ANALYSIS OF THE FOREIGN INVESTMENT M&AS IN CHINA

By

ChenFei

THESIS

Submitted to

KDI School of Public Policy and Management

in partial fulfillment of the requirements

for the degree of

MASTER OF BUSINESS ADMINISTRATION

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ABSTRACT

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This thesis is intended to introduce the foreign investment M&As in China. In order for understanding unique Chinese market, thesis first introduce basic background information about state owned enterprises and capital market. Based on the introduction of history and characters of Chinese M&As market, thesis focus on analyzing foreign investment M&As in many aspects and then draw the suggestions for all the participators of M&As : Chinese government, foreign investors and Chinese enterprises.

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Dedicated to my professor and my family

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Numbers of Listed Companies	783
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The Number of B Shares	54
Total Capital of A, B Shares	4180.16 billion shares
Capital of A Shares	4084.23 billion shares
Capital of B Shares	9.593 billion shares

Table 2[2] Statistics of Shenzhen Stock Exchange (2004-02-11)

Numbers of Listed Companies	549
The Number of A Shares	492
The Number of B Shares	57
Total Capital of A, B Shares	185.70 billion shares
Capital of A Shares	175.90 billion shares
Capital of B Shares	9.79 billion shares

[1] WWW.SSE.COM.CN
[2] WWW.SZSE.CN

List of Abbreviations

ADR: American Depositary Receipt

BSOAM: Bureau of State-owned Asset Management

CSRC: China Securities Regulatory Commission

IPO: Initial Public Offer

JV : joint-venture

POE : Private Owned Enterprise

RMB : Renminbi

R&D: Research and Development

PRC: People's Republic of China

SOEs: state owned enterprises

SOS : state-owned shares

SOLPS: state-owned legal person shares

WFOEs : wholly foreign-owned enterprises

I. Introduction

1. State-owned Enterprises in China

Since the launch of economic reform in 1978, China's economic system has moved from a centrally planned economy to a market oriented economy. China's economic reform has been generally accepted as represented by an average GDP growth rate of 9.8% per year for two decades. At the end of 2001, China had 174,000 state owned enterprises (SOEs) with 38 million employees, accounting for 5% of total employment. The SOE sector's share in GDP is estimated as around 1/3. The sector has undergone drastic restructuring since the market-oriented reform was re-launched in 1992-1993.

China's SOE reform since 1994 has been marked with increasingly intensive efforts in ownership transformation. A typical pre-reform SOE was a standing alone factory wholly owned by the state. It was not a corporation, and did not have anything like shareholders, holding companies or enterprise groups. To supervise SOEs more effectively, the Chinese state developed a system of division of labor in exercising rights in SOEs. First, ownership rights were exercised by every level of government, from the national government to provincial, municipal. Second, ownership right was shared by a wide range of government and party agencies. In the pre-reform regime, a SOE being supervised by a particular level of government would typically mean that the government and party committee at this level exercised the following rights (1) appoint, monitor, motivate and replace managers; (2) make key business decisions; (3)

provide finance and claim revenue. Nevertheless, under the regime of planning economy, some drawbacks such as low efficiency and lack of incentive were protruding problems. Therefore, reformation on SOEs as a task was brought forward by the government. The remedy prescribed by academicians and the government is to stockarize[3] SOEs. State-owned properties were evaluated and differentiated into state-owned part whose management is entitled to the Bureau of State-owned Asset Management (BSOAM) and state-owned-legal person part which was hold by other SOEs. On the surface, the ownership problem was partly solved but the desired separation between government and business was not achieved owing to their close linkage in personnel and governmental behavior inertia. And SOEs still suffered from short of money due to the suspended instill of financial support from the government.

To address these problems, policymakers started to think about building a stock market that can not only absorb money from the public through direct finance, but also help improve the management and reinforce the reformation of SOEs by introducing public investors. Therefore, SOEs try to "go public by package" [4]

Another characteristic is to differentiate state-owned shares (SOS), state-owned legal person shares (SOLPS) and pubic shares**.** Except public shares, the first two categories are not publicly transferable and the right to transfer them falls to BSOAM

[3] The objective of stockarization is to clarify property right of interest parties on a given corporation. It answers the question "who owners how much". It differs from privatization in that it does introduce new investors and it involves no shock purchase or sell. It is only a "stock allocation".

[4] Package: to present (as a product) in such a way as to heighten its appeal to the public (Merriam-Webster dictionary)

and the holding SOEs respectively[5]. The price for the SOS and SOLPS is usually far below that of the public shares even though they are equally entitled with voting and all other relevant rights[6].

The government will focus its efforts to rescue and foster a certain number of big companies and some conglomerates while retrieve from middle and small SOEs through auction, M&A and so on.

2. Stock Markets and Types of Stock in China

In December of 1990 and June of 1991, ShangHai Stock Exchange and ShenZhen Stock Exchange were set up respectively, which represents the Chinese Stock Market to be set up formally. All the stocks issued by mainland Chinese companies can be classified into: A shares and B shares in terms of exchanged currency. A shares are common stocks issued by mainland Chinese companies, subscribed and traded in Chinese RMB, listed in mainland Chinese stock exchanges, bought and sold by Chinese nationals. A share market was launched in 1990. B shares are issued by mainland Chinese companies, traded in foreign currencies and listed in mainland Chinese stock exchanges. B shares carry a face value denominated in Renminbi (RMB) [7]. The B Share Market was launched in 1992 and was restricted to foreign

[5] On April 28,1994 for the first time, SOPLS is transferred through negotiation in the M&A case of Zhuhai Hengtong Group acquiring 12 million SOPLS of Shanghai Lingguang Corp. from its shareholder, Shanghai Constructing Material company.
[6] The so-called "equal share but unequal price and right" phenomenon.
[7] RMB is the currency name of Chinese yuan.

investors before February 19, 2001. B share market has been opened to Chinese investors since February 19, 2001.

All the stock registered in Stock Exchanges can be classified into: State Owned Share(SOS), State Owned Legal Person Share (SOLPS), Public Share and Foreign capital stock.

State Owned Share (SOS) is one of the unique features that differentiate China from other countries. SOS is such a kind of share that represents the capital invested by state. Before the economic reform, enterprises were owned by government. During this reform, government transferred some enterprises into corporations in order for that state government transferred the state owned asset in the state enterprise into shares of corporation. In addition, the state government invested some new established companies, thanks to it, these kinds of shares also become SOS.

State Owned Legal Person Share (SOLPS) is non-circulated shares those are invested by entities who has legal person qualification.

Public Share, namely Common Share, is the Tradable share floated to the public.

Foreign Capital Stock is that the Chinese listed companies issue stock to foreign investors, includes foreign countries and regions like Hong Kong, Macao and Taiwan. It is one pattern to induce foreign capital. It can be classified into two types: Foreign

capital stock which go public in China and go public in foreign countries. In case of the Foreign capital stock which go public in China, there is B share which is open for foreign funds. B share should be traded in US dollars in Shanghai Stock Exchange and traded in Hong Kong dollars in Shenzhen Stock Exchange. As a consequence, stock market can absorb foreign capital. Foreign capital stock which goes public in foreign countries is traded and listed in foreign countries.

Up to now 2004, there are 782 listed companies can be exchanged in these two exchanges those come from 31 provinces, cities, autonomy regions. Among all the listed companies, 44 companies have both A and B shares; 19 companies both have A Shares in Shanghai Stock Exchange and H shares in Hong Kong Stock Exchange; 6 companies have B shares in Shanghai Stock Exchange and American Depositary Receipt (ADR) in New York Stock Exchange; 1 company has B shares in Shanghai Stock Exchange and Global Depositary Receipt in London Stock Exchange.

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[9] WWW.SZSE.CN

II. M&A Market in China: Current Situation and History

1. Basic Introduction about M&A Market

As a consequence of global economy depression, the M&A market America and Europe is not as active as before. By the contrast, Asia M&A market increases continuously which account for 20% in the global market.

