Doing Due Diligence when investing in China

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China remains a hotspot for inbound FDI

- China’s GDP reached USD7.3 billion in 2011, second only to the US.
- Financial crises reduced 2009 FDI to China to USD90 billion, not because of lower market prospects, but because of financial problems of the investors.
- Rising income and demand for luxury goods will continue to attract FDI to China in 2011 and 2012, as inbound FDI reached USD105 billion in 2010.

Source: UNCTAD (United Nations Conference on Trade and Development), 24 October 2011
## E&Y is active in China’s M&A market

### Typical M&A deals in China

<table>
<thead>
<tr>
<th>Target Company</th>
<th>Business</th>
<th>Type of Company</th>
<th>Deal stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shandong Lingong</td>
<td>Wheel Loader</td>
<td>POE</td>
<td>Majority</td>
</tr>
<tr>
<td>Tianhe Chemicals</td>
<td>Specialty Chemical</td>
<td>POE</td>
<td>Minority</td>
</tr>
<tr>
<td>Golden Jaquar</td>
<td>Restaurant Chain</td>
<td>POE</td>
<td>Majority</td>
</tr>
<tr>
<td>POVOS Electric Appliance</td>
<td>Kitchen Appliance</td>
<td>POE</td>
<td>Majority</td>
</tr>
<tr>
<td>Dabao</td>
<td>Cosmetics</td>
<td>SOE</td>
<td>Majority</td>
</tr>
<tr>
<td>Fujian Sedrin/ KK Brewery</td>
<td>Breweries</td>
<td>SOE</td>
<td>Majority and Minority</td>
</tr>
<tr>
<td>Huaneng Debier/ Yangji Nuobao</td>
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<td></td>
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<tr>
<td>Harbin Brewery/ Tsingtao Brewery</td>
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<td>Zhejiang Shiliang</td>
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<tr>
<td>Yashili</td>
<td>Dairy products</td>
<td>POE</td>
<td>Minority</td>
</tr>
<tr>
<td>Web</td>
<td>Education</td>
<td>POE</td>
<td>Minority</td>
</tr>
</tbody>
</table>
Due Diligence issues vary from transaction to transaction

**Typical DD objectives**

- Identify deal breakers early
- Gather relevant information for informed decisions
  - Valuation
  - Deal structure
  - Liabilities exposure
  - Funding requirements
  - Representation & warranties

<table>
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<th>Typical DD issues</th>
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<tbody>
<tr>
<td>- Accounting errors and differences</td>
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<td>- Quality of earnings</td>
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<td>- Fraud and unscrupulous business practices</td>
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<td>- Valuation gap</td>
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<tr>
<td>- Other transaction issues</td>
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<tr>
<td>- Representation &amp; warranties</td>
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<tr>
<td>- Price adjustments</td>
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</tbody>
</table>
Typical due diligence issues

► Accounting errors and differences
  ► Revenue recognition
  ► Cash vs accrual basis of accounting
  ► Accounting estimates
    ► Doubtful debts
    ► Obsolete stocks
    ► Warranties
  ► Staff benefits
  ► Other GAAP differences
  ► Not uncommon to see profits reduced by 20+% after DD adjustments
Typical due diligence issues

► Quality of earnings - sustainability
  ► Cost structure
  ► Product mix and profit margins
  ► Cost-to-income ratio
  ► Sensitivity analysis
  ► One-off adjustments
  ► Stand alone adjustments
  ► Related party transactions

► Analysis is limited by
  ► Free access to people and information
  ► Use of manual accounting system
  ► Design of chart of accounts
Typical due diligence issues

- Liability exposure
  - Contingent and off balance sheet liabilities
    - Cross-guarantees
    - Onerous contracts
    - Commitments
  - Land use rights
  - Tax exposure
    - Multi-sets of books
    - Negotiated tax rebates
    - Improper CIT/ BT tax adjustments
    - Customs duty – under-declare import price and misuse of bonded materials
    - Under-reporting of IIT
    - Penalty: up to 5 times (with no statutory bar)
- Share deal or asset deal?

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<th>Transaction tax rates</th>
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<td><strong>Asset deal</strong></td>
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<tr>
<td>VAT @ 2 or 17% on fixed assets (pre or post 2009)</td>
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<tr>
<td>BT @ 5% on intangibles</td>
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<tr>
<td>RPGT @ 30-60% on gains</td>
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<tr>
<td>CIT @ 25% on profits</td>
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<tr>
<td><strong>Share deal</strong></td>
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<tr>
<td>Stamp duty @ 0.05% on value</td>
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<tr>
<td>Capital gain tax @ 25% for domestic seller, @ 10% for foreign seller.</td>
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</table>
Typical due diligence issues

▶ Fraud and unscrupulous business practices
  ◀ Inflated sales
  ◀ Fictitious transactions and assets
  ◀ Complex distribution channels
  ◀ Undisclosed liabilities
  ◀ Kick-back and bribery
  ◀ US: FCPA; UK: Commercial bribery
Typical due diligence issues

- **Valuation gap**
  - Acquisition is expensive: average PE multiple 25 X to 50X
  - SOEs can’t sell below 90% of prescribed valuation
  - Need to have deep understanding of assumptions underlining projections and valuation model

*PE of Shenzhen Composite is higher than Hang Seng’s and S&P 500’s and has rebounded faster*
Key take away……………

► China is a developing market, transaction issues not peculiar to China
► China is big – one size doesn’t fit all
  ► Diverse in geography and demographic
  ► 56 minorities, 200 dialects, in 22 provinces
► Internal alignment is important
  ► China vs HQ team
  ► Division, finance and legal teams
► Involve advisers early
  ► Don’t limit scope of DD
  ► Don’t get “trapped” in the “This is how it’s done in China” syndrome
► Doing transaction in China takes time (can take 3X+ longer)
  ► Patience, patience, patience ……..