% of second million, 3% of third, 2% of four million, 1% of all sale dollars over 4 million

2.3 Research Review

Many academic studies have examined almost every aspect of M&A. This review focuses on:

- Post-merger performance
- Valuation
- Integration

Post-merger Performance

Many studies, including Dodd & Ruback (1977), Roll (1986), Magenheim & Mueller (1988), and Kennedy & Limmack (1996), etc. investigate the relationship between M&As and financial performance. Using a variety of financial measures (e.g. profit, stock price) and timeframes (e.g. pre- and post-measurement) these studies continue to demonstrate that, on average, M&As benefit the target's shareholders, but not the buyer's shareholders. In fact, there are varying results with respect to buying firms' performance (see Lajoux, 1998, for an extensive review of this literature).

Although many reasons have been advanced for these results (e.g. see Sirower, 1997), many point to aspects of high premium or over-priced deal as the major factor for failure (Eccles, Lanes and Wilson, 1999) and a number of points to aspects of M&A integration as a major contributing factor (Schweiger & Walsh, 1990; Csiszar & Schweiger, 1994). The integration issue is also reflected in a survey of Forbes 500 CEOs (Schmidt, 1999) that identified post acquisition as contributing to merger failure.

Valuation Research

Modern valuation originated from MM model in the research by Miller and Modiliani (1961). They proved to get the same basic valuation model by four different approaches. DCF is one of those four approaches. Later, Malkiel (1963) published a stricter model or dividend model based the MM model as

$PV = CF (1+g) / (r - g)$,

Where, CF is the dividend at time 0, g is growth rate and r is discount rate.

Since the emerging of the milestone MM model, many new valuation approaches were initiated. For example, adjusted present value (APV), an approach with simpler, more accurate and more informative advantage than regular DCF to use WACC as the discount rate, was proposed by Myers (1974) to divided the value of a deal into several parts to clarify the interest tax shield effect. The research by Kaplan and Ruback (1995) found that APV did very well for LBOs.

Meanwhile, economic value added (EVA) method is getting more popular in the CEOs. The EVA method focuses instead on the earning after deducting a charge for the cost of capital. The proponents of EVA comment that it makes the cost of capital visible to operating managers. In additional, some other approaches such as option valuation and other models are proposed by different scholars.

In the valuation world, there is another issue on cost of capital that contributes numbers of researches and outcomes. The most famous method is the CAPM model by Sharpe, Lintner, and Treynor (1964) on the base of portfolio theory by Markowitz (1952). In CAPM, it measures the expected return of a stock by the formula:

$Rs = Rf + \beta * (Rm - Rf)$

Where, the Rf is risk-free return or in US the long-term T-bond interest rate,

$Rm - Rf$ is the overall market risk premium.

$\beta = Cov (Rs, Rm - Rf) / Var (Rm - Rf)$

The CAPM theory begins with an analysis of how investors construct efficient portfolios. Stephen Ross's (1985) arbitrage pricing theory (APT) comes from a different family entirely. It does not ask which portfolios are efficient. Instead, it starts by assuming that each stock's return depends partly on pervasive macroeconomic influences.

Moreover, some researchers even argued that the CAPM is not accurate to estimate for companies with different sizes or book to market ratios. Based on this argument, Fama and French (1993) gave out the extension model of CAPM or Fama-French 3-factor model:
$Rs = Rf + \beta * (Rm - Rf) + \beta size * (Rsmb) + \beta hml * (Rhml)$
Where, Rm-Rf, Rsmb and Rhml separately reflect the risk factors on market, size and B/M ratio.
In addition, as more businesses move global, some researchers have developed approaches to estimate the international cost of capital. Bekaert and Harvey (1995) published the Segmented/Integrated CAPM as:
$Rs = Rf + \beta * (Rworld - Rf)$
Where, Rworld is a world index (i.e, Morgan Stanley Capital World Index)
β calculation is based on uses Rworld.

If the country's stock market is segmented from the rest of the world such as the A shares in China, use Rcountry to replace Rworld.

Given the difficulty to implement the Segmented CAPM model, Erb, Harvey and Viskanta (1997) developed a Credit Rating Model to use country credit rating a measure of systematic risk.
$Rcountry = Rf + \beta * Risk\ Rank.$
Where, the risk rank is based on the rankings of country credit risk by companies such as Standard & Poor, Moody or 'Institutional Investor' Magazine.

Likewise, in order to better implement on individual stocks, some practitioners advanced other models such as Country Spread Model or Goldman Model as:
$Rstock = Rf + \beta * (US\ equity\ premium) + SYS$
Where: US equity premium is historical (Rm-Rf)
SYS is the country's Sovereign Yield Spread.

Integration Research

This section focuses on researches of the active integration strategy for the success of M&As,

1. Definition and Stages

Using the concept of capability transfer between an acquirer and acquired firm, Haspeslagh & Jemison (1991) define four types of integration (Table 2.1), based on two dimensions: Need for Strategic Interdependence and Need for Organizational Autonomy.

Table 2.1 Four types of integration

High need for strategic interdependence	Low need for organization autonomy
Low need for strategic interdependence	High need for organization autonomy

Marks & Mirvis (1998) also take a multi-dimensional view of integration, "....ranging from full consolidation to near separation of the companies...." (p.68). they see this range as including such forms as separate holding company, strategic control, managed subsidiary, operational control and merged and consolidated.

Whereas Haspeslagh & Jemison, and Marks & Mirvis, view each acquisition as representing a different type of integration. Schweiger (2000) notes that, within an acquisition, different types of approaches may be used, based on functions, geographical areas and product lines. He notes that four types of approaches including combination, standardization, coordination and intervention might be used within an acquisition.

2. Stages of the Integration Process`

In light of the scope of the integration process, formal integration is often viewed as beginning after closing (Csiszar & Schweiger, 1994; Schweiger, 1999). A number of authors believe, however, that the process begins at the point at which a target is selected and continues through due diligence, negotiations, closing and post-closing. Schweiger (1999) labels these stages as transaction, transition and integration. Marks & Mirvis (1998) define these as pre-combination, combination and post-combination. Unfortunately, there is little empirical research that

systematically examines the relationships among the stages and how activities conducted during them affect the success of the integration process.

3. The Considerations of Integration Process

The M&A integration process covers integration planning and integration implementation. During the process, many issues relate to the success of any integration.

Culture

An objective in studying culture has been to examine how national culture affects acquirer's integration practices and how similarity and dissimilarity between cultures of combining entities affects post-acquisition integration and performance. Culture has been generally described as the norms, values, beliefs, and attitudes of a group of people. These characteristics of culture may be broadly based on societies (Hofstede, 1980), or in organizations (Schein,1985). Consequently, the M&A integration literature has addressed culture at two levels, the national level and organizational level.

a. National Culture: Several studies examines the influence of national culture on M&A integration practice. Research by Morosini & Singh (1994)examined the relationship between the degree of cultural distance of acquirers and acquired firms and the degree of integration and its effect on organizational performance. They studied 65 western European and U.S firms involved in cross-border acquisitions. They found that in highly individualistic societies a lower level of post-acquisition integration appeared to lead to higher productivity growth one year after acquisition.

Another study of 75 acquisitions in US, British and France, by Calori, Lubatkin & Very (1994), Their findings tend to support the significance of cultural dimensions, and indicate that differences exist among integration measures practiced by national heritage of acquirer.

b. Organizational Cultures: The organizational culture has been defined as 'a pattern of basic assumptions,' 'values,' (Peters & Waterman, 1982) or 'beliefs' and 'norms of behavior'

(Pettigrew, 1979). Following O'Reilly et al. (1991), we define organizational culture as values shared by members of an organizational unit.

An early study by Sales & Mirvis (1984) illustrated the impact of cultural differences on the integration process over a three-year period. They found that differences in organizational culture (philosophy, values, structure, norms of interpersonal behavior, and business related behaviors) led to polarization, negative evaluations of counterparts, and anxiety between members of the acquiring and acquired firms. The salience of organizational culture is also evident in as case study by Greenwook, Hinings & Brown (1994) that studied the merger process between two professional service firms.

The difficulties inherent in integrating firms with differing organizational cultures has led some researchers to suggest that M&As be confined to organizations with similar cultures. Several studies including Chatterjee, Lubatkin, Schweiger & Weber (1992), Lubatkin, Schweiger & Weber (1999) and Weber & Pliskin (1996) indicate that M&As among firms with similar cultures result in more effective merger performance.

Involvement

Olie (1994) observed an effort to preserve parity (i.e. the balancing of positions assigned to acquiring and acquired firm's managers) between the merging firms. Research by Gerpott (1995), studied the relationship between the degree of involvement and post-acquisition success of integrating firms' R&D functions. Results show that interventions, fostering open information exchange are clearly taken over by the acquirer's top management, seem to be particularly effective in promoting R&D integration success.

Communications

Bastien (1987) found that formal communications appeared to be associated with both positive reactions toward the acquirer, stabilization of volatile situations and minimization of management resignations. Schweier & Denisi (2001) examined the impact of communication during a merger on a number of employee reactions, all of which are believed to affect the success of the integration process.

Speed of Integration

Mayo & Hadaway (1994), found the successful acquisition was the result of selectively and simultaneously utilizing both slow and fast approaches to integration. Leroy & Ramanantsoa (1997) observed the speed at which integration occurred depends on if people were involved in a merger workshop.

Incentive Structures

Ghosh & Ruland (1998), found that ownership sharing was a legitimate incentive to retain acquired top managers. They found that managers of an acquired of an acquired firm are more likely to remain in the combined firm when they receive shares in the new firm, as payment for their ownership interests in the acquire firm.

2.4 Remaining Questions and Research Focuses

The review suggests that both valuation and integration play important roles in influencing outcome of any M&A activity.

In spite of rich research on the fields of M&A valuation and integration over the past 15 years, unfortunately, there is no one-size-fit-all valuation approach. Meanwhile, the integration research has not been systematically linked to any comprehensive theory. Most of the researches are applied to the guidance of M&A practices on the case-by-case basis. Based on this understanding, this paper focuses on how M&A fundamentals could be used to analyze M&A trends, valuation and integration issues in China so as to help companies using active M&As as a sustainable strategy of corporate growth.

The research focuses and methodologies in this paper are as follows:

1. In the trend analysis, a large amount of data and charts are used to evidence the current direction of the M&A market in the US and China. In addition, the factors that may have a major impact on M&A activities are developed in detail.

2. In the valuation section, through an in-depth comparison of different valuation approaches, the framework for the effective valuation of M&A in China is developed and tested by using a simple case study.
3. In terms of managing integration, the paper uses a survey of Chinese practitioners in the M&A market to reveal some key issues such as culture, communication and incentives cycling the success of integration. Further, the paper presents recommendations for successful M&A integration in China.
4. The final chapter discusses a case on how Chinese companies are using active M&A as a sustainable growth strategy.

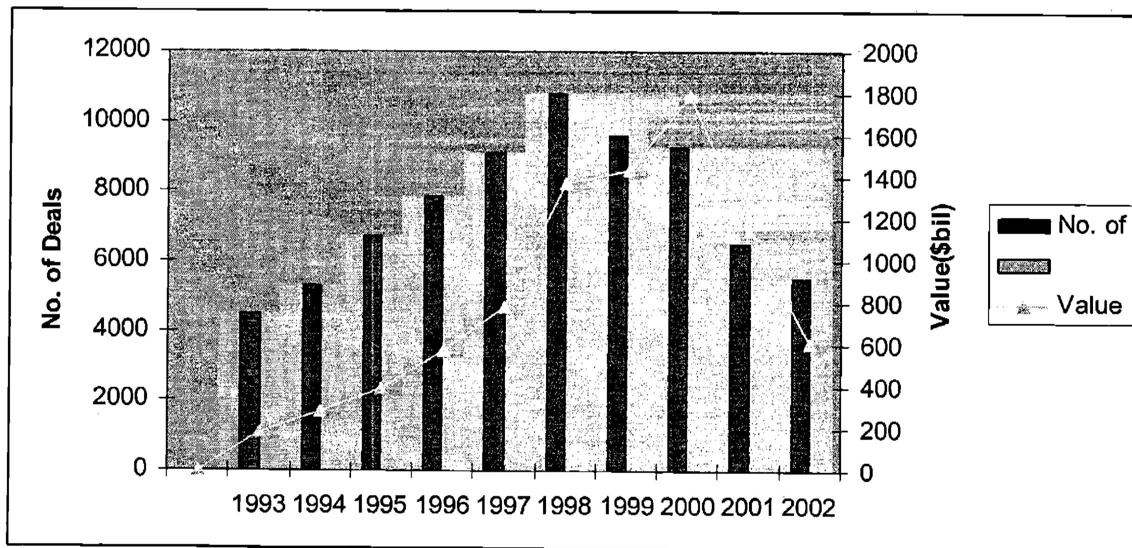
Chapter Three: New Trends of M&As at the Time of Post-Dotcom Bubble

3.1 Post-Dotcom Bubble M&As Overview

The multi-year slump in global economy has been damaging to the M&A market around the world for all participants. The feeble economy, high stock market volatility, and tight bank credit have discouraged many potential acquirers, forced sellers into a holding pattern, and left dealmakers pitching fewer transactions and spending more time consulting clients on strategic and business issues.

