IBM, Maytag, Unocal...Who's Next in China's Sights?

Does the aborted bid by CNOOC to acquire Unocal signal the end of Chinese corporate takeover attempts in the West -- or just the beginning?

On August 2, the company, whose parent is the state-owned China National Offshore Oil Corp., withdrew its $18.5 billion offer for California-based Unocal in the face of stiff U.S. political resistance. The incident prompted bad feelings on both sides, and in the near future, merger and acquisition activity from Chinese firms in the U.S. market may well slow down. But in the long term, analysts say, new efforts to purchase Western companies are likely, given factors that include China's immense foreign-exchange reserves, Chinese firms' ability to shore up weaknesses through overseas mergers, and the country's overall aim to expand its influence abroad.

This past weekend, yet another potential deal surfaced. The Sunday *Times* reported that Chinese network-equipment company Huawei Technologies is in talks to take over British telecom equipment maker Marconi for more than $1 billion. Other possible targets, according to outside observers, include companies with popular brands, firms controlling natural resources and no-name industrial outfits. Furthermore, predicts Wharton management professor Marshall Meyer, smaller Chinese firms, rather than giants like CNOOC, will likely lead the charge outward.

Think of Chinese companies as adolescents, Meyer suggests. Private or semi-private firms are only about 17 years old, and recent Chinese acquisition efforts can be seen as experiments, he says, noting that Chinese business leaders also seem to exhibit the brazenness typical of teens these days. During a trip to Beijing last week, he notes, "People were saying, 'Why don't we buy Wal-Mart?'"

CNOOC's failed bid for Unocal came at the end of a string of recent attempts by Chinese companies to acquire Western companies. In June, China appliance giant Haier tried to buy U.S. counterpart Maytag -- a bid it later dropped. Earlier in the year, Chinese computer maker Lenovo purchased the personal computer wing of IBM. Going back farther, Chinese electronics conglomerate TCL merged its television business with the TV business of France-based Thomson, parent of the well-known RCA brand.

Reactions to these moves varied. While the TCL and Haier deals drew relatively little attention in the United States, the Lenovo acquisition stirred up questions about U.S. technological leadership. Still, U.S. government officials let the takeover proceed. The CNOOC effort in June to acquire a U.S. company with substantial oil reserves, however, struck a nerve. It came as tensions already were running high between the U.S. and China over trade matters, including claims that China was unfairly keeping its currency undervalued to boost exports. A host of objections were raised to the CNOOC bid -- among them the fear that Chinese ownership of Unocal would threaten the U.S. oil supply.

CNOOC itself sounded bitter in withdrawing its bid August 2. The company said it would have improved the terms of its offer further "but for the political environment in the U.S." It called the "unprecedented political opposition" to its bid "regrettable and unjustified." And an essay in the state-run China news service Xinhua warned that the U.S. may pay a high price for the affair. "[T]he explicit message the takeover battle sends to the world is that American business is defined by political needs," the August 4 article stated. "...In the long run, the casualty will be on U.S. competitiveness if the market is to play second fiddle to protectionism with political patronage."

Not an Invasion; an Escape

According to Meyer's contacts in the Chinese business community, government officials have advised business leaders to slow down their foreign merger and acquisition activities in the wake of the CNOOC incident. Yet even if China's "internationalization" thrust does diminish in the near term, Meyer and others see more efforts by Chinese firms to snap up Western companies over the long haul.

One reason is that China-based companies are eager to move into markets that are less cutthroat, says Usha Haley, business professor at the University of New Haven and co-author of the book, *The Chinese Tao of Business: The Logic of Successful Business Strategy*. It's very difficult to turn a profit in China for a number of reasons, including a lack of protection for intellectual property -- which means knock-off products are created quickly and profits are hard to maintain, she says. "It's not that Chinese companies are invading the West; it's that they are escaping from China."

A foreign merger also brings to Chinese companies certain capabilities they frequently lack, Haley notes, such as service expertise and cutting-edge technology. "Technology is an especially important issue for Chinese companies that view themselves as global competitors. Because customers are so price sensitive, and margins are so razor thin, Chinese companies often lack the resources to make sustained investments" in research and development.

Meyer agrees that Chinese companies have a lot to gain from merging with Western firms. For example, the Lenovo-IBM deal is bringing management experience to the Chinese computer maker. Indeed, Meyer's research into the details of the transaction shows that a consortium of U.S. investors who contributed $350 million to the purchase controls key board committees.

Still another factor in the internationalization drive is China's ambition to restore its prominence in the world order, a position it had centuries ago, Haley says. "China wants to become a 'civilizational' power." The country clearly has the wealth to pursue that goal. "With the possible help of their government and its $700 billion in foreign-exchange reserves, Chinese companies are poised to become bidders for U.S. companies across a variety of sectors," Laura D'Andrea Tyson, dean of the London Business School, wrote in a recent essay in *BusinessWeek*.