According to statistics, the total value of M&A transactions in Asia region in the second quarter this year reach to 22.26 billion U.S. dollars, in particularly, the transactions value in China account for 6.703 billion dollars which is second to South Korea. Among all the M&A transactions, the majority is transferring SOE to Private Owned Enterprise (POE). In case of listed companies, there are 106 companies in Shanghai and Shenzhen Stock Exchanges which conveyed SOS in the first half year of 2003 and total amount of conveyed shares are about 6.7 billion shares which account for 2.57%[10] of the total shares of SOS of all the listed companies.

In the present stage, the motive power of Chinese M&A comes from M&A transactions happened between Chinese companies. Among all the listed companies in two stock exchanges which have 1300 more or less, there are only 130 companies which are participated by private owned enterprises. The rest are controlled by government. All the non-circulated shares[11]hold by government account for 2/3 of

[10] Data come from www.sohu.com Article: Foreign Funds's obstacles in China Market(2003-10-28). Author:LinJunLiang

[11] Non-circulated shares are refer to such shares as State Owned Shares, State Owned Legal Person Shares, Internal Employee Shares.

two exchanges' total market value. Under the influence of low maturity degree [12]of regulation and market in China, the cross-border M&A just account for 5% of the foreign funds absorbed by China. There are only about 70 listed companies of which stocks are shared by foreign investors. As the codes and regulations about M&A involved by foreign investors come out, this market will play important role in the future. If the laws and regulations totally open for foreign capital to enter Chinese M&A market, it can improve the quality of current listed companies and reduce the burden of Chinese government.

2. The history of Foreign Investment M&A in China, characteristics

A dramatic development in M&A has been witnessed in recent years in both terms of volume and value of deals. As shown in Chart 1 and 2, M&A deals happened in China increased tremendously. The transactions value developed from 0.072 billion dollars to 3.16 billion dollars.

2.1 Tentative Stage : 1995-1998

At that time, M&A is quite new topic in China, even though there happened some cases which deserve recalling. The features are as below:

- ✧ It happened in auto manufacturing industry
- ✧ Foreign investors focus on listed companies
- ✧ Forms of M&A are exchange share by negotiation and Issuing B share

[12] Maturity degree: at present, China market is not fully open , mature and developed, which is the same to the codes and regulation. In this article, maturity degree is an abstract word to indicate the development stage.

Summery:

During this period, it came out two definite modes: (1) Conveying shares through negotiation; Case: In July, 1995, Japan Wushiling Co. got shares equity of Beilv company by this mode

(2) Issuing B shares to foreign company. Case: In August, 1995, U.S. Ford Co. merged Chinese Jiangling company with this mode.

However, on September 23, 1995, China government put out a regulation that stop all negotiation of conveying State owned shares and legal person shares to foreign investors.

2.2 Cultivation Stage: 1998-2001

Many companies finished M&A with foreign companies during this period. The trade made a big progress. The features are such as below:

- ✧ The extent of M&A spread quickly. In the first stage, it spread into auto manufacturing industry but in this stage, it spread into food, plastics, glass, electronics industries
- ✧ In order for controlling power, Chinese side and foreign side compete to be the largest shareholder.
- ✧ Much more concern focus on core asset controlling
- ✧ Due to the obstacle of codes, controlling shares in indirect way appeared

Summery:

During this period, most of M&A trades came from the point of view that improving the operation of company. Of course, many foreign companies had their own strategic consideration that launching in China market and get the big share of some China listed companies share. Because listed companies usually are the representative firms in their industry and have big share in the market, at last they have good reputation.

2.3 Development Stage : 2001 - present

Under the background of Global Economy and WTO entrance for China, M&A involved by foreign investor get improvement in all round. On the other hand, the codes and regulations became more integrated than before. This stage features are as below:

M&A involved by foreign investors promote much more quickly

M&A operating techniques such as MBO, Debt-Equity Swap, become more deep and diversified.

Summery:

From current cases in China, it is clear that the M&A in the same industry play a main role among all the M&A involved with foreign funds. From the course of it, the general trend of industry scope is

Manufacturing-- →Processing- →Food, Retailing---

→ Telecom, Bank----→Public Utilities

3. Regulation Promotion and Impacts

In order to normalize the M&A market, some divisions of Chinese government make out several codes and regulations.

For the reasons of necessity of SOE reform (showed below in section of Foreign Funds' M&A and SOEs reform) and incentives from the aspect of Chinese side for M&A as talked below, on September, 28 of 2002, China Securities Regulatory Commission make out *Code of Practice on Acquisition of Listed firms.* On November,1 of 2002, *the Notice of conveying SOS and SOPLS to foreign investors came out.*

On April, 12 of 2003, *the Temporary Regulation about Foreign Funds Merge or Acquire Chinese Enterprises* came out.

Before these new regulations came out, foreign funds had to merge or acquire Chinese enterprises in indirect way due to the fact that PRC government limit the conveying SOS and SOPLS to foreign investors.

With the new regulations came out, impacts of them improve the M&A market in several main aspects:

II. In the light of regulations, the industries which are encouraged foreign funds to invest increase from 186 items to 262 items; industries

which are limited for foreign funds reduce from 112 to 75.

III. Even after conveying SOS or SOPLS to foreign investors, Chinese side should have controlling stake status and the SOS or SOPLS is still non-circulated share that can not be traded in the stock exchange.

IV. After injected foreign capital, Chinese enterprises' treatment is unchanged, which means they can not enjoy the privilege as FIEs.

III. Current Situation Analysis

1. Foreign Funds' M&A and SOEs reform

M&A is not simply 1+1,instead it should produce synergy and make society resources allocation optimized. In some sense, SOEs are burden for People's Republic of China (PRC) government. Foreign funds' M&A is good choice to solve this problem.

Foreign funds' M&A can integrate the low cost [13]of SOEs with advanced technology and management skills of foreign companies together. SOEs in China are the outcome of planning economy. Indefinite property right, high debt ratio, high cost[14] and excessive employees bother SOEs during these years.

On the basis of statistics, there are 6599 loss-suffering SOEs in the end of 1997; the deficit money of sixteen thousand SOEs reached to about

[13]Low cost: low price of labor and equipment of Chinese companies .

[14] High cost: high debt ratio and financial crisis make the cost of operation high.

60 billion RMB (which is worth 7.3 billion US dollars) in the end of 1999. [15] It was emergent for PRC government to reform SOEs. In March of 1998, PRC government put forward a target: to change SOEs' unprofitable situation in three years. Government tried it in many ways to solve the problems but they did not function very well. At present, the best way to solve the problem is to use foreign funds to acquire Chinese enterprises. Many Chinese enterprises do have skills and good managers and they have important status in their industries, their main problem is lack of capital. Foreign capital can inject capital into Chinese enterprises. With merging Chinese enterprises, foreign investors can not only get assets but also get the support of local government and resource. Therefore, with the inducement of good future market, low cost and privilege of local government, foreign funds intend to merge or acquire Chinese enterprises.

2. Reasons and Incentives Analysis for Foreign Funds to merge Chinese Enterprises

The reason why foreign funds invest in host country and then merge or acquire local companies can be summarized into two points: huge market and low cost. Market is the first factor for foreign funds to consider. Market factor can be decided by many aspects: economy developing speed, economy developing stage,

[15] RMB is the unit of Chinese yuan. In this thesis, the exchange rate between RMB and US dollar is 8.3 against 1.

population, trade barrier, monetary convertibility，policy limitation and so forth. Under the condition of attractive market, cost factor is decisive factor for foreign investors. There are many sorts of cost factors but they still can be classified into risk cost and operation risk. Risk cost is that uncertainty of operation loss resulted from a sudden event in a country, such as politics convulsion, financial crisis, market disorder, war and so forth. Operation cost is the production and operation expense under the normal conditions, such as transportation cost, labor cost, currency exchange rate, land price and so on.

As shown in Research, the first incentive for foreign funds to invest in China transfer from low labor cost to market attraction. Seizing market share is the first incentive of foreign funds to merge Chinese enterprises. From two aspects of Chinese enterprises and foreign investors, incentives can be analyzed in two ways: on one hand, there is a strong desire as supply to attract foreign funds to merge or acquire Chinese enterprises; one the other hand, foreign funds also demand to merge Chinese enterprises and enter Chinese market.

2.1 Analysis from the aspect of foreign funds

China is the most charming market in the world. After WTO entrance , many foreign companies have more chances to enter into China market and China government put out more and more favorable policy to induce foreign investment.