The economic slowdown, exacerbated by the terrorist attacks in Sep 11, 2001, has produced a high level of uncertainty which is the poison of M&A. Accounting and corporate governance scandals among a number of companies such as Enron, WorldCom Inc., Tyco International Ltd., Global Crossing Ltd., and Adelphia Communications Corp, have further dampened M&A activity. Many CEOs have been hunkering down and focusing on their own business and governance issues rather than scouring the market for possible acquisitions, leading 2002 one of the most brutal years over last decade (See Figure 3.1).

Figure 3.1 10-Year Merger Completion Record



Source: Mergers & Acquisitions Feb 2003

We find that the ten-year long fifth-wave of M&A with a focus on strategic takeovers and rocket-high in deal number and size ended since in 2000. However, some consistently successful players are still keen on expansion through M&A. They include GE, Cisco and Omnicom Group (See Table 3.1).

Table 3.1 Top10 Most Active Acquirers of 2002 & 2001.

2002	No.	2001	No.
General Electric Co.	49	General Electric Co.	45
Brown & Brown Inc.	23	Tyco International Ltd	41
Cendant Corp.	22	Arthur J. Gallagher & Co.	17
Omnicom Group Inc.	16	TMP Worldwide Inc.	17
Sonic Automotive Inc	16	Omnicom Group Inc.	15
L-3 Communications Inc	10	Clear Channel Communications Inc.	13
Automatic Data Processing	9	Citigroup Inc.	12
Bank of New York	9	Dow Chemical Corp.	12
First Data	9	Penton Media Corp.	12
IBM	9	Great Plains Software Inc.	12

Source: Mergers & Acquisitions Feb 2003

The flip side is that more-realistic seller expectations and valuation are giving M&A pros a reason to be optimistic, though, ultimately, the timing and the strength of the recovery will hinge on the performance of the economy and the stock market.

In terms of change in industry focus, table 3.2 shows that the IT or Bio are no longer the shining stars in the M&A stage while some old-economy industries such as oil & gas, utilities, and real estate account for substantial shares in the overall M&A activities. As the steady increase in house price in many cities, the acquisitions in real estate sector became incredibly active last year. Although software industry experienced the second most active in deal numbers of 423 on total 5488, it is out of top 10 by dollar value.

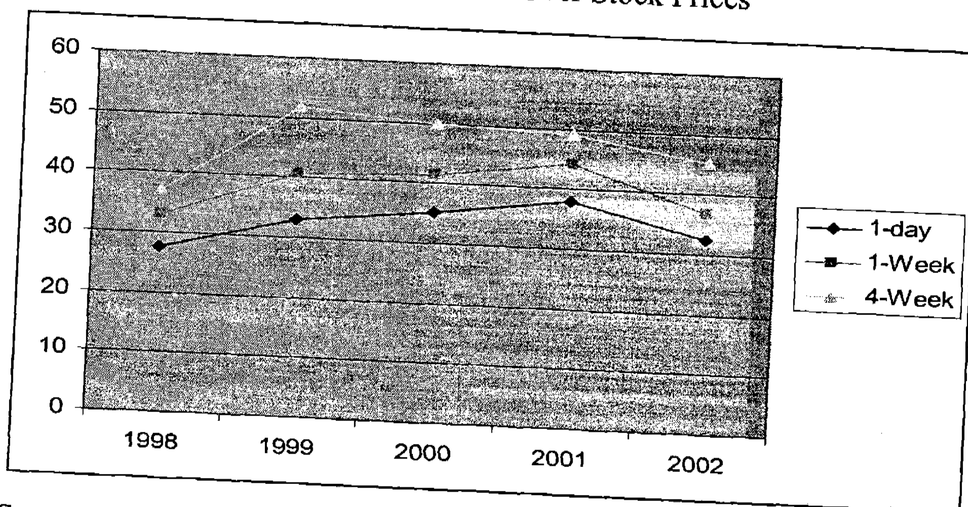
Table 3.2 Top 10 M & A Industries of 2002 By Value and No. of Deal

Industry	Value(b)	%	Industry	Deals	%
Radio & TV Station	96.2	15.7	Business Service	1035	18.9
Oil & Gas	58.8	9.6	Software	423	7.7
Electric, Gas & Utilities	47.0	7.7	Investment & Commodity Firm	241	4.4
Business Services	41.5	6.8	Insurance	188	3.4
Computer & Office Equipment	28.9	4.7	Measuring, Medical & Photographic Equipment	188	3.4
Real Estate	27.6	4.5	Real Estate	176	3.2
Drugs	26.1	4.3	Electronic & Electrical Equ.	174	3.2
Investment & Commodity Firms	25.5	4.2	Oil & Gas	159	2.9
Food	24.2	4.0	Health Services	142	2.6
Telecommunications	19.8	3.2	Telecommunications	142	2.6

Source: Mergers & Acquisitions Feb 2003

In addition, the annual average premiums over stock prices dropped near 10% from 2001 and 13% from the peak of 1999. However, given the dramatic drop in stock prices, the actual valuation has plummeted since the broken of internet bubble.

Figure 3.2 Annual Average Premiums Over Stock Prices



Source: Mergers & Acquisitions Feb 2003

In the global context, the size and deal are all recorded lower than last year as the discourage performance in US and EU (See Table 3.3).

Table 3.3 M&A in Global Markets In 2002 (By Number of Deals)

Target Country	No. of Deals	Value ($bil)
US	5488	$612,6
UK	1396	125.7
Germany	707	64.1
France	541	56.7
Canada	502	43.4
Japan	500	62.5
Australia	426	18.9
Spain	349	20.0
Netherlands	211	18.7
Finland	185	15.2
Italy	182	43.7
Malaysia	167	3.2
Sweden	162	10.9
Russia	145	5.6
Hong Kong	125	4.1
Switzerland	124	3.3
Brazil	118	10.9
Singapore	114	1.9
Belgium	108	5.4
New Zealand	104	3.1
China	103	18.7
Denmark	102	1.7
Portugal	88	2.9
India	79	3.3

Source: Merger & Acquisition Feb 2003

By breakdown of the global M&A activity, Europe has almost the same M&A activities in comparison with U.S. But east and middle Europe countries stand out as some light-spot. Meanwhile, some high-growth countries in Asia such as China and India are becoming more active in takeover activities.

Likewise, traditional industries such as services, food, investment & commodity and real estate sectors dominated the major M&A activities last year globally (See Table 3.4). Many deals involving software or telecommunication are related to restructuring or bankruptcy.

Table 3.4 Most Active Industries for Deals Done Outside of the U.S – 2002

Industry	No. of Deals	%of All Deals	Value($bil)
Business Services	1012	13.2%	$12.0
Investment & Commodity	509	6.9	31.3
Food	403	5.2	19.1
Transportation	319	4.2	27.0
Real Estate	283	3.7	36.0
Durable Goods Wholesaling	269	3.5	6.0
Nondurable Goods Wholesaling	240	3.1	3.8
Telecommunications	226	2.9	65.1
Printing & Publishing	218	2.8	7.6
Software	211	2.7	6.0
Machinery	207	2.7	2.3
Metal & Metal Products	207	2.7	28.4
Insurance	202	2.6	24.6
Utilities	200	2.6	86.6
Construction Firms	188	2.4	9.1
Industries are determined by the target companies Based on 7677 deals done outside the U.S. in 2002			

Source: Mergers & Acquisitions Feb 2003

However, in year 2002, through skillful negotiations, innovative structuring, and sheer persistence, dealmakers closed some deals that will have long-lasting impacts in their industries for years.

The huge biotech deals of Amgen Inc's $16.9 billion acquisition of Immunex Corp. in early 2002 and the acquisition of Pharmacia by Pfizer of $60 b last summer created unparalleled portfolios of blockbuster drugs, Industry analysts believe that as fellow biotech companies look to expand product portfolios and add infrastructure to manage product marketing and distribution, they will look to Amgen/Immunex and Pfizer/Pharmacia as models for attaining growth through M&A.

Another triumph was IBM's 3.5 b purchase of the PwC Consulting unit of PwC, which creates a company with unmatched end-to-end capabilities to help clients solve their business issues. Blending deep business and industry consulting expertise with information tech services, this deal may lay the groundwork for what the IT market is going to look like for the next two to five years--- the giants will dominate. Likewise, Legend Co, No. 1 PC producer in China, announced its acquisition of the active IT consulting firm Hanpu Consulting Co to seek for the synergy in the value chain. Meanwhile, IBM's biggest transaction, was negotiated at an attractive price for the buyer—only 0.7 times revenues compared with historical norms of 1.5 times to 2.5 times, and as high as 5.0 times revenues at the market peak.

Two noteworthy food industry deals in 2002 included Nestle SA's sale of its ice cream business to Dreyer's Grand Ice Cream Inc. and the merger of certain H.J. Heinz Co. assets with Del Monte Foods Co. Being one of the few creative, strategic, and high-premium transactions of 2002, the 2.6 b Nestle/Dreyer's deal would create an ice cream giant, jointing two companies' brand names and broad range of product lines into a business that would prove to be a worthy competitor to Unilever NV. So far, this deal is waiting for regulatory approvals but is expected to close this year.

2002 also spawned the largest buyout – the 7 b sale of the QwestDex telephone directories unit of debt-riddled Qwest Communications International Inc. to a group of private equity firms including Carlyle Group and Welsh, Carson, Anderson & Stowe. The objective of the deal was

to generate substantial liquidity for Qwest Communications, which needed to repay nearly $7 b in debt maturities, and generally de-leverage the company. Another interesting buyout story happened in China is that a US buyout fund New Bridge signed the agreement to acquire the first listed bank Shenzhen Development Bank.

The leveraged buyout market in general has been one of the brightest spots recently. In 2002 buyout firms snapped up companies at more than double 2001's pace. Strategic buyers have been more focused on internal governance and business issues, and this has left more targets for LBO buyers to go after.

Consortium bids by major private equity firms drove some of the biggest acquisitions of 2002, and the trend is expected to continue. There will be more buyout groups pursuing large, traditional LBO deals – especially in the industrial manufacturing, utilities, and health care sectors. Private equity firms that choose to lead rather than follow will have the potential to do some of the highest-return transactions in the next few years if the sluggish economy sustains.

3.2 Factors Affecting the Current M&A Market:

The sudden brake of US economy initiated the overall slowdown of global economy except for some emerging regions such as China and east EU. The affecting factors both positive and negative on the takeover games could be seen in three aspects.

1. Desperate economy and changes in rules

Sluggish economy, laggard stock market, tight credit market, uncertainty on safety issues and corporate governance scandals as a whole become the major hurdle to the M&A activities so far.

The forthcoming Sarbanes-Oxley Act and the cost of compliance issues become the main concerns in the regulation side although it is still going to take some time to get this issue through. Increase in the integrity of capital market and the cost of compliance may make the director much more responsibility as a public company and find IPO less attractive exit than

selling the business. In addition, the new regulation may also make the foreign companies more difficult to list there, which impact the way to make acquisitions in US.

Further, now more transparency appears in M&A antitrust reviews. The antitrust enforcers in Bush administration are stricter toward M&A than in Clinton administration. The US FTC (federal trade commission) issued, in October 2001, a new Merger Review Process initiative by Antitrust Division to have the initial waiting period to discuss any deals if raising competitive issues.

In terms of accounting rules, the elimination of pooling is very positive for the market from a strategic and structuring perspective. A perfect example is Pfizer's acquisition of Pharmacia. When Pfizer acquired Warner Lambert it had to wait two full years under the pooling rules to divest certain assets. Now with Pharmacia, the separation of Monsanto went ahead ASAP. It allows companies to implement their strategic mission much more quickly, rather than be constrained by pooling rules that delay divestitures or spin-offs. The elimination of pooling is very helpful for both sides in hostile transactions. It was also good for management that had to walk a very fine line to get a pooling, even though it didn't always make economic sense.

2. Rich resources from supply side:

In recent years, there are more divestitures and bankruptcy driven by the bad economy. Meanwhile, large companies with excess baggage are more like to accept market clearing prices to spin-off while start-ups are eager to source new funds. As a result, the M&A market has far more promising resources than last decade.

Private equity and LBO firms are contributing on both sides, involving the sale of the strongest portfolio and to pick up troubled businesses. Public companies are offering more going-private transactions, especially for small and mid-cap firms that fared poorly after going public because with the new Sarbanes-Oxley Act and other compliance pressures, the cost of remaining public is becoming prohibitive.