What sorts of Western acquisitions are Chinese firms probably going to make? "It's likely to be consumer-oriented, brand-name activity," predicts Christopher Mark, Sr., chairman of The Signal Group, a consulting firm with offices in Princeton, N.J., and Shanghai. Mark suggests that Chinese companies will look to complement their strengths in low-cost production with the distribution networks and brand power that can come with a foreign acquisition.

Among the possible acquisition targets in the West are companies controlling natural resources such as oil, Meyer says. China's economy not only is consuming more and more resources, but the country tends not to trust its ability to buy what is needed in the market. "China is going to try to get its arms around basic commodities, because the Chinese prefer control and are willing to pay a premium for it."

Chinese companies also may seek to buy Western industrial firms that are little-known and private, Meyer adds. One feature of such acquisitions is that they are unlikely to spark much public outrage in the United States. "There will be virtually no opposition to acquisitions of factories making unbranded industrial products," he suggests.

Although the noteworthy buy-out attempts so far by China-based companies have involved relatively large Chinese firms, Meyer thinks future foreign acquisitions may look quite different. "Internationalization will be a small-firm phenomenon," and the companies that go shopping abroad will be ones in industries that haven't yet consolidated in China. Why? Meyer says that buying up Western companies can provide key competitive advantages to Chinese firms struggling to survive in hypercompetitive domestic markets.

Two Waves of M&A

According to Holger Michaelis, a manager in the Boston Consulting Group's Beijing office, the first wave of outbound M&A happened in the second half of the 1990s, "driven by the objective of the Chinese government to build and strengthen the foundations of the economy and its future development." It therefore focused on natural resources and infrastructure, such as oil, telecommunications and transportation. "External triggers to this wave included changes in the regulatory environment, the return of Hong Kong to the mainland in 1997 and the Asian crisis," which resulted in some takeover opportunities in neighboring countries.

The second wave picked up only in 2003, says Michaelis. "It is carried by a much broader base of industries, is targeted to a more diverse set of geographic destinations" and involves large as well as small deals. In addition, it is "more driven by economic considerations, such as growing the business overseas and reaping higher margins, accessing advanced technology and IP, realizing cost synergies in areas like production, sourcing and R&D, and creating competitive advantage for the fierce competition in the home market."

Strong national players -- such as Haier, Huawei, TCL and Pearl River Pianos -- are part of this trend, Michaelis notes. "After years of rapid expansion at home and developing an important export business for established overseas producers, these players now have the size, financial strength and product quality to take on the competition on an international or even global scale. Given their low cost base, they may even have the potential to change industry dynamics globally."

Welcoming U.S. Investors

More takeover bids from Chinese companies may be forthcoming, but more opposition to China's push outward can be expected as well. Among those wary of a policy of "engagement" with China is University of Maryland business professor Peter Morici. "The Chinese government sees itself as redressing hundreds of years of Western humiliation," Morici wrote in an essay in the Asian *Wall Street Journal* last month. "To sustain the Communist Party, China has a strong interest in selling its brand of authoritarian capitalism to its neighbors, and making the international rules of the game less supportive of democracy and human rights."

Tyson, however, says systems are already in place to protect U.S. national interests in the event of proposed Chinese corporate takeovers. And she argues that China, despite some limits, has welcomed U.S. investors. "China is remarkably open to foreign direct investment," she wrote in her essay. "Last year, American companies put $60 billion into China (including Hong Kong), vs. only $2 billion of direct investment by China in the U.S."

Mark says China's expansion push in the United States stands in contrast to the Japanese investment "invasion" of the 1980s, because China is much more receptive to U.S. investment and imports. He worries that if the U.S. doesn't handle the aftermath of the CNOOC bid deftly, China could decide to take its investment dollars to places like Iran, Sudan and Angola. "The Chinese quest for resources could well become more troublesome."

Even so, Mark questions whether CNOOC could have succeeded in running Unocal. Of the major Chinese oil companies, CNOOC has the strongest leadership, he says but all three firms are weak in that category compared to other Chinese companies. The Chinese oil companies are "quite a bit behind in terms of adopting Western management and financial practices," he says.

Lack of management expertise recalls Meyer's point about Chinese firms resembling adolescents -- a theory that may provide a way to further understand the buzz about China acquiring Wal-Mart. Business leaders in China chafe against the way Wal-Mart controls its suppliers, Meyer says. Thus, buying out Wal-Mart would be a classic act of rebellion. While he doubts it is likely to happen, given the retail icon's massive $209 billion market capitalization, the actual acquisition attempts so far show a country and business community growing up. "Chinese firms are making their international debut, if awkwardly," Meyer says.

What's more, the Chinese appear to realize they have some maturing to do. The same Xinhua essay criticizing the United States for its response to CNOOC's Unocal bid suggested the country is eager to learn from its mistakes -- and to keep going global. "The unsuccessful CNOOC bid may make domestic enterprises pause for a while to carefully review their expansion plans," the essay said, "but it will not stop them from transforming themselves into competitive players in the international arena."

