Offshore Planning for Chinese Companies: Risks and Solutions

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I. Introduction

Since its opening in the 1980s, China used to serve as a manufacturing country for the western world mostly for cheap clothes and toys, due to the low labour costs in China. This changed in the last 15 years, when more and more money flowed into China, and Chinese companies, privately run as well as state run companies, became richer and richer.

Due to the increase of their capital, Chinese companies started to invest their money abroad. The China outward foreign direct investment in 2002 was less than 50 million USD, whereas it increased to more than 120 **billion** USD in 2017. One of the aims of this increasing outbound business is, of course, the acquisition of foreign knowledge, but also the reinvestment of money. There are not only the "big deals", such as the Rio Tinto deal in Australia, or the acquisition of Volvo by a Chinese company, but also many small Chinese companies that try to expand their business to other countries.

However, it is a fact that most of the directors of Chinese companies do not have much or even no experience at all in doing business in other countries, because most companies are quite young and only did domestic business in the past. In addition, the Chinese culture is playing an important role when doing business in China, and Chinese investors must be aware that some rules in regard to contract negotiations may be different due to the different cultures.

Doing outbound business is a good way for Chinese companies to acquire new fields of business, but it must always be considered that there are some risks when going out of China. The following short newsletter is supposed to give a quick overview about some of the risks that Chinese companies may face and how these risks can be dealt with.

II. Risks for Chinese Companies

When taking over another company, there is a certain course of action, and each of these steps is bearing special risks. This course of action can be divided into three main parts:

- Target identification, evaluation and selection
- Due Diligence, negotiation and deal closure
- Post transaction management process

<u>1. Target Identification, evaluation and selection</u>

During the first phase of the acquisition of another company, it is to consider that the owners and directors of the Chinese companies are not sure yet how to invest and which risk they should bear. Many Chinese companies are not privately run, but belong at least partly to the state, so that there might exist conflicts of interest between the owners from the state side, and the private owners of the company, and this might lead to a weak and slow decision-making process.

Furthermore, Chinese investors may be lacking relevant knowledge and experience in regard to the different countries and cultures where they would like to invest. During the first phase of the acquisition, there might be insufficient information and incomprehensive analysis or evaluations, and the information that is available can be quite limited, e.g. only publicly disclosed information is provided, and it might be difficult to assess the earnings forecasts. Since many Chinese companies only have limited experience in doing outbound business, they are not familiar with the equity structures of foreign companies, and there might be differences in the accounting policies (e.g. some countries have not adopted IFRS yet), so that Chinese investors might have problems in comparing the financials.

2. Due Diligence, and deal closure

Problems can also occur during the negotiation process. For instance, some target companies use a wide range of derivative products, which Chinese companies are not familiar with, or the target company may have working capital pressures and high shortages, e.g. having large-scaled capital expenditure plans and a series of corporate restructuring programs that require capital injection.

There might also be significant differences in law and regulations between the different countries, e.g. some countries have strict legal requirements regarding employee welfare and severance requirements (e.g. 613a German Civil Code), and due to this, the worker's union of the target country can be quite powerful. Another legal issue is that the Chinese company might be required to bear all or at least parts of the target company's historical tax burden and might not be able to identify the appropriate deal structure and related requirements and implications. In the past, Chinese investors were not used to conducting in-depth due diligence checks, but this is nowadays unavoidable before acquiring a foreign company, because the legal, tax and financial background of the target must be checked carefully.

3. Post transaction process

Even though the two first mentioned phases are finished, and the target company is acquired, there might still be some significant problems that need
to be considered during the post-transaction process. This is mostly due to the changing of the systems (both operational and financial) and the change or adoption of the processes, and the consequence might be that expected synergies may in fact not materialize.

It is essential for the Chinese company to have a follow through plan that can help monitoring the mechanisms and actions to address the above mentioned issues. There must also be an effective auditing system and an inspection of the post deal circumstances, and for the worst case, the company needs to have an ultimate exit plan that causes minimal costs.

III. Conclusion

As identified, the acquisition of a company in a foreign country can be quite interesting, but there are also some risks that need to be considered.
Some of the following recommendations might be useful to avoid the indentified risks:

- Understand and align the investment objectives
- Check the entire process from the very beginning in regard of all aspects: strategic, financial, operational and compliance
- Undertake a comprehensive due diligence process
- Analyse future financial needs
- Plan upfront for post deal integration risks
- Establish comprehensive monitoring processes
- Have an ultimate exit strategy
- Ensure adequate resources during all phases of the process.

We believe that the information provided was helpful for you.
If you have any further questions, please do not hesitate to contact:

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