3. Constant Cautious in buy side.

The Sarbanes-Oxley Act and related new rules released by NYSE and Nasdaq on having independent directors have raised serious issues on corporate governance that slower CEOs and CFOs in takeover games.

Changes in the nature of board meetings make that board members spend enormous time with internal and external counsel reviewing the implications of the new provisions and determining how to work in the new environment. Three-fourth may be in auditing-meeting. In addition, the new provision requiring certification by CEOs and CFOs of financial results will no doubt make the M&A process more troublesome.

Further, in bubble era, a lot public-to-public deals negotiated in very short time with limited due diligence and significant reliance on audited financial statements. Now, the in-depth, extended due diligence process becomes the norm for buyers.

3.3 New Trends in Post-Dotcom Bubble Era

1. Bankruptcy – the Hottest M&A Market

As the rest of the M&A market continues to shrink, buyers are looking to bankruptcy courts for takeovers in the two major regions US and EU. Last year from Jan to Sep the acquisitions out of bankruptcy were running at a pace more than double that of 2001 in value.

Not only the turn-round expert Warren Buffet was getting into the game, big companies like AT&T and Sprint Co. were considering ways to pick off customers of the giant's MCI division (See Table 3.5). WorldCom's was the largest bankruptcy in history, but it has plenty of valuable properties such as wireless operations in Latin American. Other deadbeats include Enron, Polaroid, United Airline and MCI. Buying the assets of severely troubled companies has become a growth business.

Table 3.5 Top 10 deals in bankruptcy in Jan 2002 to Sep 2002

Acquirer	Target	Value ($m)	Announced date
GE Capital	Comdisco	$665	1/14/02
Nucor Co.	Birmingham Steel Co.	615	2/14/02
Gray Comm. Systems	Stations Holding Co.	500	4/1/02
Investor Group	Republic Technologies Int.	450	4/24/02
WL Ross & Co.	LTV Co.(steel assets)	394	2/27/02
GE Power Systems	Enron Wind Co.(turbine manufacturing)	342	2/20/02
Leucadia National Co.	Williams Comm. Group (45%)	330	7/26/02
Clear Harbors	Safety-Kleen Co.(chemicals services)	311	2/25/02
Bank One Co.	Polaroid Co. (65%)	255	4/18/02
Stop & Shop Co.	Big V Supermarkets	255	1/21/02

Source: Dealogic

2. The Diversification of M&A Activities

In general, the synergy effect of strategic acquisition makes it still the main stream, ahead of revenue driver and customer base acquisition that are popular in internet era. The strategic acquisition usually positions on more long-term run in terms of R&D, patent, and market shares as seen in the cases of Pfizer/Pharmacia and IBM/PwC.

At the same time, LBOs and non-strategic acquisitions account for a big share of M&A market as well. The active LBO is due to the inviting prices of many target companies worldwide. The success of non-strategic acquisition is evidenced by two big players of GE and Berkshire Hathaway, both of them were also enthusiastic in growth by acquisition over the last few years.

In the academia, through thorough analysis, researchers also conclude that companies can pursue non-synergistic deals profitably (Patricia L. Anslinger & Thomas E. Copeland, 1996)

3. The Emergence of Eastern Europe and China

The on-going Eastern European entry into E.U. offers some hopes of an M&A boost in that region. Most likely in next few years expect to see the activity centering mainly in Poland, Hungary, and Czech Republic as a result of E.U. enlargement. Sectors for best acquisitions opportunities are telecommunications, utilities, pharmaceuticals, banking, insurance, and retail. In Poland and Czech Republic, especially, the restructuring and consolidation of the banking industry will continue to attract cross-border M$A for mainly German, Austrian, and French banks already made investments in those countries to consolidate their banking activities. Meanwhile, the energy companies are increasingly targeting eastern European counterparts. Other packet of opportunity exists in Czech Republic's sophisticated manufacturing sector, which is adept at precision engineering of plastic and electronic products, and in Poland's publishing industry. Certainly, the integration of companies in East and Central Europe remains challenging.

With its global attitude, China is experiencing more and more takeover activities in both size and deal numbers since the sign of WTO agreements, the emerge of privatization and the encouragement of restructuring of state-owned enterprises (SOEs) by government. According to Thomson Financial, China was one of the brightest spot and the most active market in Asia, with 766 transactions worth $25.07 billion, or 24% of the region's total value. In addition, as the deregulation in telecommunications, financial services and utilities sectors, the cross-border takeovers are activated.

4. The Reuse of Old Vehicles in M&A Activities

Reverse stock split are coming in droves since the stock market began sliding in US. They are getting more attention because they are being used by bigger companies than usual and are being linked to mergers and restructurings, such as AT&T's divestiture of its cable TV operation. The warning is that a reverse split won't cure long-range problems that depressed the stock since they are only reverse stock splits, or equity markets plays on the law of supply and demand designed to boost stock prices simply by shrinking the number of shares available for public trading. The

reality is most reverse split could adjust the equity capitalization for worse-than-expected financial results and could get the recognition of reduced prospects for the future. This move rarely works for long-term and sustainable boost in stock price, unless a sound plan for shaking up strategy and operations to dramatically improve performance.

Believe or not, there have been hundreds of such cases since the technology bubble burst and the stock market tumbled over the last two years. In 2002, big-players such as AT&T Corp., Lucent Technologies Inc., Nortel Networks Ltd., Palm Inc., and Ethyl Corp. ride on those vehicles.

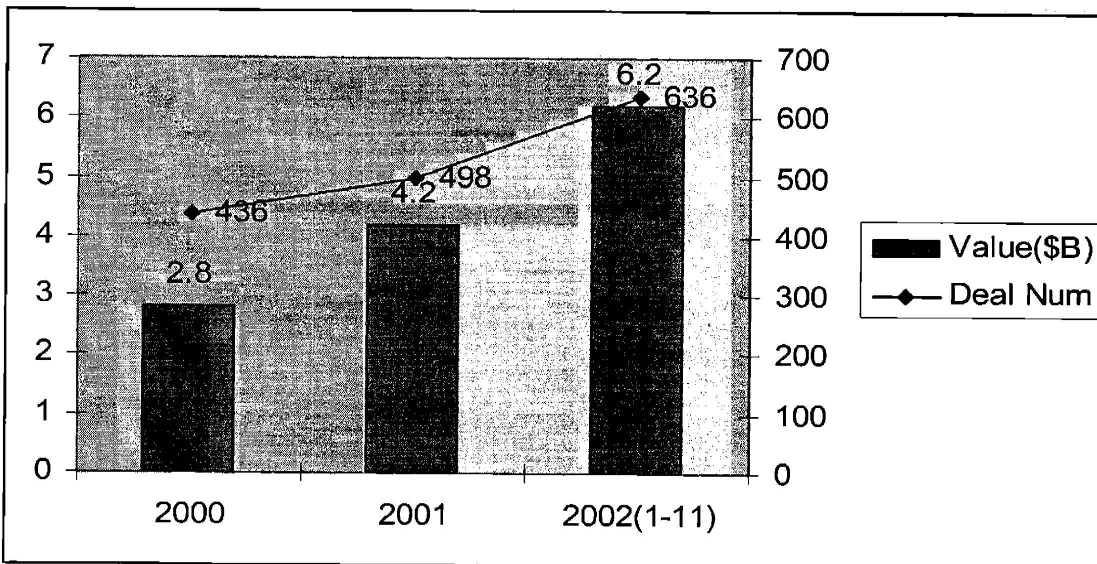
However, reverse split could pave way for M&A and restructurings. A company with fewer shares might make a better target. On the buy side, a company does get a lift from a reverse split have more valuable currency to distribute. Although no strong linkage between reverse splits and mergers, a number of reverse splits last year have been connected to deal-making. For example, AT&T has a 1-for-5 reverse split in the works after it spins off AT&A Broadband and merges it with Comcast Corp with a purpose that fewer outstanding shares will fit better with surviving operations, including its wire line telephone biz and other communication services.

Chapter Four: Mergers and Acquisitions in China

4.1 Introduction

The year 2002 was another dire year for merger and acquisition activity in Asia and it would have been a lot worse without China (See Figure 4.1). According to Thomson Financial, with regard to completed deals, Asia registered a 21.6% fall in 2002 to $72.63 billion from $92.67 billion in 2001. China was one of the most active markets in the region, with 766 transactions worth $25.07 billion, or 24% of the region's total value. One reason for the high value in China was the largest deal of the year for Asia: a $10.34 billion acquisition by China Mobile of eight mainland mobile phone subsidiaries from its parent, China Mobile Group.

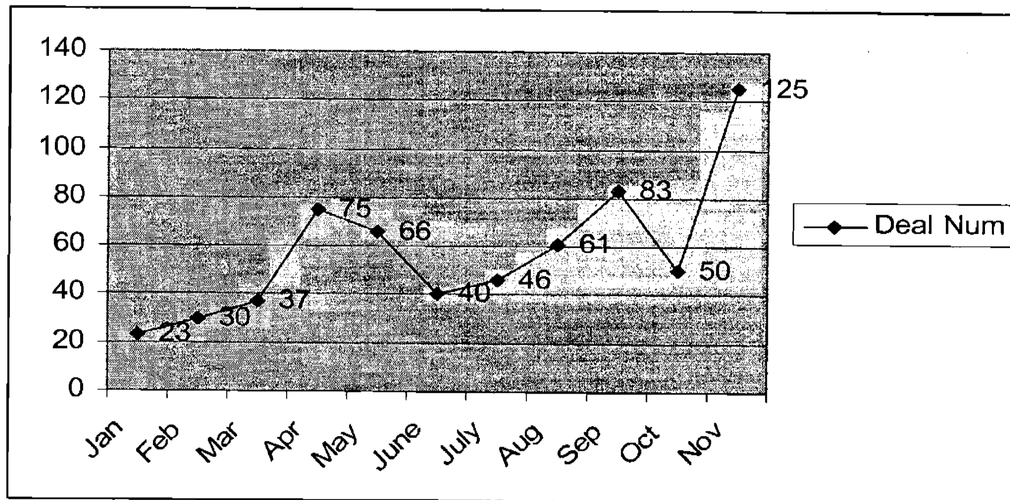
Figure 4.1 Value & Numbers of Listed Company M&A Transactions (2000-2002)



Source: China M&A Annual Report 2001, 2002 & 2003

Many signs demonstrate that China's M&A market has sustainable advantages over other Asian countries, the EU and the US. Those factors include consecutive GDP growth over 7%, a low M&A deal base, and impressive activities in privatization and deregulation in certain sectors. Before the challenges and opportunities of China M&A markets are identified, the chapter will first review the development processes of China M&A activities.

Figure 4.2 Wave of Listed Company M&A Transactions in 2002 (Jan-Nov)



Source: China M&As Annual Report 2003

4.2 Historical Perspective of China M&A Activities:

China's M&A activities can be divided into three phases: 1984-1989, 1990-1998, and 2000-present.

1) Phase One (1984 – 1989)

This was a period during which China's modern economy was in its infancy. The Chinese government and state-owned enterprises both lacked experience in operating and management, financing, and open-market skills. What Chinese government did was to facilitate the channels for foreign investors and to setup some special policies for attracting FDI. During this phase, the private sector represented only a tiny portion and active in small town and some labor intensive sectors. Rarely would management anticipate using M&A as a strategy for corporate growth. But in the joint-venture sector, there were many successful cases due to promotions by government.

Meanwhile, continuing low productivity in many state-owned companies caused local governments to seek help by transferring the ownership among state-owned or semi-state-owned companies. The first case occurred in 1984 when Baoding Machinery Co. acquired Baoding Textile Machinery Co. After that, the same practice appeared in many central cities. In 1989, the

government published two rules: The Temporary Regulation on Corporate M&A and The Temporary Regulation on Selling state-owned SME. As a result, in 1989, there were 2559 deals, amounting to 250 million. In the 1980s, more than 6966 companies were acquired, with amount of 1 billion assets being transferred.

Key features of this phase:

- The government was the dominant dealmaker deciding both the seller and the buyer, as well as the structure and the price.
- The deal happened normally with a profitable acquirer acquiring a continuing losing target with the help of the local government.
- Horizontal M&A: The intention of the acquisition was to simply erase the loss of the target firm by acquirer in the same line of business.

2) Phase Two (1990 – 1998)

The Chinese open-market policy was influenced by certain events at the time. The government realized the importance of both the internal market and export. Meanwhile, the reform reached the stage of setting up an efficient capital market. In 1990, two stock exchanges opened separately in Shanghai and Shenzhen, which highlighted the acceleration of economic reform. With the help of stock exchanges, many modern corporate theories and practices were now available to the business community. In 1993, the first hostile takeover case took place within two listed companies – The China Baoan Group announced its acquisition of Shanghai Yanzhong. Since then, the takeover is viewed as being an active strategy for corporate growth in the public and private sectors alike. But the takeovers that occurred in this phase concentrated on financial benefits on either stock market value or the interest-transfer between target and acquirer.