BCG's Michaelis says it is important to keep in mind that China "has been a centrally planned economy and still could be called a 'guided' economy. Most large corporations, even those that are listed overseas, are still controlled by the state or by provincial governments. Therefore it is not surprising that important transactions like overseas acquisitions need strong political backing or have often been driven by political interests." In the last two years, however, progress has been made "in terms of approval and access to foreign currency. This trend clearly supports an increase in outbound M&A on a general basis."

Successful mergers, he adds, "depend not only on the buy side but also on the supply of deals. As the past several transactions have shown, it is the private deals (e.g., IBM-Lenovo, TCL-Thomson) where a selling company carves out a business unit and sells it to a Chinese competitor, that tend to be successful. In these cases, public or political objections are much less likely."

Last but not least, Michaelis adds, realizing the benefits of a transaction "depends strongly on the experience, discipline, approach and cultural sensitivity of the acquirer when actually negotiating the deal and merging the operations. Given the comparatively low level of experience Chinese companies have with large-scale cross-border M&A transactions -- for example, only a few Chinese companies will have a professional M&A group or department, let alone experienced program managers to see the integration through -- a lot still needs to be learned until Chinese outbound mergers can be executed successfully."

But overall, he says, "China outbound M&A will become increasingly professional and also increasingly successful. What we have seen so far is just the start."

The View from China

In this new era of globalization, says Kang Rongping, a professor at the Chinese Academy of Social Science, "an enterprise has to be able to reallocate its resources globally to reach its optimal condition. Today, multinational corporations have become common. And Chinese companies should not be an exception."

Since China joined the World Trade Organization in 2001, he says, "Chinese companies have been facing growing competition worldwide; that competition is forcing them to speed up the efforts to improve their global reach .... I have talked to a lot of entrepreneurs and they have realized that they cannot compete based only on low costs. They must do research and development and build up their brands. One way to grow is to make acquisitions in foreign markets.

"It usually takes a long time to grow internally," Kang says. "Acquisitions make it faster to [increase market share], but the risks are also bigger. I don't think Chinese companies have acquired the ability to make big deals, and I think they are pressured by global competition to go overseas."

According to Kang, a successful acquisition means that "within three years of the deal, the acquiring company's stock price exceeds the average stock price in its industry. Based on this standard, it's impossible that the acquisition by Lenovo of IBM's PC business will be successful. But Lenovo did it anyway because it didn't want to risk its No. 9 ranking in the PC industry. Many companies face more risks by not making acquisitions than by making deals. As a result, Chinese companies seeking technology, R&D, brands and distribution channels are very likely to venture out overseas ....The trend won't stop."

Private companies, he adds, "will have a higher success rate because they are more cautious, while state-owned companies tend to be less prepared." He suggests looking at the overseas acquisitions made by WanXiang Group, a private enterprise based in Hangzhou, whose main business is auto-parts manufacturing and whose assets total around RMB 10 billion ($1.23 billion). It is a company that planned well, negotiated patiently, mapped out very good strategies, and implemented those strategies well, he says.

According to Wang Wei, chairman of China M&A Management Holdings, overseas markets that traditionally have had high barriers of entry for Chinese enterprise have recently become more attractive. Nowadays, "almost every industry has experienced overseas acquisitions. Even in real estate, big state-owned developers have gone to Russia to develop residential properties. However, some of the foreign acquisitions are more likely driven by government strategies, focus on natural resources like energy, and rely on government support such as deal financing."

Niu Wenwen, editor-in-chief of *China Entrepreneur,* predicts that "those who have a good understanding of the local market and customers worldwide are likely to become successful multinationals.... I would bet on telecommunications. In addition, steel, shipping and heavy chemicals are the private sectors that have developed fast in recent years. I'm very confident that we will see multinationals in those sectors."

Zhao Xiao, head of the macro-strategy department at the Research Center of the State-owned Assets Supervision and Administration Commission of the State Council in Beijing, recently told the local business press that "China is entering an era of global acquisitions" mainly because of "changes in China's resources. Since China adopted reforms and its opening-up policy, its citizens have accumulated savings and its enterprises have accumulated capital. China has also continued to attract foreign investment." Consequently, he says, the country "is bound to experience a net outflow of capital."

Lu Zhiming, a doctoral student at Shanghai's Fudan University, gave the following example to illustrate one way that Chinese companies are making overseas acquisitions: Jay Muskovich, CEO of the Huffy Corp., the second largest bicycle maker in the U.S., recently went to China to visit his new shareholder -- also his supplier. Earlier, in October 2004, after Huffy had sought bankruptcy protection, it didn't have money to pay its Chinese supplier. A plan was worked out under which the Chinese supplier and China Export Credit Insurance company would hold a 30% stake in a reorganized Huffy in exchange for forgiving the old debt. The supplier would also have four out of the seven board seats in the reorganized company.

This deal, says Lu, "shows the inter-dependence across the Pacific and represents another way to make acquisitions overseas. Deals must be mutually beneficial and mutually dependable. Chinese companies entering foreign markets must become localized in order to be accepted by the local customers and governments.... It is a good strategy to go to the international market, but Chinese companies still have a long way to go."

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