Some time ago, introducing FDI into China depended on cheap labor cost, benefit policy of local government, plenty resources. In this case, green field[16] investment is main choice of foreign companies. However, with the competition from other developing countries like India, this advantage became weak by degrees. Within these years China economy developed rapidly, foreigners transfer from green field investment to M&A to take maximum advantage of the massive privatization of the state-owned enterprises in China.

From macroeconomic point of view, facing competition pressure and new investment regions open, more and more enterprises participate in global economy. In these years, western economy grows slowly so vast foreign capital has to find out new market to invest. On account of Asia economy increasing stably and China leading position in Asia, many transnational corporations and foreign capital increase investment in China. The most effective investment method is to merge or acquire Chinese companies. Reasons are showed as below:

- Seeking new market and develop international market share
- Seeking cost advantages and rely on comparatively lower price of resource and labor so that low down production cost and transportation cost
- Seeking monopoly advantage, which is to solidify and strengthen the position in the world. Compared with investing a new factory directly, merging local enterprises has many more advantages. For instance, foreign investors can take advantage of target company's production and operation

[16] Green Field: is to set up a new business through foreign investment

system, specially sales system to seize new market. Moreover, merging local good quality companies is to reduce competitors and weaken competition intensity.

- If the Chinese enterprise is listed company, foreign funds enter into Chinese stock market by acquiring or merging Chinese listed company. At present, there are three ways for foreign funds to enter into Chinese stock market: First, wholly foreign-owned enterprises (WFOEs) enter into A or B stock market through Initial Public Offer (IPO); Second, Joint Venture as one of founder to participate Chinese enterprise go to public; Third, foreign funds merge or acquire Chinese listed company and this company becomes joint venture. Nowadays, the way to enter stock market by IPO is still very difficult, consequently, merging enterprises become main trend for foreign funds to enter into stock market.
- Foreign investors take advantage of cheap labor cost and avoid high tariff to produce cheap product for export

From microeconomic point of view, abundant supply of Chinese target company give foreign investors enough options to choose.

i. There are plenty of target companies in China.

Many non-SOEs are eliminated in the fierce competition and pushed into the Property Right Exchange Center[17]. In addition, SOE reform will supply more

[17] Property Right Exchange Center: an place where Assets or Enterprises' owners trade their ownership.

and more enterprises as target companies. In current stage, China has four hundred thousand SOEs, among them there are 500 super size SOEs; 10,000 large ones; 40,000 middle-size ones; the rest are small ones. Obviously, government needs huge amount of capital to accomplish this capital structure optimization. Under this situation, it is a practical and feasible way that taking advantage of foreign funds to merge a number of middle-size and small enterprises to solve the problem of lack of capital.

ii. Great scope of choice for target companies

In China, enterprises which may be merged are classified into six types:

1) Duplicated Construction Enterprises. For instance, there are hundreds of production lines in refrigerator, air conditionings, colorful TV, productive capacity is redundant.

2) Non-economic-scale Enterprises. There are thousands of township enterprises go to bankrupt every year. This type of enterprises will be the emphasis of M&A in the future.

3) Unemployed Enterprises. On the basis of estimation, the unemployed assets of SOEs reach about 4.82 billion U.S. dollars[18] from 1996 to 1997. Among these assets, 7 per sent can be employed.

4) Enterprises which need to migrate for the reason of environmental protection. In many big cities, local government in order to develop their cities to international metropolis try to transfer some types of enterprises (such as

[18] 40 billion Chinese yuan in the light of $1=8.3 Chinese yuan

cement, printing and dyeing, metallurgical industry) to rural areas.

5) Enterprises which are going to be auctioned as mortgages.

6) Enterprises which can not pay back their debt

iii. Large Target company's development potentiality

- Low labor cost and land price
- Huge market
- Target companies have certain level of skills and management experience

2.2 Analysis from the aspect of Chinese side

With SOE reform developing further, there is a demand for foreign funds, particularly through M&A to enter Chinese market.

i. Participating the global economy trend and make use of foreign resources to develop domestic enterprises

ii. SOE's equipment is not good and technical innovation capacity is weak. Using foreign funds to merge Chinese enterprises can promote enterprises' core competition capacity.

iii. Using foreign funds to merge Chinese enterprises can transform operation system and set up modern enterprise system.

iv. There is a great capital gap in SOE reform and development. It is necessary to take advantage of foreign funds to make up this gap. This gap is: First, Social Security Funds; second, there are hundreds of billion of state owned assets need to be realized. One side of SOEs' debt: non-performing loan. Absorbing foreign capital

and using foreign funds to make up with this capital gap.

v. Local government behavior encourage foreign funds to merge Chinese enterprises. At present, local government play a decisive role in the foreign funds M&A transactions. As a matter of fact, this sort of behavior is beyond property right exchange mechanism in current economic system. Some local government in China prefer to let foreign funds merge Chinese enterprises and this encourage foreign funds to do in certain level.

vi. Current economic policy encourage foreign funds to merge Chinese enterprises. Given an example, Chinese import policy does not permit import whole automobiles and the auto industry policy is that foreign companies can not set up new auto joint venture in China. Consequently, foreign companies have to merge Chinese enterprises to control share so that they can get into Chinese market quickly.

vii. Favorable policy environment: first, SOEs are try to set up modern enterprise system; encouraging foreign funds investment and M&A codes and regulations are made out

viii. Owing to current mission of technical betterment, industrial restructuring, many SOEs which contribute tax income to local government greatly are facing with the problem of lack of capital. If SOEs are merged by foreign funds, they can not only get enough capital to develop their enterprises but also transfer operational system. Therefore, local government and Chinese enterprises are ready to transfer SOEs' property right to foreign funds.

3. The Main Modes of M&As : Case Analysis and Evaluation

There are two M&A strategies for foreign funds to take:

First, merging or acquiring Chinese Co. according to current codes or regulations strictly.

Second, Avoiding codes or regulations to enter Chinese market

Foreign investors are currently allowed to buy only one category of shares, called B shares of Chinese companies listed on China's two stock exchanges (in Shanghai and Shenzhen). The Chinese government has suggested that it may eventually open the A-share market to foreign investors as well. Even so China does not, in any event, permit hostile takeovers of public companies through open-market purchases or tender offers without the consent of the China Securities Regulatory Commission(CSRC). Private placements of unlisted state-owned shares in listed companies can generally only be made to other SOEs.

3.1 Direct M&A

Direct M&A is that foreign funds purchase non-circulated shares of listed companies or buy circulated shares in the secondary market in order to secure control power of a company.

a) **Purchasing non-circulated shares through Negotiation**

Case : In February17,2003, HuarunQingfang Co. purchased 51% shares of HuarunJinhua Co. with 19.3 million U.S. dollars ($1=8.3 Chinese Yuan) and then this 51% become foreign capital stocks. As a matter of fact, HuarunJinHua Co. tried to merge HuarunJinhua in September of 2001. However, this kind of merger behaviour was limited by the Chinese policy at that time. Therefore HuarunQingFang had to set up China Huarun Co. in Chna to merge HuarunJinhua Corporation. Till November 4, 2002, Chinese government put out *the Notice of conveying SOS and SOPLS to foreign investors,* HuarunQingFang can get 51% shares through equity transference.

Evaluation: The problem of pricing SOPLS or SOS

According to the current Chinese government regulation, the price of SOLPS cannot be lower than the net asset value. However, with regard to the international standard, foreign bidder consider much of State Owned Asset value is lower than net asset in book value and even negative. On this account pricing SOPLS or SOS becomes the main obstacle for foreign bidder to purchase non—circulated shares.

b) purchasing shares owned by other foreign investors or circulated shares

Case : As one of foreign founders of Yaopi Glass Co. which is listed in

Shanghai Stock Exchange, PerJindun Co. is one of the two second shareholders with holding 8.35% stocks. The other three Chinese shareholders with 16.7% stocks are the first shareholders. In 1999, PerJindun Co. purchased 8.35% stocks from another foreign founders then became the first shareholder. However, because PerJindun considered Chinese Glass Industry would have a good future, then it purchased B shares of Yaopi Glass Co. with 18.98% shares it became the absolutely first shareholder eventually.