In addition, since most of those companies were still very small in market value, market share and management power, the added value to shareholders is not meaningful, and the post-merger integration seemed unsuccessful. However, some strategic acquisitions and cross-border acquisitions occurred in large state-owned companies and foreign companies were noteworthy (See Table 3.1).

Table 3.1 Key Cases in Phase 2

Acquirer	Target	Year	Value($mil)	Intention
Yucai Machinery Co.	Ford(Brazil Machinery Co.	1992	25	Strategic Merger
China Baoan Group	Yanzhong Inc. Aishi Co.	1993 1995	20 10	Financial Merger
Beijing Capital Steel Co.	A plant of Peru Steel Co.	1994	312	Strategic Merger
Japan ISUZU Co.	Beilv Auto Co.	1997	15	Strategic merger
Ford Motor Co.	Jianglin Auto Co.	1997	20	Strategic merger

Source: 'China M&A Annual Report' 2000.

Key features:

- The internal pressure of companies to expand became the primary motive.
- The government still played an essential role in mergers and actively facilitated the process in terms of policy-making and some special treatments but no longer dominated the deal.
- Some essential policies and law were published that improved perfected the legal system, e,g. Corporate Law, Security Law and The Assessment Approach of State-Owned Assets.
- Mergers became more complex. The acquirers looked for vertical acquisition to control resources and conglomerate acquisition to lower risks.
- Major acquisitions are by listed companies and multinational companies.

3) Phase Three (1999 – Present)

The current wave is occurring as many important events emerged in China.

- The government supported in industry consolidations and restructuring for SOEs.
- China rejoined the WTO.
- A new government policy, State Step Back, Private Move In' opened the window for M&A in nearly every sector.
- There was deregulation in some industries such as telecommunication, and financial services.
- There was rapid growth in China's capital market and corporate size.

- There was wake-up or encouragement by the new economy worldwide.
- The globalization process helps China highlight its advantages in R&D, manufacturing, and sources in the global context.

The important events above have been making this stage important to the future of the Chinese economy. Thus, this chapter will analyze in depth on the following part.

4.3 Current Key Issues in China M&A Market:

Industry Deregulation and Consolidation:

Some industries such as telecommunications, petrochemicals, financial services, and electricity, once viewed as the sensitive sectors to the state economy, have been deregulated. Certainly, the opening of the window is not comprehensive for private and foreign investors.

Table 3.2 China Top 10 M&As in 2000

Acquirer	Industrial & Position	Target	Value ($mil)	Post Market Share	Date
China Mobile	No.1 in Telcom	7 Province network	32840	48%	10,2000
PetroChina Co.	No.1 in Oil No.2Petrochemical	8500 gasoline stations	3730	28%	04,2000
ZXTF(HK)	Conglomerate	ZXGA	220	2% CableTV	11,2000
China Southern	No.1 in Airline	Middle Airline	180	15%	08,2000
Tsingtao Brewing Co.	No.1 in Beer	8 Brewing companies	50	11%	2000
Sanlian	Retail	Baiwen	36		12,2000
Dalen	Global No.1 in Food	Shanghai Meilin	23	15% in bottle water	12,2000
CRC(HK)	No.1 Food Wholesale	Vanke Real Estate Co.	22		08,2000

Source: China M&A Annual Report 2001

At the current phase, deregulation mainly lies in the permission for firms foreign-listed in Hong Kong and NYSE and in the limited entry for competitors in telecommunication. Some sectors are open to domestic private investors such as investment banking firms.

The deregulation also makes the acceleration of consolidation possible in almost every sector. The industry consolidation is not only driven by the government for the purpose of strengthening China Fortune 500 to compete globally, but more importantly, also driven by the free market principle to get the pricing power by the monopoly position (See Table 3.2).

Acceleration of Privatization in Many Sectors

As the government implemented a new policy, State Step Back Private Move In, and the protection of private assets was put into law, the process of privatization was suddenly accelerated in many sectors around the nation. For example, in Shenzhen, the pioneering city of reform, the local government is giving out the control of over 30 listed companies in the financial services, utility, transportation, gas, water, real estate and food sectors to foreign investors. The most interesting case is that US New Bridge Group, which signed agreement to purchase an 18% stake in the Shenzhen Development Bank Co. In this on-going deal, the acquirer is allowed to control the board and management and there is a possible future increase in the stakes.

Prosperous Management Buyouts (MBOs)

Since the debut of the Stone Group in 1999, MBO is becoming popular in business community accompanying with ESOP, presenting a numbers of advantages in facilitating the reform process:

- To offer an effective solution for agency problem. In many state-owned companies, no one is accountable for the performance of the company. MBO could bind the owner and management together to provide a good solution for the serious agency problem.
- To balance the maximum of short-term value and long-term goal for the company given the unified management and owner.

- To help solving brain drain problem in state-owned companies. The open market and free economy presents many opportunities to high-tier managers to look for well-paid positions in the private sectors and with foreign firms. The use of MBO could crystallize the outstanding managers in SOE.

Given the fact that MBO is still in its infancy in China, some problems are frequently encountered in practice:

a. **Financing:** since the price is far more than the management could afford in many cases, how to fund the deal puzzles many entrepreneurs. Thus far, the Chinese commercial bank has hesitated making any loans due to the tight credit policy of the central government. In practice, processes such as personal credits, and stake collateral loans are widely used.

In the US and Europe, LBO funds and commercial banks are the major funding sources for MBOs. Those sources could not only share the risks in finance, but also be actively involve in the post-merger reorganization and operating.

Fortunately, very recently, some non-state-owned banks and trust firms began offering this new service. Additionally, some affluent individuals and foreign LBO fund joint-ventured some China LBO funds in Shanghai, Beijing and Shenzhen.

b. **Valuation**: In many cases, the government allows the management to buy at a slight discount over the book value (BV) of the firm, given that the management has contributed substantially to the growth of the firm. But when this rule applies to a listed company, the argument comes out on the fairness to individual investors. Under current corporate law, the company could have three different types of shares, state share, corporate share and individual share. When a company gets listed in Shenzhen or Shanghai Stock Exchanges, the stock price is usually 5 to 10 times of the BV. If the discounted BV is lucrative, individual investors should have the same opportunity to bid. Meanwhile, the confirmation of BV is heavily relied on the asset assessment firm in China while this valuation method is somewhat controversial.

c. **Information Disclosure**: The main argument for MBO is the insider trading or interest transfer that includes the manipulation of the valuation process and the cooking of the financial numbers afterwards. Given the imperfection of the security law, the information disclosure is still somewhat problematic. Thus, how to solve the insider trading issue and keep the deal fair and open represent a challenge in M&A practice. Recently, China Security Commission (CSC) issued regulations to guide the mergers for listed companies on how to disclose necessary information concerning the deal-making process, valuation and the opening bid.

Cross-border M&A Becomes Popular in China

Gone are the days when foreign companies wishing to invest in China were limited to green-field investments. They can now purchase Chinese businesses and can restructure their existing investments in China through mergers, spin-offs, and holding companies that was impossible a few short years ago. This improvement is not contributed solely to foreign investors. Domestic Chinese companies are also actively merging with each other. Some successful players, such as Huawei, and TCL have initiated to aim targets cross the border. The result of all these changes is the sudden emergence of a huge M&As market in China.

Nowadays, cross-border M&As have become a two-way process in China. Not only do the Global Fortune 500 companies use acquisitions to share the high-growth potential of the Chinese market, Chinese companies look for aggressive acquisitions of foreign companies to access resources, market presence, and core technologies.

The Advancement of a Legal Framework

The legal framework of M&As has been evolving with the advancement of China's economy and overall M&A activities. China's regulatory regime had long been hostile to M&A transactions. The government published some rules only on bankruptcy and joint-ventures. Later, both to accommodate these recent developments and to further stimulate foreign investment, corporate law and stock administrative rules cover some simple items on this issue. Since the oversimplified framework puzzled many practitioners and also discouraged the M&As, in 1998,

there was the enact of Security Law regulating corporate control issues in detail for listed companies. In addition, many experts content that a more general law is needed to guide transactions involving both listed and unlisted companies. In 2001, a milestone regulation published by the central government opened a window for foreign investors to acquire listed companies in China.

Though Chinese law is becoming more flexible, the forms of M&A transactions and accompanying procedures authorized under Chinese law still differ in important respects from those in other jurisdictions. The available options generally depend on the result intended (acquisition, divestiture or merger); whether the transaction involves other foreign-invested enterprises (FIEs) or domestic Chinese companies; and the extent to which the transaction takes place within the Chinese regulatory jurisdiction. In general, many of the more onerous restrictions on FIEs, such as minimum export requirements and required utilization of advanced technology, are being lifted in preparation for China's WTO entry.

4.4 Challenges and Opportunities in M&A Market of China

Some of the challenges for M&A transactions in China lie in the following aspects:

Due Diligence

Publicly available records on many aspects of a Chinese company's business, such as legal title to land-use rights, the existence of pending litigation, and priority security interests over assets, are often either unavailable or uncompleted. Corporate accounting is also quiet different with foreign standards. And some companies, particularly SOEs, are still accustomed to rigid secrecy policies and may be uncooperative in disclosing their records. As a result, conducting satisfactory due diligence can be difficult. Under these circumstances, most acquirers will want comprehensive representations and warranties, indemnities for breach, and security for those indemnities. These arrangements are unfamiliar to many Chinese companies, and obtaining acceptable terms and conditions that incorporate them is often a challenge.

Financing

Numerous obstacles complicate debt financing for M&A transactions. Foreign investors and private companies so far are most often the acquisition vehicle but are subject to maximum leverage ratios that cap their borrowing ability. Existing FIEs may already have used up some or all of their authorized borrowing and private companies are strictly limited to access the bank loan. Because procedures for pledging equity interests or registering security interests in assets are not fully developed, and because enforcement of such interests is difficult at best, banks are often unwilling to loan funds for acquisitions. Even cash payments can give rise to problems for foreign buyers because of the inconvertibility of the RMB. If the Chinese party is required to make the payments in hard currency, it may be unable to obtain authorization for the conversion. When the foreign party is bringing new funds into China to make the acquisition, it must consider that, once converted to RMB and registered in the FIE's capital account, its funds may be difficult to convert back to hard currency and repatriate later.

Taxes

In June 2000, the State Administration of Taxation issued the Circular Concerning Several Income Tax Questions Concerning Enterprise Equity Investments. The general rules are typical of those elsewhere: profits derived from the sale of an investment in an FIE or Chinese domestic company are taxable income; a withholding tax of 10 percent applies if the seller is an offshore company; and transfers among affiliated enterprises may not be taxable events but may require adjustments in the cost basis for the investment. Many other complex tax and accounting issues may arise, some of which the circular addresses and others of which remain to be elaborated upon.

Closing

Most M&A transactions in China require approval from an examination and approval authority (EAA). The EAA will typically not advise the parties when approval will be granted and will not make its approval conditional on future events, such as payment of the purchase price. Approval,

however, in the form of an "approval certificate," transfers ownership. The seller will not want to initiate a government approval process that may result in the legal transfer of its assets to the buyer without payment in advance or a satisfactory guarantee of payment. Conversely, the buyer will not want to pay the purchase price until government approvals have been obtained and actual transfer of ownership is assured. (The buyer may also want to insist on an amended business license as a condition of payment, which requires action by the registration authority and can take additional weeks.) As a result, it is virtually impossible to affect a simultaneous closing of a Chinese M&A deal. Various escrow and letter-of-credit arrangements are sometimes used to bridge the gap, but the laws governing these arrangements are not well developed in China.

Future of M&A in China

Multinational corporations are constantly seeking to restructure their businesses in order to improve efficiency and profitability. This restructuring, often via M&A transactions, can only be effective if it can be accomplished quickly and through reliable procedures. These requirements of international business clash directly with China's longstanding preference for state planning of the economy generally and tight controls over foreign investment in particular.

The recent changes in Chinese M&A laws reflect China's movement toward a legal and economic structure that will accommodate the requirements of international business. China's need for more foreign investment and the legal obligations China will undertake in joining the WTO, will continue to push China in this direction. For M&A transactions, the most significant impact of China's WTO entry may be the country's implementation of its commitments to open, or raise the limits on the maximum foreign investment permitted in, several important service sectors, notably telecommunications, insurance and banking. China has also agreed to eliminate prohibitions on foreign distribution activities in China, which will effectively broaden the authorized business scopes of many existing FIEs and permit investment in a much wider range of distribution and retail activities. The result will be an M&A market that is larger and increasingly relevant to both foreign and domestic companies in China.