Evaluation: PerJindun Co. M&A experience gave others some inspiration: 1. In order to merge or acquire a company, it can deal with legal person shares of foreign funds; 2. through purchasing B or H shares to get the company.

For a foreign investor, it is much easier to merge legal person share of foreign funds than to merge SOS or SOLPS. In addition, B shares' price is comparatively low in the long run so it is suitable for merging. With regard to the regulation if ratio of holding stocks do not reach to 30%, there is no need to get permission from Chinese government. The whole procedure is much convenient. However, if to control an A share company, merging circulated shares is not quite practical. Because there are only 87 companies which both have A and B shares 29 companies which both have A and H shares. Furthermore, the ratio of B or H shares is far less than non-circulated shares.

c) Issuing new capital, that is listed companies issue stocks, bonds or other financial instrument to control the shares of listed companies, in the meanwhile, foreign funds purchase them with cash, assets, or stock.

Case : issuing B/H shares to foreign funds

In 1995, Jiangling Auto Co. issued B shares and Ford Auto Co. purchased 20% stock of its. In 1998, Ford Auto Co. purchased new issued B shares of Jiangling Auto Co. again. As a result, Ford Auto Co. has 30% share approximately.

Case : issuing convertible bonds to foreign funds

In September, 2002, Jiangling Auto Co. issue convertible bonds to U.S. Anheuser-Busch Group three times. These bonds will be transferred to H shares of Qingdao Co. in seven years. After this transference, Anheuser-Busch Group will have 27% share that will be second to the first shareholder, Qingdao State Asset Management Bureau which has 30.6%. As a result, win-win deal formed between Qingdao Beer Co. and Anheuser-Busch Co. As for Qingdao Beer Group, it introduced huge capital and cooperate with transnational corporations with controlling stake situation. As for Anheuser-Busch Co., it cooperate with the largest beer manufacturer in China, which means transforming one large enemy to a friend, and at the same time, with support of government and partner, it can easily know well Chinese market.

Evaluation: 1. It can be easily accepted by foreign investors. 2. Reducing

cash pressure for foreign investors if foreign investors use strategic assets to purchase

d) Purchase assets of listed Co. by setting up a joint venture with target Chinese company

Foreign funds set up Joint Venture with listed Co. and through Joint Venture to purchase the Chinese enterprise's core assets

Asset purchasing method is used in China as elsewhere, when a buyer wishes to acquire a business but wants to avoid that business's existing liabilities. Asset purchasing is particularly attractive in China because of the unusual difficulties in identifying all of the liabilities of a target company. The foreign investor generally are unable to hold the acquired assets directly. It will, therefore, either have to use an existing Foreign Invested Enterprise(FIE) or establish a new one. The establishment of a new FIE (with a Chinese partner if it is to be a Joint Venture) will be subject to applicable foreign-investment approval and qualification requirements. The actual asset purchase, however, will be an entirely onshore transaction[19] between the seller and the new or existing FIE.

Case: In September, 2000, Tyre Plastics Co. set up a joint venture with Franch Miqilin Co. and sold its part of core assets to this foreign company. As

[19] transferring or acquiring Chinese business assets is to keep the entire transaction onshore.

a matter of fact, Tyre Plastics Co. business went down from 1999 and got loss in 2000. Facing serious financial distress, Tyre Plastics Co. had to sell its core asset to get capital to save itself.

Evaluation: Owing to the reason that foreign investor did not merge or acquire Chinese Co., it avoid all kinds of procedures of examining and approving. On one hand, foreign investor can get assets in good quality; on the other hand, it needs not to face financial distress and Chinese enterprises' operation problem. In this sense, if target Chinese company is in financial crisis, this M&A mode is a practical option.

Nevertheless, in this situation Chinese company maybe can not get advanced technology and skills from foreign investor, on the contrary, it lost core assets in order to get cash to overcome financial crisis. Even solve the financial problem, Chinese company will be easily be the foreign investor's follower. This option should be prudent for Chinese company.

3.2 Indirect M&A

a) Foreign funds merge or make joint investment with listed company's parent company so that it can hold listed company's stock indirectly.

Case : Foreign funds make a joint investment with listed company's parent company in order to control the listed company Huayi Group, the holding company of Minfeng Agrochemical Co. (listed in Shenzhen Stock Exchange),

set up a joint venture with Guotai Pigment Co. Huayi Group use related asset of Minfeng Agrochemical Co. (which include 91.18 million SOS that account for 58.82% in Minfeng Agrochemical Co.) as 32.89% share in new company's registered capital; Guotai Pigment Co. use 20 million U.S. dollars as 67.11% share.

In this way, Guotai Pigment Co. merge Minfeng Agrochemical Co. indirectly by setting up a joint venture. The most important point is that 20 million dollars as part of registered capital are still under control of Guotai Pigment Co. Compared with purchasing target company with huge amount of capital, this method is very economical and rational.

In many cases, parent company of listed company has more problem than the listed company. In China, one Group which has some subsidiary companies maybe use the best one that has good quality, lower debt ratio to be the listed company. As a result, parent company's quality is less than the listed company. So cost for merging the parent company may be not quite high. However, foreign investors should be familiar with this feature of indirect M&A in China.

b) Merging or Acquiring through Off-shore transactions

The most effective way for foreign investors to avoid China's burdensome regulatory environment when transferring or acquiring Chinese business assets is to keep the entire transaction offshore. If an investment in China

is held through an offshore company, such as a Hong Kong or Cayman Islands holding company, a second offshore company can simply purchase the shares of the first company under the laws of the applicable foreign jurisdiction. The Chinese government generally does not purport to regulate such offshore transactions and requires no People's Republic of China (PRC) government approvals. If the offshore company owns an interest in an FIE in China, the consent of the Chinese joint-venture (JV) partner is not generally required, unless the transaction requires amendments to the FIE's articles of association or joint-venture agreement.

Many foreign investors structure their holdings in China through intermediate offshore holding companies, often one for each FIE, precisely to permit this flexibility for subsequent transfers of their interests. By using multiple intermediate offshore holding companies for different FIEs, corporate groups can also readily accomplish many forms of intracorporate restructuring without becoming enmeshed in the Chinese regulatory system.

4. Areas Distribution Analysis

Most M&A transactions which are about 75% happened in South-eastern area in

China

Reason Analysis:

1) Listed companies are mainly distributed in these areas such as Shanghai, Guangdong Province. And the listed companies in those cities are operated in good conditions, financial and operation are relative transparent than others.
2) Familiar with these companies because when the foreign companies first entered in China, they launched in eastern area of China.
3) These regions are more open than others. Local government encourage foreign funds to merge local enterprises and has already get used to deal with foreigners, so its policy is more convenient and work more efficient than other places.
4) Infrastructure is better than western part due to more developed local economy.

   However, western part has much more resource than eastern part, there are more chances.

5. Industry Distribution Analysis

The reason why foreign funds try to enter into Chinese market is that Chinese market is large and has huge potential space; labor cost is quite low. The industry profit capacity and safety are the main consideration factor for foreign funds.

<Manufacturing Industry>

Considering low labor cost, many multinational Co. transfer their manufacturing center to China. In such cases, foreign funds will prefer manufacturing industry such as Electronics Industry, Electric Appliance Industry.

<High barrier industry>

Higher barrier industry, more attractive to foreign investors.

High tariff industry. For instance, auto industry has protection of high tariff and limitation of quantity for import. And the same to chemical industry. Chinese auto consumption market has tremendous potentialities undoubtedly. M&A may make foreign funds evade current policy obstacles to enter this market. Current listed auto companies are mostly joint venture, therefore auto components companies will be targets for foreign funds.

Service industry which is limited or not permitted to be invested by foreign funds, which includes financial service industry, telecom industry, commerce and so forth.

Particularly, Telecom Industry has tremendous profitability but now it is not allowed foreign investors to invest. PRC government promise it will cancel the limitation of mobile phone five years after WTO entrance; after six years it will cancel the limitation[20], of domestic telephone market. These years many famous

[20] After WTO entrance, PRC government promise that it will open many industries step by step. Among these industries, some are open at that time; some are limited to be invested; some are not allowed to be invested but it

international telecom companies set up JV with Chinese leading companies.

In Finance Industry, foreign finance institutions have many years experience on risk controlling, agency business. On the contrary, Chinese finance institutions are infantile and have no much competition capacity compared with foreign institutions. Holding competition advantage can give super profit to foreign finance institutions after China open this industry.

Few limitations, low barrier industry

- Retailing Industry. Up to now, 70% of top 50 of retail in the world set up joint ventures in China. In some large-size cities[21], foreign retailers merge or acquire the local emporiums to extend their selling network and market share.
- Supply Chain Industry. As rising industry in China, it is low efficiency, lack of competition capacity. After foreign companies enter into transportation, wholesale, retailing industries, supply chain will be the next step for foreign companies to merge Chinese companies in this industry.

Good developing prospect industry

Medicine Industry. Chinese medicine industry is one of early open industry. M&A with foreign funds can stimulate Chinese medicine industry integration and escalation.

II. Ideal Target of M&A for Foreign companies& the Factors for

indicate that after some certain years these industries will open.

[21] Large-size City: the city's population should be more than 5 million people.

Consideration

Transnational companies apply cross-border M&A in order to realize their global development strategy. In this sense, they are very critical about choosing the target companies.

1. The industry of target companies is whether encouraged by government or not.

   SOS withdraw from the competitive industries and those will be encouraged and regulation will loose. At present, industries which limit foreign funds investment or set up joint venture.

2. Having joint venture or cooperation relationship

   Facing the complex and unique environment in China, foreign funds prefer those companies which have joint venture or good cooperation relationship as target company. On account of foreign funds can know much about them so foreign funds can make development strategy and company integration design earlier.

3. Having B or H shares

   Merging B or H shares is more feasible than A shares because of less policy obstacles. Therefore, the listed companies which both have A and H or B shares have more probability to be target companies.

4. Good quality Companies. The companies which have leading position in their industry, have brand reputation and sales network can be target companies of

foreign funds. Some companies which produce rare resource also may be preferred by foreign funds.

5. Whether corporate governance conform to the standard or not. If the other conditions are the same, foreign funds prefer the companies which have good corporate governance and transparent operation.

   When foreign funds merge a Chinese company, it prefer control the stake of target company’s. Therefore, a company with diffuse stock structure and good corporate governance may be preferred by foreign funds.

6. The degree of Local government support it.

   From the beginning of 2002, in Shenzhen, Shandong, Sichuan and region like that, local government absorb foreign funds to merge local listed companies and those become the focal point in the stock market. Shanhai experience evidenced, some industries which has strong regionalism and large market share (such as medicine, cement, construction materials) may be target for foreign investors when there is support of local government.

In summery, foreign funds can build some index to form a model for choosing target companies:

- Financial Situation, Market Share (specially the main business market share)
- Cooperation experience
- B Share per sent in total capital structure

- Degree of Industry Policy Encouragement
- Degree of stake diffuse
- Region of company

Given weights to every index, foreign investors can compute the weighted mean to get the evaluation for the target companies.

III. Positive& Negative Effects Analysis

Foreign funds merging Chinese enterprises is not only the demand of transnational companies' global strategy but also the demand of Chinese enterprise reform and development. After economy reform, foreign funds' M&A produced positive effect, however, it also bring some negative effect and impact to Chinese enterprises.

1. Positive Effects Analysis

1) Foreign funds' M&A can enlarge the enterprise scale and produce economic scale

2) Foreign companies bring advanced technology and skills to target companies so they reduce the time and cost of studying excellent enterprises

3) Better for Chinese enterprises to inaugurate new channel to absorb foreign capital.

Equity investment and controlling-stake operation have much more advantages than

common investment

- Investment period is short. Compared with new investment items, it avoids many procedures about examination and approval, waive purchasing land and equipment, building factory.
- Investment Effect is quick.
- Investment Risk is smaller. For the reason of shorter investment period, the risk during investment resulted from market changes become less. In the meanwhile, owing to the target company already have customer, market and products, operation risk become less.
- Operation Cost of Controlling stake become less. Presently, Chinese listed companies' capital structure is disperse, so once foreign funds get SOS or SOLPS which account for major share through negotiation then it easily becomes the first shareholder to participate management.
- Advertisement Effect. Any listed companies in China is focus because millions of investors care about its information. Once there is a M&A transaction, there will be a sensational effect like advertisement.

4) Promoting Capital Market Standardization

With the loose policy of SOS transfer to foreign funds, infusing capital by foreign funds makes SOEs' capital structure more multidimensional and larger scale.

For Chinese stock market, M&A is not only to develop enterprise but also to make the resources allocation optimized once more. Particularly, during the transformation of Chinese stock market, listed companies' capacities of stable

operation, financial management, long term Research and Development(R&D), products innovation do not reach to the international level. Vice chairman Shimeilun(史美伦) [22] of China Securities Regulation Commission said: M&A can perfect the structure of corporate governance, active stock market and attract foreign investors. [23]

PRC government has two big problems, those are to circulate SOS and SOPLS; incorporate A and B share together. Foreign funds' M&A can alleviate this contradiction. Nevertheless, even if foreign funds can acquire non-circulated shares like SOS or SOPLS , they are still non-circulated shares in stock market, which means they can not be traded in exchange. Therefore, it avoids foreign funds' speculation activity in the stock market and to keep stock market stable.

The prerequisite for internationalized stock market is internationalized listed companies. Through foreign funds acquiring Chinese companies, listed companies will close to international standard in the aspects of accounting, shareholder meeting, board.

In aspects of attitude to investor , paying out dividend in large ratio on time, listed companies of which management is participated by foreign funds will show a good example to stock market. In addition, Foreign funds may bring rational investment philosophy to Chinese investor. The company's achievement as direction for investment will be recognized by stock market. And that will change the old

[22] Miss. Shimeilun: a specialist from HongKong.
[23] www.news.sina.com.cn

pattern ,which is the policy and institution information is direction of investment.

5) Better for companies transform system to strengthen competition capability

Under the situation of foreign funds participating management and controlling the stake, Chinese companies' property right relationship become more definite[24] than before. In addition, foreign investors bring advanced skills and management experience to Chinese enterprises. If merged by transnational corporation, Chinese enterprise may get a channel to international market. With these advantages, Chinese enterprises maybe have probability to finance capital and participate competition in the international market.

6) Promote Corporate Governance Structure

SOEs' property right structure has a big problem, simplex equity structure which means wholly nation owned enterprises are majority of enterprises. This capital structure limits enterprises develop in the long run. Despite the fact that PRC government make stockarizaion reform in SOEs but it did not establish definite property right structure due to traditional economic system influence.

The corporate governance structure on director board is badly distorted due to the fact that SOS and SOPLS ratio in the capital is still very large which damages

[24] PRC government stockarize SOEs's share into SOS and SOPLS in order to clarify property right of interest parties on a given corporation. It answers the question "who owners how much". But the desired separation between government and business was not achieved owing to their close linkage in personnel and governmental behavior inertia. And SOEs still suffered from short of money due to the suspended instill of financial support from the government.

small investors' benefit; the property right of SOS is indefinite and fictitious; the phenomenon of SOS holder's office management[25] in the listed company and 'insider control'(which means someone in the government can control company, that violate the economy regular rule). On account of the reasons showed above, some board chairman and manager do not feel responsible for shareholders or pressure.

Owing to SOS monopoly position and absence of SOS owner in the board, the board and the board of supervisors did not perform the supervising function very well. That is the main reason for the low effectiveness of enterprises. Furthermore, the too large ratio of SOS in the capital structure is the important reason for listed companies lack capacity of supervision and decision-making.

Under the condition of centralized capital structure, large shareholder supervising company is the direction for promoting corporate governance. Foreign funds' M&A can reduce the ratio of largest shareholder's share and then optimize the capital structure. There is a good evidence for it: GreenCool Co.(foreign company) acquire 20.6% SOPLS of Kelong Electric Appliance Co. (which is Chinese listed Co.) with 0.56 billion RMB (which is worth 67.5 million dollars) and then became the largest shareholder. This just satisfy the local government's initial incentive which is that it hopes this multinational company can promote this Chinese company's corporate governance after acquisition.

[25] Office Management: the management in the company is carried out like government sector.