In addition, some of the unique advantages for M&As in China such as the low industry concentration, low market entry level but great market potential, privatization and government support will substantially boost the overall M&As in this region. Plus, the use of some new vehicles such as LBO, restructuring and tender offer will help enrich and facilitate the transactions.

Chapter Five Gap the Valuation Framework and M&A Reality in China

5.1 Fundamental Valuation Framework

The valuation for any acquisition is a two-way process. The acquirer needs to value the target to determine the proper offer and whether the target meets the acquirer's financial criteria. The target, in turn, needs to know what it is worth. Basically, the valuation process should be able to tell the management and boards of both sides whether the offer is in the shareholder's best interests.

Numbers of valuation approaches are used in the valuation process of M&A. Each approach has its unique characteristics that make it different from others. But the fundamental framework is almost the same to analyze the financial statements and financial ratios which could highlight the basic performance issues considered in business valuation for M&A. Since the thorough discussion of valuation could be found in any corporate finance textbook, this paper would shield lights on the comparison of different approaches and their unique applications as well as how to apply this framework to the valuation of M&A in China.

In practice, since the enterprise discount cash flow (DCF) provides the most essential understanding of any business in terms of cash flow prediction, opportunity cost and volatility that are critical in the valuation of any M&A deal, DCF is top of the approaches used in M&A transaction, though, it is not the most widely used in general valuation practice (See Table 5.1). Certainly, there are also some new approaches such as the economic value added (EVA) model and option method which make certain business sense and are becoming more popular.

Understandably, analysts in Wall Street are much more like to use some easy methods such as different multiples that have some shine sides versus the traditional DCF. However, multiples valuation could also be seen as simplified DCF.

The underlying assumptions for multiples valuation include market efficiency hypothesis, the availability of pure-play and the acceptability of the bias of valuation.

Table 5.1 Major Valuation Approaches Used by Analysts

Earnings Multiple	99%
P-E	97%
Relative P-E (PEG)	35%
Price-to-Book	25%
Revenue Multiple	15%
CF Multiple	13%
DCF	13%
EVA	2%
'Model'	4%

Source: Asquity et al, 2001

What make the multiples top of the valuation approaches?

- Convenience: When it is easy to find comparable companies in the same sector and the efficient stock market reflects the relative intrinsic value of each company, the convenience makes the analysts could use it on the daily basis.
- Popularity: multiples are widely used by financial analysts, making these approaches a dominate language in the valuation process.

Hence, although there are some inherent disadvantages for multiple approaches such as difficulty in pure-play and no in-depth understanding of the business performance, multiples methods are also frequently used in valuation of M&A transactions. The best evidence for multiple-valuation is that the year-by-year average premiums are in a narrow range from 30% to 50%. Certainly, in the M&A valuation, the multiples are not used solely. Instead, they are co-used with traditional approach of DCF analysis to reach more precise results.

DCF analysis is the cornerstone for the M&A valuation. DCF uses the analysis of historical performance in finance and operating as well as the post-integration and development plan for predicting growth to reach the pro forma statements of the target firm. This approach makes sense in merger perspective for both sides so it becomes the start point for most M&A valuation.

Table 5.2 Comparisons of Different DCF Approaches

	WACC	Equity Cash Flow	APV
Definition of Cash Flow	FCF=EBIT(1-T)+Depr-CapEx-ΔNWC+Extras	ECF=NI+ Depr-CapEx-ΔNWC+Extras Prin Repayments +New Debts	NPV=FCF + Interest Tax Shield + Other Financial Side Effects
What Value?	Firm Value	Equity Value	Firm Value
Which Discount Rate?	WACC= D%* (1-T) * Rd + E% * Re	Levered cost of equity Ke	Kd for value of the un-levered firm, Kd for value of the interest tax shields
What if leverage changes?	WACC is not appropriate.	Ke is very sensitive to capital structure changes.	No, Ku is invariant to leverage changes.
Terminal Value	Use last year of FCF: (FCF*(1+g))/(WACC-g)	Use last year of ECF, same as WACC	TV=TV(FCF)+TV(Tax Shield)
Advantages?	Easy to use, simply to explain	Direct estimation of equity. Used in LBO.	All special scenarios: subsidies, guarantees. Give more information.
Limitations?	Inaccurate when debt is very high and risky.	Inaccurate when debt is very high and risky.	Inaccurate when debt is very high and risky
When to use?	No change in capital structure, and no other financing side-effects, e.g. guarantees, NOL's, subsidized debt, etc.	ECF can be used in changing leverage situations when debt is not too risky. If used in a risky debt situation, best to explicitly calculate the magnitude of the bias and add back	Change in capital structure if know the level of debt: complex financing side effect calculations.

Source: Myers & Brealey. 'Corporate Finance' 2003 & MIT Course Material by Lisa Meulbroek, 2002.

Thus far, the DCF approach has developed many varieties such as WACC (Weighted Average Cost of Capital), DCFE (Discount Cash Flow for Equity) and APV (Adjusted Present Value). Each of them has its unique application based on different scenarios (See Table 5.2). For example, the equity DCF model is best suited for financial institutions such as banks and insurance companies. The APV model is good for valuing companies with changing capital structures, such as leverage buyout targets .

5.2 Basic Issues for DCF valuation

Analyzing Historical Performance:

The first step in valuing the target firm is to analyze its historical performance. A sound understanding of the company's past performance provides an essential perspective for developing and evaluating forecasts of future performance in the strategic and financial aspects (Pro Forma Statement).

The key for historical performance analysis is to analyze the 3 or 5-year financial performance. Based on the 3 to 5-year audited annual reports, the main financial indicators such as ROIC, capital structure changes, growth in sales, inventory, pretax net income and after-tax net income could be realized. In addition, through some cross-industry comparison against major competitors, the corporate strategic analysis, the overview of the industry and the macro-economic analysis could benchmark the overall performance and the future trend against the industry.

In practice, the basic performance information could be found in annual reports, while others could be only reached by reorganizing the accounting statements and to gain greater analytical insights and to calculate the results such as FCF and EVA. In addition, more advanced analyses are needed to be solicited in the depth analysis of financial performance and strategic move, analysis of credit health and liquidity, as well as analysis of the growth potential.

Estimating the Cost of Equity

The basic formula used in estimating cost of equity is the Capital Asset Pricing Model (CAPM). Based on this model, the required return on equity is a risk-free return plus the adjusted risk component, or $Re = Rf + \beta * Rp$. In US, the risk-free rate usually uses the long-term government bonds while the risk premium, many researches target on this issue but no consensus. The thumb of rule is the market equity premium appeared to be in the range of 6.5% to 7.5% (Myers & Brealey, 2003). In US, it is easy to get a fair number for the public companies while for private firm, the estimation of beta is a little tough since it is highly relied on the pure-play with the reference firms cross the industry.

However, in the estimating of betas of either public or private firms in China, the task becomes really challenging given no historical and systematical data on beta analysis. In later section, the issue will be discussed in-depth on how to estimate a meaningful beta for a target firm.

Estimating the Cost of Capital:

The cost of capital in principal is the weighted cost of capital (WACC). The general principal in estimating the cost of capital is to be consistent with the overall valuation approach and with the definition of the cash flow to be discounted. For example, to be consistent with the enterprise DCF approach, the estimate of the cost of capital must:

- Calculate the weighted average of the cost of the all sources of capital (WACC).
- Be computed after taxes.

The standard formula is: $WACC = D\% * (1-T) * Rd + E\% * Re$

T, the corporate tax rate

D%, the debt ratio

E%, the equity ratio

Rd, the average cost of debt

Re, the cost of equity

Forecasting Growth and Estimating Terminal Value:

The practical estimation of growth and terminal value could follow some basic analyses:

- Determine the length and level of growth for the forecast. Usually a two-stage approach is used, a detailed forecast in the near term followed by a summary forecast for the longer term with a constant growth rate of g.
- Develop a strategic perspective on future company performance, considering both the industry characteristics and the company's competitive advantages or disadvantages.
- Translate the strategic perspective into financial forecasts.

Based on the above analyses, the estimation of terminal value could be calculated from formula:
Terminal Value = PV (CFn /(r – g))
Where, CFn, the beginning year cash flow for constant growth
g, the constant growth rate which could be zero or negative.

5.3 A Practical Way of Valuing Chinese Companies

Overview of Valuation in China

China is an emerging market in which precise business valuation is much more difficult given the uncertainties that company faces are greater than in developed markets. Major risks and challenges include higher levels of macro-policy uncertainty, illiquid capital markets, control on the flow of capital in and out of the country, and unstable legal framework.

There is so far no agreement on how to address these challenges among academics, investment bankers, and industry practitioners. Methods vary considerably and often involve making subjective adjustments based on limited empirical evidence.

The popular of book value assessment approach in China lies in many M&A cases involving state-owned companies given the regulation encourages the sale price to be higher than the book value (See Table 5.3). In practice, the book value could not reflect the real value for most

companies. Thus, the book value assessment is giving way to other meaningful approaches such as DCF and multiples that certain adjustments could help to arrive more precise estimation.

Table 5.3 Major Valuation Approaches Used in China

Approaches	Usage
Multiples (P/E, PEG)	Asset management, M&As
Book Value Assessment	M&As
DCF	M&As, project investment

The major difference between valuing companies in US and China is the increased level of risk. You need not only to account for risks related to the company's strategy, market position, and industry dynamics, but also to deal with the risks of greater volatility in the capital markets, and macroeconomic uncertainty of China. Risks to consider in China include macroeconomic volatility, capital controls, regulatory changes, and poorly defined contract or investor rights. Those risks still exist in different level before the re-entry of WTO can smooth substantially the business environment both macro and micro to match with free market rules.

Where should we incorporate country risks by using traditional DCF and multiples in China? There are different ways to incorporate uncertainties into the estimation of business value.

1. Use DCF with probability-weighted scenarios that explicitly model the risks that the business faces in different emerging market.
2. Use DCF with adjusted cost of capital that the higher level of risks is adjusted by the higher cost of capital.
3. Adjusted multiples. For the sake of conservatism, you could also adjust the multiple benchmarks to some extent so as to keep the valuation more cautious.

Approach one is no doubt most precise theoretically and has some economic meanings in some aspects (Copeland, Kollar and Murrin, 2000) such as:

1. Most country risks such as expropriation, devaluation, and war are largely diversifiable. Finance theory indicates that the cost of capital should reflect only non-diversifiable risk.

Diversifiable risk is better handled in the cash flows. Meanwhile, the practices by many multinational companies are building the risks into the cash flows.

2. Many country risks do not apply equally to all companies in a given country. For example, banks are more likely to be nationalized than retailers; or some companies may benefit from a devaluation (raw materials exporters) while others will be damaged (raw materials importers). Applying the same risk premium to all companies in the country would overstate the risk for some and understate it for others.
3. Country risks tend to be one-sided (only down). It is much easier to build one-sided risks into cash-flow scenarios than discount rates. Most attempts to build risk into the discount rate are ad hoc or based not on equity risk but the credit risk of the country. A common approach is to add a country-premium equal to the difference between the interest rate on a local bond denominated in US dollars a US government bond of similar maturity. In many situations, equity investments in a company in the country will actually be less risky than investing in government bonds. In addition, equity investments carry potential upside risks, while bonds carry only downside risks.
4. Putting the effect of these explicit risks on cash flows provides more insights for managers that a 'black box' addition to the discount rate. By identifying specific factors that have a large impact on value, managers can better plan to mitigate these risks.

When constructing scenarios in emerging markets, company-specific and industrial scenarios should be aligned with macroeconomic scenarios. Start with the macroeconomic scenarios because they influence industry and company performance.

The major macroeconomic variables that need to be forecasted are GDP growth, inflation rates, foreign exchanges rates, and interest rates. These items must be linked in a way that reflects economic realities. Next, determine how each of the components of the cash flow is driven by changes in the macroeconomic variables. Link these items to the macroeconomic variables, so that when the macroeconomic scenario is changed the cash-flow items adjust automatically.

But the greatest problem facing this approach lies in the extremely subjective forecasting of the possibilities of different scenarios in any given country which in turn limits the use of this

method. For example, as the latter explanation for the important indicators of Chinese macro economy of GDP, inflation rate and exchange rate, the short- or middle-term trend is very clear but the long-term forecasting is almost impossible.

Hence in the practice of M&A valuation of Chinese business, my paper recommends to use the combination of two methods:

- DCF with probability-weighted scenarios only for micro situation.
- Adjusted cost of capital that highlights the risks or uncertainties of macro economy.