7) Better for improving regulations, laws and authority management level

As foreign funds' M&A appear, related laws and regulations lag is one of the main obstacles in current stage. At present, PRC government has three laws and regulations about foreign funds investment as such: *Code of Practice on Acquisition of Listed firms, the Notice of conveying SOS and SOPLS to foreign investors , the Temporary Regulation about Foreign Funds Merge or Acquire Chinese Enterprises.* But in some aspects, for instance, anti-monopoly law has not been made out in China. Therefore, it is very important for PRC government to make out foreign funds' M&A laws system in order to speed up Chinese stock market internationalized process.

In addition, authority should prevent foreign funds from violating regulations .

2.Negative Effects Analysis

1) Impact to the Chinese market and Promising Chinese companies

China is a large market and growing up rapidly developing country. So foreign investors come for Chinese market not for developing China economy. As mentioned above, foreign funds prefer to acquire Chinese enterprises which have leading position in their industry. In this case, if they proceed M&A plan successfully, the majority of Chinese market will be occupied by them and Chinese companies' market share will reduce due to it. *The third time industrial*

researching materials of China indicates that among all the FIEs (Foreign Invested enterprises), 64.8% of their sales come from Chinese market and only 35.2% is sold for abroad. Obviously, they may squeeze other Chinese enterprises out of market. Moreover, it may make PRC government difficult to arrange and control domestic production and market reasonably.

With the squeezing effect by FIEs, some promising Chinese companies maybe are forced to cooperate with foreign investors to survive eventually. Because of this reason, the global plan of some promising Chinese companies has to be stopped.

2) Foreign funds ,specially transnational corporations or large financial group, after acquiring Chinese listed companies can easily monopolize their industry with privilege policy on joint venture. In this case, it exacerbates the environment of other Chinese competitors so that it can get super monopoly profit.

3) There are some problems in the specific operation in the foreign funds' M&A transaction

With foreign investors' strategic M&A, there are some speculation M&A transactions. Speculation M&A activity includes capital speculation and property speculation investment. Financial speculation investment' core meaning is to merge or acquire a Chinese enterprise and package[26] it to go to public offshore to

[26] Package: to present (as a product) in such a way as to heighten its appeal to the public (Merriam-Webster dictionary)

get super speculation profit. In China, this phenomena is called “炒企业”(chaoqiye) or “中策现象” (zhongce phenomenon). Property speculation investment is to acquire a Chinese enterprise which has a good location in the city, after foreign funds migrate the factory location, they develop real estate in the original place in order for super profit. Many Chinese enterprises lack capability of discrimination so that they are easily cheated by foreign investors’ speculation tricks.

4) Local government give excessive privilege to foreign investors.

After 1990’s, Chinese central bank use tight monetary policy so that local government and enterprises’ financing channel became much narrower than before. As a result, selling property right of SOEs’ and realize state owned assets into cash became choices for local government and enterprises in order to finance and develop local economy. However, in order to introducing foreign funds, some local government increase the degree of privilege to low down requirement such as low down holding share ratio of Chinese side, no requirement about technology introduction. More seriously, there may be corruption in the transaction between local government and foreign side for their own benefit. Moreover, foreign investors usually get super citizen privilege treatment that makes foreign investors have more benefit and advantage than Chinese enterprises.

Owing to the lagged laws about state owned assets management and property exchange, there are some phenomenon such as state owned assets are not

evaluated strictly, transfer price of equity is unreasonably low. Consequently, sometimes the Chinese equity and state owned assets in the acquired enterprise may be damaged, as a result, the nation and widespread investors' interest may be damaged.

5) Chinese Brand Loss (Indirect Loss of intangible asset)& Manufacturer Oppression

In developed countries, there are many famous brands such as Coke, Microsoft, GM of U.S. and SONY, Panasonic, Honda of Japan, and those are one of main driving factors for their countries' fast development. Nowadays, Chinese also have famous brands like "Hair", "Changhong", but those cannot compete with foreign famous brands at present. In 1996, one international authority valued 364 famous brands in the world, but there is no Chinese brand at all! It indicates that China enterprises lag behind developed countries tremendously. There is still worse thing: some SOEs in order to solve the capital shortage or less efficient management problems, they hurriedly cooperate with foreign companies to set up JV without protecting self-benefit, which makes Chinese brand replaced by foreign brand.

For instance, in one seaport city of China, among all the joint ventures there are 12% JV in which Chinese side make a price with their brand and transfer it to joint venture; 30% JV in which Chinese side transfer permit of brand name to joint venture; 11% JV in which JV use foreign side brand name instead Chinese

brand name;45% JV in which both foreign and Chinese side brand name are not used in it , JV use make out a new brand. After setting up JV, some foreign investors take advantage of Chinese side's production capacity and sals network to sell its own brand products, in the meanwhile, foreign side stop using Chinese brand step by step. Some foreign side position Chinese brand in the low price level so that Chinese brand remains but reputation goes down. In some cases, Chinese side use their factory, equipment and employees to cooperate with foreign side to build JV, but they have no capacity to produce and advertise their brand at all.

Current situation of Chinese brand after foreign funds M&A

- Part of brand disappear in the market. In many cases, foreign funds prefer this way to limit Chinese brand. In the agreement, foreign funds require Chinese enterprises can not use their own brand in a few years. For instance, Yangzi (“扬子”) refrigerator Co. was required in the agreement that it can not use this brand in sixty years. But there is no influence of Yangzi and nobody can remember it after sixty years.
- Although Chinese brand is still in use but it depreciates. Some Chinese brand like Meijiajing (“美加净”), a Chinese cosmetic company, has to buyout its brand in this situation.
- In the beginning, Chinese enterprises realize brand importance and protect itself in the agreement.

Famous brand means that large market share, loyalty of consumer and competition advantage.

Foreign funds apply brand M&A strategy during competing with other Chinese enterprises. With merging or acquiring Chinese competitors' brand, foreign funds not only can get rid of competitors but get the competitors' original market. On account of Chinese enterprises have no sense about brand self-protection and only care about introducing technology and skills, Chinese brand is replaced by foreign brand during M&A transactions. Brand loss is intangible asset loss of which result impede Chinese enterprises growing and in the long run, it blocks Chinese enterprises to participate international competition.

It also results **manufacturer oppression**, which means by merging or acquiring competitors, foreign investors snatch market and squeeze out the host country's competitors and meanwhile, take advantage of capital, technology and scale to build up high barrier to prevent other potential competitors enter.

Taking example of electronics industry, the excessive competition means there is no one can dominate this industry, this kind of situation reduce the cost of entrance for foreign investors. Some Chinese companies in order to solve financial crisis, they convey large shares to foreign investors, even convey goodwill, brand, raw materials purchasing channel, sales network with low price or for free. All the cheap intangible assets help foreign investors to easily build up a giant in front of other Chinese competitors.

Cases: In 1995, Samsung set up JV with Suzhou Xiangxuehai electric appliance company, JV is named after Suzhou Samsung. From then on, Xiangxuehai, famous brand in China, disappeared forever.

6) Impact to Chinese economic policy

Transnational corporations have their own global strategic plan that may be conflict or bias from Chinese government policy. They want to get payoff quickly from their investment, however Chinese government really hope to get advanced technology from foreign investors to develop agriculture, forestry, grassland industry, fishery, which are not interesting to foreign investors unfortunately. In addition, foreign investors maybe focus some regions those will make unbalanced developed region in China.

7) Impact to the distribution of person with good ability

Transnational corporations, FIEs, JVs can attract many persons with good ability. That will offset the talents inflow to government and Chinese companies. Furthermore, most of transnational corporations, FIEs and JVs are located in eastern part which is talked above, if many talents go to this area, it will aggravate the nation economy asymmetry.

8) Individual R&D capacity decrease

Many Chinese companies shortsighted emphasize on introducing transnational corporations' advanced technology so they could be the leader in their industry hurriedly, as the result, their own R&D capacity decrease due to the passive

attitude. This myopia causes Chinese companies position to be passive because innovation and research capacity is always dominated by foreigners. (1)With regard to the research on foreign companies' technology diffusion in China, more than 93% FIE (Foreign Invested Enterprises) have diffused technology in China (that is called nationalized technology), however, most of them are in the low nationalizing level which account for 77.5%, only 6.25% FIE make technology innovation. In order to keep technology in secret, many transnational corporations who make R&D activities in China just make them adapt into Chinese environment instead promote technology innovation.