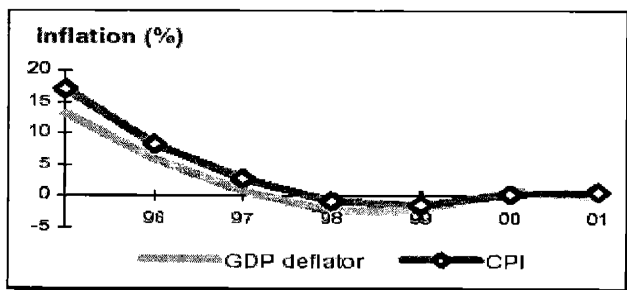
This approach has some unique advantages in targeting Chinese economy:

- Chinese macro-economy has its specialty that makes it differentiated from many emerging market in terms of sustainable GDP growth, stable political system, relatively fixed exchange rate, continuously increasing of FDI and the on-going privatization although it is still in the emerging phase.
- For micro economy, given many short-term substantial moves in the policy and consumer sides, the forecast of different scenarios is necessary and possible.

Effects of Inflation on Financial Analysis in China

High and unpredictable levels of inflation are often an important feature of emerging markets. But China is quite different from other emerging market since 1990. The inflation of China is well-controlled in a very acceptable range which will not be rocket-high in the foreseeable future.

Figure 5.1 Inflation of China (1990-2001)



Source: www.worldbank.org

In most countries, financial statements are not adjusted to reflect the effects of inflation. This means that assets and liabilities are recorded at historical cost and are not revalued to current currency units. This would create distortions in PP&E and inventories if the inflation is remarkable. However, as we could see in figure 4.1, the inflation in China is similar with that in most developed countries especially slight deflation occurred in year 2000 and 2001. So, this paper views that the inflation is ignorable in the valuation in China.

Cost of Capital

As the review describe in the first chapter, there are many models that target the cost of capital in the global context. Here we use the Goldman model or country spread model to get the cost of capital for Chinese business. The model is:

$Re = Rf + \beta * (\text{US equity premium}) + SYS$

Where, Re is cost of equity of any company,

Rf is the risk-free rate in China,

SYS is the China's Sovereign Yield Spread

The advantage of this model lies in that the every component has very clear meaning and can find related sources especially for Chinese companies listed in US stock market, the beta is more accurately reflect the risks of the firm.

5.4 Case Analysis: Valuation of China Mobile

About the China Mobile (CHL):

China Mobile (Hong Kong) Limited was incorporated in Hong Kong in September 1997. It was listed on the NYSE and The Stock Exchange of Hong Kong on October respectively. The company is one of the constituent stocks of the Hang Seng Index and has obtained a sovereign rating of BBB by Standard & Poor's and Baa2 by Moody's.

The company is a provider of mobile telecommunications services in 21 provinces in China. China Mobile reported 119.8 subscribers in the end of January 2003 which accounts for near

60% market shares in China. The company's major shareholder is China Mobile Group holding about 75% of the outstanding shares through a BVI subsidiary China Mobile Hong Kong Co.

For the fiscal year ended 12/02, revenues rose 28% to RMB128.56 billion. Net income before U.S. GAAP rose 17% to RMB32.74 billion. Results reflect higher usage fees due to growth of the subscriber base, partially offset by increased depreciation expenses.

Lines of Business:

As the No. 1 service provider in the wireless telecommunication sector of China, China Mobile covers a wide range of lines of business. The primary items are:

- GSM Mobile Service
- Digital Mobile Fax and Data Services
- Voice Mail Alert
- Short Message Service (SMS)
- Caller Number Display (CND)

Main Competitors in China:

Mobile Service: China Unicom

Fixed-Mobile Data Service: China Telecom Group

Growth Strategy:

Since 1997, China Mobile has been experiencing some unexpected juicy increases in the mobile sector and meanwhile some slight beats from its major but struggling competitor China Unicom. Throughout this time horizon, China Mobile takes advantage of its dominant role in this sector for strategic planning and development.

1) Squeeze-out strategy for China Unicom: China Mobile leverages its capacity in infrastructure investment such back-bone networks and GSM base station as well as the lobby power in central government to influence the pricing policy to give strong impact on the strategic planning on its competitor China Unicom.

2) Stake on GSM system: while China Unicom indulges a large amount of investment and efforts on the emerging CDMA system, China Mobile insists on GSM and rapidly increases its penetration in main central cities and suburb area around the whole nation. This increases substantially the hurdle for its competitors.
3) Strategic alliance with intra- and international players: over the past five years, China Mobile formed solid strategic alliances in the telecom industry, for instance, with leading equipment and handset manufacturers such as Nokia, Ericsson, Huawei and Zhongxin, with SMS content providers like Sina and Netease. The strong value chain around China Mobile strengthens its marketing power and service flexibility against China Unicom.
4) Advancement in post-sale services: offers the comprehensive customer satisfaction surveys and specially targeted service enhancement programs.
5) Seamless transfer to 3G by use of GPRS: GPRS was commercially launched in the first half of year 2002. This secured the foundation for the future development of data business applications such as MMS and customers who are looking for some services defined for 3G.
6) Aiming for rapid development in wireless data service. The rapid increase in wireless data service might open a new window to boost current sluggish growth in avenue especially in profit. In order to leverage this new driver, the company launched a large company in Shenzhen to focus on the R&D and commercialization of new applications.
7) Successful defensive market segmentation plan to avoid price cuts across the subscriber base. In light of the specific demands and position from the customer side, China Mobile initiates numerous of new plans to streamline the customer acquisition and to secure current subscribers. Meanwhile, the pre-paid plan efficiently segments a pool which looks for a more flexible vehicle.

Potential Competitions:

1) Pricing war: Possible pricing war with China Unicom and China Telecom Group especially in the lucrative high-end market following the latter's rollout of CDMA 1X by Unicom.
2) The Threat of Decrease in ARPU (Average Revenue per User) by one-way charge: As the progress of the deregulation in this sector, some pressure both form consumers and

from industry brings in some substitutes like 'Xiao Lin Tong' which actually bypasses the current policy to reach the same service but only one-way charge.

3) New Entrants: some emerging competitors like China Netcom are giving certain pressure on one or more aspects of China Mobile's development. However, the real pressure comes from the foreign competitors in the near future when deregulation is progressed towards a new phase to allow foreign players into this sector under WTO agreement.

FCFE Analysis:

Cost of Equity:

By using country spread model, the cost of equity equals: $Re = Rf + \beta * (Rm - Rf) + SYS$

Where: $Rm - Rf$ is US Equity premium to use of 7.5%

SYS is the China's Sovereign Yield Spread.

So far, China has no long-term government bonds as of 20 or 30 years. The interest rate of 3-year government bond is 2.32%. The interest rate of 5-year government bond is 2.63%. I adjust the long-term interest rate based on the comparison of the trend among US government bonds.

US interest rate of treasury bond: 3-year 1.98%, 5-year 2.78%, and 25-year or above 4.9%. (Source: www.research.stlouisfed.org.com)

We use Rf in China 5% slightly higher than US.

For China Mobile, the beta is 1.59 (Source: Yahoo! Finance).

China has a sovereign rating of A3 by Moody's. The typical default spread for A3 rated bonds is 95 basis points. There are many researches on SYS of China. Here use the result of 0.95% for SYS of China (Source: Allan Huang, Economic 202, San Jose State University).

So, $Re = 5 + 1.59 * 7.5\% + 0.95 = 17.9\%$

Growth Forecasting:

1. Baseline Scenario:

China Mobile enjoyed stellar growth in year 2000 and 2001 in which both sales and net income increased more than 50%. From the semi-annual report issued by the company, we see that growth has returned to a reasonable pace. Still, in year 2002, CHL will see an increase of sales and profit by 16% and 19% respectively. Beyond 2003, assuming that China's GDP growth can be sustained at 7-8% per annum, we believe that wireless telecommunication has the potential of doubling the GDP growth of the country. We estimate China Mobile's sales growth of 16% per annum. Taking the COGS from 2001 at 18%, average SG&A at 22%, tax rate at 32%, we estimate that CHL's profit will grow at 14% per annum from 2003 to 2006. CHL saw a decline of in working capital from 1999 to 2001. We see this trend to continue from in 2002. However, we believe that from 2003, the accrual of working capital will fall into the range of 10% sales growth.

Table 5.4 Free Cash Flow to Equity (Baseline scenario projection)

Fiscal Year	**2002**	**2003**	**2004**	**2005**	**2006**
NET SALES(M)	116,383	135,005	156,606	181,663	210,729
% Increase of Sales	16%	16%	16%	16%	16%
COGS	20,949	24,300	28,189	32,699	37,931
% of Sales	18%	18%	18%	18%	18%
SG&A	25,604	29,701	34,453	39,965	46,360
% of Sales	22%	22%	22%	22%	22%
NI(Loss)	33,252	38,003	43,400	49,525	56,465
% increase of Net Income	19%	14%	14%	14%	14%
Depre.	20,930	25,116	30,139	36,167	43,400
ΔNWC	(1,106)	1,862	2,160	2,505	2,906
CaExp	(50,381)	(58,442)	(67,792)	(78,639)	(91,222)
Free Cash Flow	4,907	2,815	3,586	4,546	5,737

Because of the uncertainties in 3G services, in this baseline scenario, we ignore the possibility of having major capital expenditure in the near future. We expect capital expenditure to grow at the same rate of sales growth. The growth of wireless service will not out pace the country's economy for ever. We expect CHL's growth to slow down to 7% range beyond 2006. Table 5.4 illustrates our cash flow projection.

Terminal value TV1 = 5,737,000 /((17.9% - 7%) *1.179^5) = 23,080 (million)

PV1 = 13,246 + 23,080 = 36,326 (million)

2. 3G Scenario:

It is widely expected that Chinese government will grant 3G licenses to four full telecom services providers no later than 2004 especially that a Hong Kong provider will offer this service in late 2003. The following scenario is based on intensified competitions from existing rivals and new entrants. Sales growth down to 10% and capital investments mushrooms from 2004. Following table illustrates the intensified 3G competition scenario (See Table 5.5).

Table 5.5 Free Cash Flow to Equity (3G scenario)

Fiscal Year(Mil)	**2002**	**2003**	**2004**	**2005**	**2006**
NET SALES	135,005	156,606	172,266	189,493	208,442
% increase of Sales	16%	16%	10%	10%	10%
COGS	24,300	28,189	31,008	34,108	37,519
% of Sales	18%	18%	18%	18%	18%
SG&A EXP	29,701	34,453	37,898	41,688	45,857
% of Sales	22%	22%	22%	22%	22%
NI (Loss)	40,849	46,816	49,790	46,571	38,931
% increase of NI	23%	15%	6%	-6%	-16%
Depre.	20,930	25,116	30,139	45,208	67,813
ΔNWC	(1,106)	2,160	1,566	1,722	1,894
CaExp	(58,442)	(67,792)	(101,689)	(76,266)	(91,520)
Free Cash Flow	4,443	1,979	(23,325)	13,790	13,329

Given the maturity of 3G, attractiveness in quality and services but the great pressure on capital investment, we assume the probability for this scenario is 70%. So the probability of base scenario is 30%.

TV2 = 13,330 /((17.9%- 7%) *1.179^5) = 53,637

PV2 = 3,960 + 53,637 = 57,597

Conclusion:

The final valuation of China Mobile is:

PV = PV1 * 30% + PV2 * 70% = 51,216 (million)

Chapter Six Adding Value through Successful Integration

6.1 Integration Process and Metrics

Why Integration is Key to the Success?

Although poor strategic fit and overpayment are often responsible for unsuccessful M&A deals, poor integration planning and execution is also crucial to the success of any merger & acquisition (See table 6.1). As we know, the integration process is the only way to make the well-designed and well-structured deal adding value to the acquirer. Compared with the valuation, the integration process is more art-like and people-oriented. The integration relates many intangible issues, including culture, communication, relationship and leadership. Unfortunately, many executives ignore these aspects as if they were a waste of time or difficult to measure. Indeed, with people, there are too many variables to deal with that are easily out of control.

Integration is particularly crucial for strategic acquisition in which some companies look for core technologies, market channels or talent people. The failed integration will dilute substantially the value or even kill the deal.

This chapter uses a survey on some soft issues about integration from the M&A participants in China. The survey covers 37 responses out of 50 candidates as executive, human resources manager, investment banker, venture capitalist and attorney.

Although the financial performance tops the factors to successful M&As, many respondents admitted that the other issues are all related to integration to some extent or in certain phase in many situations except that the valuation is somewhat out of control when having some bidding offers. It is fair to say that integration is more internal and the results are correlated to how much efforts the company put in.

Table 6.1 Most Important Factors to Successful M&As

Valuation & Financial Performance	78%
Increase in Productivity	67%
Compatible Cultures	59%
Successful strategic match	53%
Attract Key Talent	48%
Unified Management Styles	53%
Adopt to Manage Change	52%
High morale	47%

Note: percentages indicate the respondents rating the factors as highly important (4 or 5 on a 5-point scale) to successful takeover.

Integration Approaches

There are many different approaches for integration since each acquisition represents a different type of integration, this paper uses Schweiger's (1999) definition that, within an acquisition, different types of integration approaches may be used, based on functions, geographical areas and product lines. He notes that there are four types of approaches that might be used within an acquisition.

1) Combination – The extent to which the separate functions and activities of both the acquirer and the target firms are physically consolidated into one.
2) Standardization – The extent to which the separate functions and activities of both firms are standardized, but not physically consolidated (e.g. separate operations may be maintained, but the operations are made identical). This is typical when acquirers formally transfer best practices across firms.
3) Coordination – The extent to which functions and activities of both firms are coordinated (e.g. one firm's products are sold through the other firm's distribution channels).
4) Intervention – The extent to which intervention are made in the acquired firm to turnaround poor cash flow or operating profits, regardless of any inherent sources of combination value (e.g. replace management, drop unprofitable products).

The Process of Integration

Some people think that the integration happens only after the close of the deal. In fact, many researches show that the integration in many cases is throughout the whole process (Csiszar & Schweiger, 1994; Schweiger, 1999, Marks & Mirvis 1998). My survey shows that more than 70% of the acquirers in China begin to prepare the integration plan well ahead the closing of the deal. The benefit of earlier preparation is that the acquirer could get continuously feedback from the whole process.

Key Determinants of Successful Integration

Managing integration and designing appropriate metrics are complicated tasks, requiring close attention to a number of variables. The key determinants of successful integration are the following:

1. Strategic fit in finance, marketing and technology
2. Human resource issues
3. Effective communication
4. Cultural issues

Table 6.2 Top Indicators of Successful Integration by Respondents

Strategic fit	92%
Human resource issues	83%
Effective communications	80%
Cultural issues	53%

Some respondents also mentioned the relationship with local community, media and government as the indicator of success.

6.2 Managing the Key Issues of Integration Process

Over 60% of the respondents believe the top priority for implementing successful M&As is to define the integration philosophy, process, and timeline as early as possible. Indeed, managing the integration process successfully requires a clear, coherent, and strategic-height plan. The major components should be the following:

- Strategy clarification: An explicit statement of the long-term vision, short-term goal in the strategic perspective; the business model, competitive positioning and culture identity; the values proposition; organizational compatibility; and the follow-on integration philosophy. Top management should articulate the rationale for the deal in a way that makes as much sense for employees as for shareholders. All participants should reach to a consensus to follow the new company's direction. Further, everyone should understand the unified company's long-term vision and objectives and the reasons for creating a new business model, organization structure, people systems, and work environment.
- Project management structure: Decision-making authorities and process, roles, and accountabilities; means for conflict resolution; performance measurement and progress reporting. A sound approach to integrate a merger involves the establishment of a steering team composed of senior and support executives of the combined entity. In addition to the steering team, a core multidisciplinary team should serve as a dedicated, full-time analytical resource and focus for managing and coordinating global and functional integration teams.
- A master schedule for addressing global issues, functional integration, shareholder management, contingencies, and so on. It is critical to develop a master schedule and a roadmap of discrete tasks, activities, and deadlines for the integration process. In addition, a project tracking system must be developed to continuously assess progress.
- Communications strategy and plan for key shareholders (customers, mutual funds, employees, and others. Understanding shareholders perspectives is critical to the long-term success of any M&A. Meanwhile, key shareholders must understand how changes will be implemented and have a sense of how they will be affected. Plus, employees tend to be skeptical about what will affect on them or even some rumors. They need to know where they stand and what they can expect in the post-merger work environment.

Managers should ensure as little misunderstanding as possible through effective and endless communications.

- Team mobilization arrangement and change program design: Membership, training, logistics, etc for the understanding of integration milestones and change process. Team mobilization could facilitate the communication obstacles and brainstorm solutions for the integration from every aspect. Meanwhile, companies could find ways to manage change while maintaining current momentum.

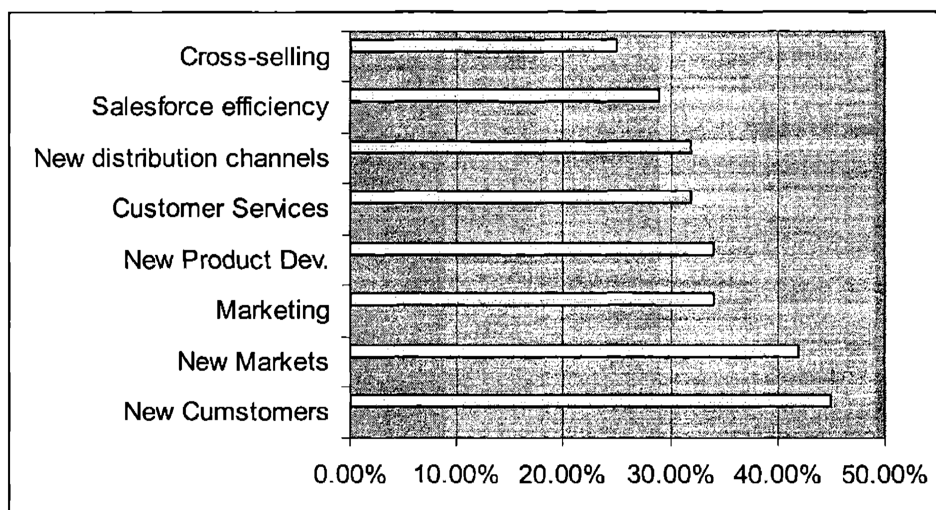
Through the integration process by the assistance of above components, some unforeseeable problems will inevitably emerge, so management could easily advance the process and find some solutions. The ultimate goal of the whole integration process is to smooth the key issues below:

6.3 Strategic Fits

Synergies

The synergy is no doubt the first priority for some of the acquirers. But, in which areas or to what extent the integration could benefit? A survey (Figure 6.1 and 6.2) by KPMG shows the breakdown of the benefits in cost-cutting and synergies of what M&A could bring in value.

Figure 6.1 Frequency of Benefits in Synergies through Integration

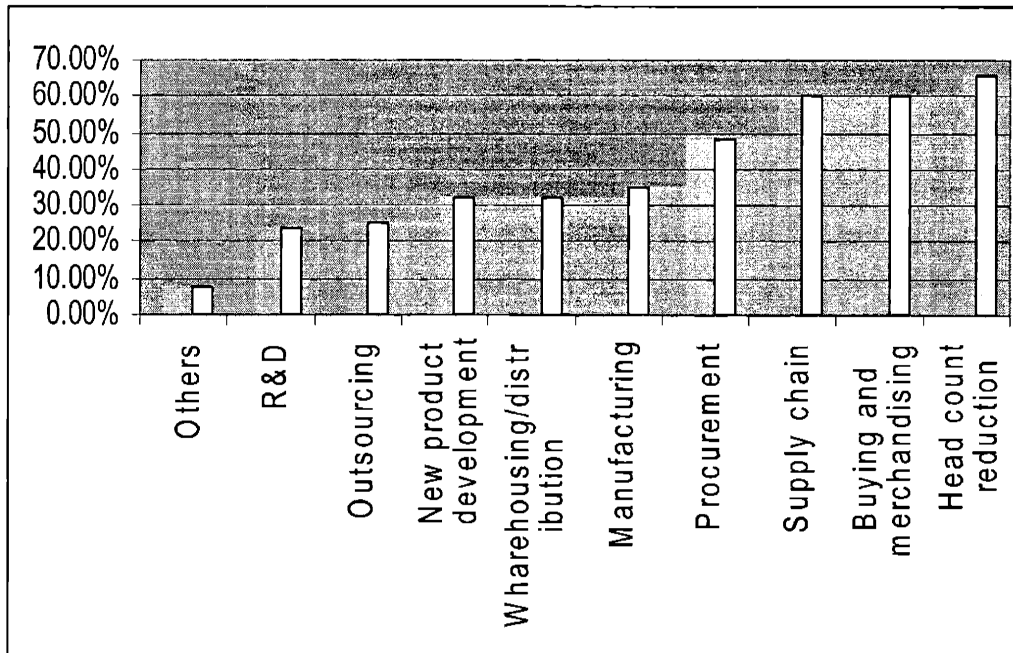


Source: KPMG, 1999

Cost-cutting

Whatever the acquirer views the strategic or financial fit as the first priority, the cost-cutting will be on one of top lists in the integration process. The figure below shows the frequency of benefits from post-merger cost-cutting action.

Figure 6.2 Frequency of Benefits in Cost-cutting through Integration



Source: KPMG, 1999

6.4 Effective Communication

Effective communication is important throughout the acquisition process, but it is particularly essential once the entities are combined. There are four criteria for effective communication in a post-acquisition situation. It must be (a) simple; (b) structured; (c) consistent; and (d) balanced.

Meanwhile, the communication should cover the different information needs of all shareholders. Key shareholders must understand how changes will be implemented and have a sense of how they will be affected.

Table 6.3 Elements of M&A Communication Plan

Clear Rationale for Deal	73%
Incorporating Integration Details	68%
Providing Milestones and Road Maps	66%
Two-Way Dialogue with Employees	59%
Addressing Distinct Information Needs	55%
Providing Multiple Shareholder Perspectives	55%
Tied to Change Management	51%
Addressing Readiness for Change	49%

Some other issues related to the communication by the respondents such as:

- Morale and productivity should quickly recover after the new organization is restructured.
- The merger is not used as a cover for reducing pay and benefits.
- Management should communicate openly and honestly through the process and handle displaced employees compassionately and generously.
- The positive aspects of the learning environment should remain unaffected, or even better.
- New approaches should be taken to promote on merit and to sweep away mediocre managers and other weak performers.

6.5 Human Resource Issues

Upon the merger, many respondents thought that the human resources department (HR) of the company should play crucial role in some specific aspects.

Note: the data shows the consensus in HP accountabilities by respondents.
Since there are many human resource issues that will puzzle around the company, whether the company could handle those issues well will reflect profoundly in the implementing stage to further affect the final result of the merger.

Besides these tasks, some other important issues that need the management to direct in the integration planning and implementation are:

Table 6.4 HR Involvement in Integration Planning Activities

Developing a Strategy for the New Entity	75%
Planning and Guiding Integration Efforts	68%
Developing Employee Communications System	67%
Designing Programs to Retain Key Talent	60%
Helping Employees Cope with Change	60%
Monitoring Employee Attitudes and Engagement	53%
Defining an Organization and Staffing Plan	50%

a. Compensation: given the sensitivity to compensation, this issue can cause animosity and behavior that undermines the successful integration or at least peaceful, cooperative coexistence of the employees of the two companies.

Table 6.5 Compensation Issues

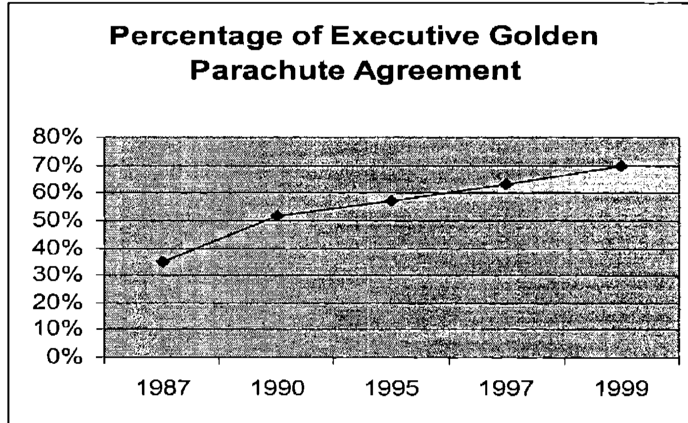
	Executives	Managers	Employees
Own shares of unified entity	92%	40%	10%
Increase salary	58%	90%	70%
Tie salary with performance	82%	80%	50%

Note: Except the data from executives, the data of managers and employees is randomly chose from 10 middle-level managers and 10 employees from 3 Chinese companies.

Given no option plan so far is allowed for Chinese companies, employees are more likely to choose among the ownership of the unified entity, increase in compensation package and new metrics tied with compensation as the response to the M&A (See Table 6.5). Generally, the higher the position, the more interest on the ownership. For employees, they care more about the instant impact on salary.

Meanwhile, Chinese companies do not provide some special policy for executives like Golden Parachute under takeover situation as their counterparts have in US (See Figure 6.2).

Figure 6.2 Fortune 1000 companies with Golden Parachute for Executives



Source: ECAS, May 2000, database of 1049 companies among Fortune 1000.

b. Position: this issue appears impacting those in high profile positions more, but has certain effect on every level of the organization. There are two tendencies in this process that must be avoided. The first tendency is too much concerned with most senior levels of management. The second temptation is to develop shared titles to avoid conflict and damaged egos at the expense of clear accountability. While this may work in some circumstances, it is generally better to have one person clearly responsible for a particular function within the organization. Rather than shared titles, an approach that can work is to further divide the job into clearly defined, discrete functions and put individuals in charge of the more focused areas.