4. Obstacles for Foreign Investment M&A

1. Laws and Regulations Obstacles

-----Up to now, there is no special laws or regulations directly about foreign investment M&A. Especially, some kinds of regulations are distributed in several laws. And some laws are too mechanical and impractical. Most important thing is that PRC government have no anti-monopoly law till now , so it is hard to defense national companies against hostile foreign companies. Due to the fact that there is no definite codes or regulations, there has to be a great cost and complex procedures for foreign hostile takeovers . In addition, there is interim which is from 3 to 5 years and entrance limitation in some industries. In some sense, it limits the foreign funds' M&A progression.

2. Evaluation Difference of Chinese assets

One of the successful factors of M&A transaction is to evaluate target enterprise's value objectively and that should be accepted by two sides. Nevertheless, there is large difference of evaluation price between two sides. And this maybe affect foreign funds to merge or acquire Chinese enterprises in large scale in China. The basic way to solve this problem is to make specific regulations and codes to regulate the . As a matter of fact, making regulations is very time-consuming and at the same time regulation is behind of practice. Despite all, Chinese enterprises and government must not let state owned assets be undervalued.

3. RMB can not be feely converted by foreign investors

In China, the currency used by foreign funds in M&A comes from

a. Foreign funds can use foreign currency which is freely converted
b. Using equipments, proprietary technology
c. RMB from JV in China invested by this foreign funds

If PRC government can not realize the problem of RMB free convertibility, it will limit financing channel of cross-border M&A.

4.SOEs' high debt ratio and redundant employees

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--Many domestic companies are transferred from state-owned factory to business company, so employees are over demand for them and some have big financial distress because of high debt ratio. Once all of these have to be solved and intervened by local government, political issue becomes an important determining factor in M&A instead it should be determined by market.

5.Capital market is not open enough and not very developed

Nowadays, the capital market is not fully open for foreigners though it is processing. Nation shares and legal person shares cannot be traded in the market so it causes some transactions' information disclosure is not intact and transparent, which maybe result some black transactions.

6.Evaluation about target company is not normative or professional

----When foreign investors who try to purchase a company have to face the market repossession value instead face value. But there is large difference between them. In many cases, it leads to failure of M&A of foreign investment.

----There are no more than 40 companies those are in the evaluation business and too few professional are in this profession. All of these factors make the deal inefficient.

5. Strategy for Chinese Enterprises & Government

1. Chinese Authorities Measures facing with foreign funds M&A

i. Continue the reform policy of State Owned Capital drawing back management but care about effectiveness and safety

In accordance with *the Notice of conveying SOS and SOPLS to foreign investors,* the examining and approving power of transferring SOS and SOPLS is controlled by central government not local government. This incentive is to guarantee the safety of state owned assets but the cost is the local government's low effectiveness and initiative.

Therefore the suggestion for PRC government is to separate the power in different situations. If special industry which is restricted in the light of codes in China, or listed companies due to the large extent influence and numbers of shareholders, central government control the power. If not, local province level government can make the decision.

ii. Establish anti-monopoly system

First, establish anti-monopoly report and examination system

When the currency amount, transaction amount or market share reach to some level, related sector of government should make a decision whether to permit

M&A deals or not. Enterprises and industry association also can apply for this procedure from government.

Second, establish anti-monopoly controlling system. The system should include before the mergers or acquisition, government can stop the monopoly incentive M&A. After M&A with monopoly feature, government segment the enterprise and punish the enterprise' leader.

iii. Perfect Primary Status Judgment

Judgment about investors' nationality decides the entrance limitation in one country. Foreign investors' M&A can avoid related policy limitation of entrance by indirectly M&A or investment. Therefore, primary status judgment should be decided precisely.

In the world, there are three standard about this judgment: standard of registered place; standard of main operation place; standard of capital controlling. China use the traditional standard of registered place. Because of this standard, there is probability that foreign investors can take some indirect M&A or investment strategies which are mentioned above to avoid entrance limitation in some industries. From the aspect of international development, capital control standard is accepted widely. Therefore, the suggestion for PRC government is to apply capital control standard to judge foreign investors' primary status.

iv. Promote the information disclosure system

Although China has information disclosure system of listed companies, government still should build this system aim at foreign funds' M&A. Foreign investors should disclose their financial condition, business reputation, specially the computation procedure and basis of their bidding price. Moreover, stake holding time, payment arrangement also should be disclosed.

v. Promote the Agency institution Establishment

Cross-border M&A goes on through investment bank, assets valuation, law and finance consultation institution. In case of organs of state owned assets evaluation, there are only more than 400 and 10 thousand staff, which are far from the market demand. Moreover, these organs belong to government sector such as state owned assets management bureau. So lack enough professional, unscientific valuation methodology and political intervention make it difficult for foreign investors to trust.

Therefore, China should establish independent and all-round service agency system which includes property right exchange, finance collateral, accounting & audit, assets valuation and law consultation, in the meanwhile, it should introduce and cooperate with international service agency to make Chinese service agency standardized.

vi. Establish fair play competition environment

Besides to prevent foreign companies from monopolizing in China, government should cancel the discrimination treatment between foreign companies and Chinese companies.

2. Suggestions for Chinese Local Government

i. Consider one M&A transaction in the aspect of the whole city

One Mergers or Acquisition transaction maybe cause many employees lose their job, which maybe result regional society structure unbalance. How to deal with unemployed workers due to M&A is the main factor for consideration.

ii. Forbid corruption in the M&A transaction. Some persons of local government intend to low down state owned assets' price in order to get rebate from the bidder. In order to protect interest of nation and investors, local government should strengthen supervision over related sector of local government.

iii. Encourage foreign funds merge or acquire these scope: it is favorable for introducing advanced technology; improving management skills; resource recycle; SOEs reform. In addition, in the encouraged scope, local government had better simplify the examining and approving procedures;

offer some reasonable privilege such as low down land price, electric expense.

iv. Rationally treat foreign funds and do not give super privilege, resulting to damage the benefit of nation or local enterprises.

v. Promote Social Security System to solve the problem of unemployment due to M&A.

3. Strategy for Chinese Enterprises which prefer to be merged by foreign funds

Foreign funds' M&A bring challenges and opportunities to Chinese enterprises. Because Chinese enterprises have such problems that property right is indefinite; are not familiar with international customary rule, maybe they lose some interest which they should have had.

i. Knowing what foreign funds want to get

Chinese enterprises should know what the foreign funds want, what is the demand of foreign investors. For example, Chinese enterprises' excellent employees, management system, potentiality. Knowing the demand or requirement of foreign investors, Chinese enterprises should improve the level in these aspects and overcome related demerits.

ii. Preparing early and solve self problem before M&A

In the aspect of financial accounting, one target company with profit and achievement should be better than other Chinese competitors. Good quality assets is the most important factor.

If one enterprise want to attract foreign purchaser, it should prepare to solve problems 3 to 5 years before M&A transaction. Enterprises should invite professional accountants to audit their account book of the past three years in order to make the account book more transparent and normative.

iii. Manager should prepare the answer for the questions asked by foreign bidder

Managers of enterprises should prepare all sorts of sharp questions about financial statement, development plan. They should prepare a concrete development plan after M&A.

iv. Faith should be fundamental

In the procession of absorbing foreign funds, although manager should show the best part to foreign investors, yet he can not make anything fictitious to damage enterprise's reputation.

v. Introducing foreign capital from Multiple-sides

In many foreign funds' M&A transactions, foreign investors have much more advantages of negotiation. The reason why is such :

Foreign funds with definite long-term strategy consider China market As a

entire. But Chinese enterprises consider benefit individually so that it forms the situation of " one side against multi-sides".(one foreign investors negotiate with many Chinese enterprises at the same time, it seems like one demand side against some supply sides). Therefore, foreign investor is in the favorable position in the negotiation, on the contrary, Chinese enterprises compete with each other so that it weakens the capacity and opportunity to bid the price.