Table 6.6 Reactions to position change

	Executives	Managers
Mind different functions?	46%	60%
Mind in target company with higher level?	30%	20%
Mind in target company with lower position?	100%	90%

Note: Managers are ten in the middle level with M&A activity companies. The data shows the positive answers to the questions.

Interestingly, managers and executives in Chinese companies have stronger reaction to the downstream move to the target company. This reflects somewhat that the 'losing face' concern is still an important factor to consider in the M&A with any Chinese company.

6. 6 Cultural Issues in the Chinese Context

In the post-acquisition integration process, one of the constant subjects seems to be related with culture. Especially in cross-border transactions, culture is named as a substantial factor of success or failure. A multitude of studies have dealt with the differences in national cultures in cross-border transactions, and have come to very different results[1]. It is not clear in how far different national cultures have correspondingly positive or negative influences on post-acquisition integration experiences. On the other hand, it became clear that in cross-border transactions the culture instruments (e.g. cultural due diligences) were not considered to be more important than in national transactions. There was also no difference in respect to the nationality of partner when indicating possible mistakes made in this area by the participants in the study. This empirical result is supported by Morosini's (1999) study (See also Morosini, Shane and Singh, 1998), which even stresses a slightly positive correlation between national cultures' differences and post-merger success.

There are several issues related to the culture and history of the individual organizations that can interfere with their successful combination. Cultural norms in companies play an important role in developing a sense of camaraderie, teamwork, and shared mission. When companies combine, particularly companies with significantly different norms, the disruption that ensues can have a deleterious effect on productivity and employee morale. It is therefore critical to undertake a process that clearly defines existing norms in the two organizations.

Those norms should then be categorized into those that have a high level of importance to employees and those that have a low level of importance to employees. The common problems include some of the most difficult to manage those of unsatisfied employees undermining the integration process. For example, traditions such as the company picnic can have important emotional meaning to employees, and any adjustments perceived to be unfair or insensitive in this area have been known to have a profound effect on employee morale.

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1 Examples for several studies with M&A focus: Olie (1994); Morosini (1999); Gersten, Soderberg and Torp (1998).

Unlike their counterparts in US, Chinese companies are in a revolutionary change period as they face the challenges of economic reform and more severe global competition. They share many cultural norms but have also some unique features that have strong impact on the integration process.

First, Paternalistic leadership (Farh and Cheng, 2000) is rather prevalent in Chinese companies. Paternalistic leadership can be broadly understood as a father-like leadership style that is characterized by authoritarianism, benevolence, morality and integrity. Organizations with paternalistic leadership would emphasize stability, respect for authority, and following rules and regulations. Such a leadership style may imply a particular type of organizational culture in the Chinese context.

Second, as China has a strongly relation-oriented culture (Yang, 1993), employees in Chinese companies are more responsive to organizational cultural values that emphasize interpersonal harmony and collective goals. In China, organizational cultural values that emphasize internal integration may be more strongly related to employee commitment than will values that emphasize external adaptation.

Third, harmony is highly valued in China. Companies are perceived as like families especially for private companies. Members of such a 'family' are encouraged to share not only their ideas and thoughts, but also their emotions and feelings. This goes beyond what typically is referred to as 'teamwork' in US.

Another feature exists in many SOEs is the pragmatism since SOEs move from a planned economy to the market economy, they are still used to the scientific management such as clear objectives for employees, consistency and unified actions, comprehensive and integrated systems, and skills and technology development.

Finally, in terms of external adaptation to its environment, to compete with localized joint ventures and global companies, Chinese companies now put great efforts on customer relations

and services. But many Chinese companies are not future orientated. They do not have clear goal and objectives as well as the balance between long-term benefits and short-term gains.

Based on the analysis of cultural issues in the Chinese context, some actions are essential to the successful M&A integration of Chinese companies (See Table 6.6) and these actions could be functional in three catagories.

Table 6.6 Effective Ways to Smooth Cultural Conflict

Actions	% of Respondents
Clarify cultural difference and mitigate conflicts	92%
Training program, meeting and functional team	85%
Communicate among management and employees	85%
Informal gathering, picnics, and activities	62%
Using consulting services	16%

a. Cultural Interaction: In the situation of combining companies with different corporate culture, the management will need to construct a strategy to minimize the detrimental effects of such a historical relationship or distinction in culture. One approach is to form task forces and functional teams comprised of members from each of the organizations as early after the transaction as possible. They could work together to overcome obstacles and to achieve goals in erasing historical, usually highly inaccurate, perceptions of employees at the other company. Moreover, they are guided to form a culture that could root and prosper in the new unified entity.

b. Operating Style: In combining entities with different operating styles in China, trying to force employees of either firm entirely into the working style of the other company is highly unlikely to be successful, instead, it makes sense to try to fuse the styles at the margins and only where absolutely necessary mandate one or the other style. Given the operating style is a subset of cultural norms, any major adjustments must be communicated in a simple, structured, consistent, and balanced manner.

c. Existing Relationships: as the analysis above, the reality of company operation dictates that many businesses are conducted on the basis of personal relationships in China. In the case of a merger of two firms that overlap some relationships, there must be a process to guide the combined entity in reconciling which suppliers, distributors, customers, and other relevant entities. Given the subjective and emotional basis on which personal relationship with these entities exist, it is best if the process for determining continued interaction is objective. Use of an objective process is the only approach that will be perceived as fair. The proliferation of customer, supplier, and distributor scorecards should facilitate the process of evaluating these relationships objectively and determining which will exist and on what terms into the future. Again, effective communication is also the key to expanding the meaningful relationships of the combined business.

Chapter Seven: Conclusions of the M&A Framework and A Case Analysis of Corporate Growth through Active M&As in China

7.1 A Systematic Approach for M&As

Corporate growth through M&A has the potential for achieving rapid increases in revenue, market share, and return for shareholders in its core businesses if the process is well-conceived and executed. However, the pursuit of growth through acquisition is not as simple as only two problems of valuation and integration especially when M&A is still in its infancy in China. Given the fact that M&A is an extremely complex process and typically involves significant risks, when a company is planning to use this strategy, it must employ a systematic approach that includes the following ingredients besides the trend identification, valuation and integration:

Develop an Effective Corporate Strategy to Lock the Target

M&As have recently tended to emphasize core business activities. The definition of core varies somewhat from company to company, but clearly the trend is away from conglomeration and toward strategic focus. On the whole, it seems prudent to remain in businesses that the management team already knows well. For example, Cisco uses very strict primary target evaluation criteria (Source: 'Inside Cisco'):

- The target and Cisco must share a compatible vision of the future from both an industry and a product perspective.
- The acquisition must produce a quick win for Cisco shareholders, preferably within 12 months of the purchase.
- The companies must share a complementary culture, or what Chambers calls the right 'chemistry'.
- There have to be long-term wins for the four major constituencies-namely shareholders, employees, customers, and business partners.
- For large acquisitions, the target must be geographically located close to a Cisco office.

Conduct an Honest Self-Evaluation

Acquirers should conduct a detailed self-evaluation to review their operational capacity to pursue M&A deals. They should know whether they possess the management expertise and technology needed to run the combined entity.

Perform Thorough Due Diligence

The conduct of due diligence includes the following:

- A legal structure review, including tax liabilities, employee disagreements, class action suits, and other pending litigation.
- A review of ownership and capitalization structure.
- Detailed marketing and sales evaluation of the customer base.
- A review of IP rights and technology.
- A review of financial performance.

Monitor Process and Keep Track of Implementation

In the monitoring process, the company needs a very specific measuring system to ensure that the information channel is open and ready for management. A formal feedback loop could facilitate this process.

7.2 Case Analysis: China Netcom (HK) Acquires Asia Global Crossing

On March 17, 2003, China Netcom (HK) Co. disclosed that Asia Netcom, a joint-venture by CNC(HK), Newbridge Capital and Softbank Asia Infrastructure Fund closes a deal to acquire Asia Global Crossing. In this transaction, Asia Netcom paid US$80 million in cash to acquire near US$1.9b book value assets in pan-Asian area of Asia Global Crossing.

Why China Netcom Use M&A for Growth?

China Netcom was founded in 1999 as a facilities-based broadband telecommunications provider and further merger with China Telecom (North) in May 2002 since 2000, the government decided to reorganize the industry based on the region and services. Besides the reorganization, the government also issued licenses to four new telecom carriers, China Netcom, China Railcom, Jitong and China Satellite. Given some historical reasons, the resources of the industry were once concentrated in China Telecom, and China Mobile. The No. 3 player, China Unicom, has a longer history than China Netcom and its unique advantage in CDMA system. Before China Netcom's acquisition of Asia Global Crossing, its global business relied on the high cost of backbone networks owned by China Telecom. How to decrease the operating cost and expand effectively to the international market to survive under the shadow of these giant players becomes the first priority of China Netcom.

Chance is that since the coming of winter of global telecommunication industry, the performance of Asia Global Crossing plummeted. Worse, Global Crossing Ltd, the original owner of Asia Crossing Ltd with 58.8% stake, was acquired by Hutchison Whampoa Ltd and Singapore Technologies Telemedia Pty after its Chapter 11 filings, leading the impossibility to inject US$ 400m as planned to save Asia Global Crossing Ltd. Meanwhile, Asia Global Crossing needs to pay two equipment providers, NEC and KDDI, about $347million and $408million debt recently. All bad events coming together made Asia Crossing rush out to find a buyer.

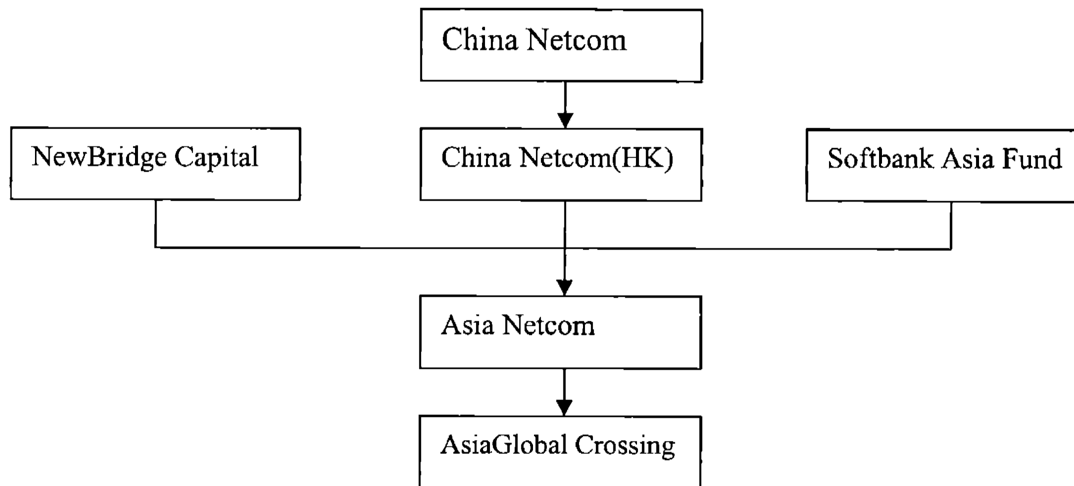
The flip side of Asia Global Crossing is the attractiveness in the assets offered to China Netcom, with a book value of $1.9billion including $254million in cash and two major backbone networks connecting 16 countries and more than 200 cities through far-east fiber-cable system and pacific fiber-cable system. The integrated system is what China Netcom is looking for in expanding its core business to become a global telecommunication provider.

Deal Structure

In 2000, Asia Crossing Ltd announced its acquisition by Asia Netcom Co at the very low price of $80million to get a basket of assets with book value about 1.9billion. The deal agreement also includes: Asia Netcom injecting 120million and China Commercial Bank offers $150million

bank loans for operating cash. Meanwhile, in order to avoid uncertain risks, Asia Crossing filed for bankruptcy in the US with the SEC after the announcement of the agreement. In addition, Asia Crossing Ltd must divest and restructure some of its liabilities.

Figure 6.1 Deal Structure



7.3 The Integration Challenges for China Netcom

Apparently, the deal is very worthwhile in terms of synergies potential and valuation. Meanwhile, China Netcom teamed with two partners with strong LBO experiences and fund sources. But to make this acquisition work, there is still a long way to go as analyzed in the previous chapters.

The problems facing China Netcom include:

1. Asia Crossing is still in downstream performance with difficulties in operating and finance: this is no hope of making a profit in the short-term, high annual maintenance cost and depreciation, and huge debt liabilities.

2. China Netcom itself is under-going some reorganization and integration since its merger with China Telecom (North).

3. The constant bear market makes the raising funds through an IPO highly uncertain.

Obviously, any of the problems above could lead to the failure of this acquisition. The results will vary dramatically by good or bad integration. Thus, systematical integration becomes the most important step to realize the value from deal. The value could be acquired from the deal existing in both financial restructuring

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