For instance, Canada introducing foreign capital excessively rely on America, as a result, Canada' economy structure is a little frail. Introducing foreign capital for an enterprise is in the same way as one country. Enterprises should attract more demand sides to make foreign funds compete each other in order for more benefit. In fact, the competitors of most transnational corporations which invest in China are foreign companies instead Chinese enterprises. There is a classic case as evidence in China: one auto company in Guangdong province, a joint venture with France PEUGEOT auto company has divergence with this France investor. For the purpose of getting a favorable position in negotiation, Chinese auto factory contacted with Opel, Huyndai, Honda, eventually it cooperated with Japan Honda Group with satisfied price, equity ratio and technology upgrade level.

vi. In some industries in which Chinese enterprises have advantages of resource or market, enterprises should cooperate with controlling stake.

Scrambling for equity is very important for Chinese enterprises. 50% equity ratio is necessary in some industries. With definite incentive to integrate China market into their global developing strategy, controlling stake is the only way to realize it for transnational corporations. Chinese enterprises should try to get at least 50% equity with the purpose of equal treatment. Equal right is better for Chinese enterprises develop in the future.

vii. Self-Protection of Chinese Enterprises

Take advantage of foreign funds to develop technology

In case of technology transfer, transnational corporations control the product research right and the advanced technology. Their strategy is to keep the critical technology in secret. In such cases, host country just copy the production normative procedure and form a dependent relationship with foreign side. Eventually, it will limit host country development and competition capacity.

Brand self-protection

Famous brand means that large market share, loyalty of consumer and competition advantage, it seems like market barrier for the other competitors. Long history, good technology, good reputation and sales network can not be easily get by foreign funds. The most effective way for foreign investors is to

acquire all of these by merging Chinese enterprises. Their targets are very clear:

- Occupying market by merging or acquiring
- Getting Profit
- Global strategy

When foreign funds acquire Chinese enterprises, it does not stop using Chinese brand immediately. It has different tricks in different situations:

- Controlling stake to get the decision-making right is first step; reducing Chinese brand investment ratio to decrease Chinese brand value.
- Controlling sales and market promotion. By this means foreign funds weaken Chinese brand's sales network so that consumers can not buy the products. As time passes by, consumer will forget this brand.
- Increasing Capital to weaken Chinese side. Once Chinese side do not have enough capital when Foreign side require increasing capital, foreign side's equity ratio will increase and Chinese side' ratio decrease. As a result, decision-making power weakens more and more.

Taking advantage of foreign funds, technology and experience is good for Chinese enterprises but enterprises should be careful of not being wiped out. With understanding the incentives and tricks of foreign funds, Chinese enterprises should care about :

- Brand self-protection. Chinese enterprises should try to have equal position

in the post-merged enterprises with view of protecting their brand and other benefit.

- Realize and evaluate enterprises' brand value correctly. Traditionally, when Chinese side set up JV with foreign side, they make price with land or equipment but not includes intangible assets, which is a great waste. Certainly, it is necessary to set up standard asset valuation system.
- Good brand should have large independence in JV. This is pivotal for Chinese brand survive in the future. The independence includes ownership of trade mark, decision-making power and sales& market controlling power.
- Powerful enterprises can cooperate with Chinese enterprises first, to strengthen themselves, that is better for negotiating with foreign side in the future.

4. Strategy for defense takeover

Probability of Hostile Takeover Analysis

Only one year ago, it is impossible for foreign hostile takeover to merge or acquire SOEs or listed companies which SOS and SOPLS account for large share because at that time it is not permitted to purchase SOS and SOPLS for foreigners. However, in Jun.29, 2003, government set out one policy about *Convey SOS and SOPLS to foreign investors Code,* so from then on it is possible for hostile foreign takeover. In despite of this, foreign hostile

takeover still has to face a lot documenting work and audit by local government. So if the local government exert their power correctly, it is also very difficult for foreign hostile takeover to merge or acquire Chinese companies.

If a foreign company wants to purchase SOS or SOPLS, they should bid price in open. Even if they get SOS or SOPLS, those shares cannot go public for trading. So in that case, there is little impact to stock price. In addition, there are some industries those are not allowed to purchase SOS or SOPLS for foreign investors.

Defence Tactics

- Cross-holding stock. According to current Chinese law, it does not permit listed companies cross-holding stock, so listed companies can reach an agreement with trustable companies to cross-hold each other's stock and guarantee do not transfer stock when there is hostile takeover.
- Director Board by installments and by rank

It is good for stable director board with the object of defending takeover. According to *Chinese corporation law* and *Listed companies Constitution Guidance,* director board and shareholder meeting have this right to carry on it or not.

- White-knight strategy. If Chinese enterprise does not satisfy the bidder company, it can send invitation to satisfied companies to participate M&A. In

case of current codes and regulations, Chinese securities market leaders prefer this strategy because it can prevent shareholders' benefit.

□ Laws suit. Suit hostile takeover when there is law drawback in the procedure of M&A.

VIII. Summery of Conclusion& Suggestions

As the analysis mentioned above, foreign funds' M&A has positive effect but also has negative effect. With China market opening step by step, it is inevitable and advantageous for China economy development and enterprise reform to introduce foreign capital to merge or acquire Chinese enterprises. Therefore, China government should try to take advantage of positive effect and avoid or offset negative effect in order to make Chinese M&A market for foreign funds.

PRC authority:

1) Establish and promote related codes and regulations. Standardize foreign funds' M&A behavior and market in China.
2) Establish and Strengthen supervision system to prevent from state owned assets damaged in M&A transactions and corruption when evaluating state owned assets.
3) To accelerate the privatization process[27] and eliminate the different treatment on SOS, SOPLS and public shares
4) To constitute comprehensive and effective protection institution to

[27] privatization process : government encourage transfer SOS and SOPLS to private enterprise or person.

defend minority shareholders' interest from being damaged

5) Protect important nation industry which are mentioned in *the Foreign Investment Instructions*. Prohibit foreign funds to make use of lagged regulations to enter into entrance-limited industry.
6) Standardize M&A market and offer health and fair play competition environment. Protect Chinese enterprises' benefit from forbidding monopoly M&A transactions.
7) Promote information disclosure system and capital market.
8) Promote agency institution establishment.

Chinese Enterprises:

1) In order to develop in the long run, Chinese enterprises should strengthen themselves and do not depend on foreign funds to solve all the problems.
2) Large enterprises had better cooperate with other Chinese enterprises to strengthen their competition capacity and then conditionally cooperate with foreign funds.
3) Protect self-benefit during the time of cooperating with foreign funds. Perceive the tricks of foreign funds and precaution it before and during making agreement. Rational cooperate with foreign funds and strengthen the ability of perceiving foreign funds with speculation incentive.

4) In order to attract foreign funds, Chinese enterprises should normalize themselves in all rounds such as financial management, operation and management.
5) Reasonably evaluate state owned assets when transferring SOS or SOPLS. Protecting nation and investors' benefit should be the first factor for consideration.

Local Government:

1) Cooperate with central government to supply a healthy and active market. Introducing foreign capital and protecting state owned assets should be considered at the same time.
2) Strengthen supervision work to prevent state owned assets to be damaged.
3) Offer reasonable privilege to foreign funds in some scopes which are mentioned above, however, control the degree of privilege in order to protect Chinese enterprises' benefit.
4) Strengthen Social Security System and reasonably arrange re-employment for unemployed workers due to M&A.

In general, these three sides of China should cooperate together to promote M&A market development, SOEs reform and modern enterprise system. Chinese authority should play the role of positive effect to induce foreign capital to help Chinese enterprises' reform and development. In the meanwhile, it should reduce

and minimize the negative effect by scrupulous analysis and consideration in order to make foreign funds' M&A service Chinese economy development optimally.

APPENDIX A

Numbers of Listed Companies	783
The Number of A Shares	773
The Number of B Shares	54
Total Capital of A, B Shares	4180.16 billion shares
Capital of A Shares	4084.23 billion shares
Capital of B Shares	9.593 billion shares

Numbers of Listed Companies	549
The Number of A Shares	492
The Number of B Shares	57
Total Capital of A, B Shares	185.70 billion shares
Capital of A Shares	175.90 billion shares
Capital of B Shares	9.79 billion shares

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