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OPPORTUNITY IN CRISIS

CHINA'S LATENT INTEREST
IN THE US COULD SURFACE IN
THE FORM OF DISTRESSED
ACQUISITIONS.

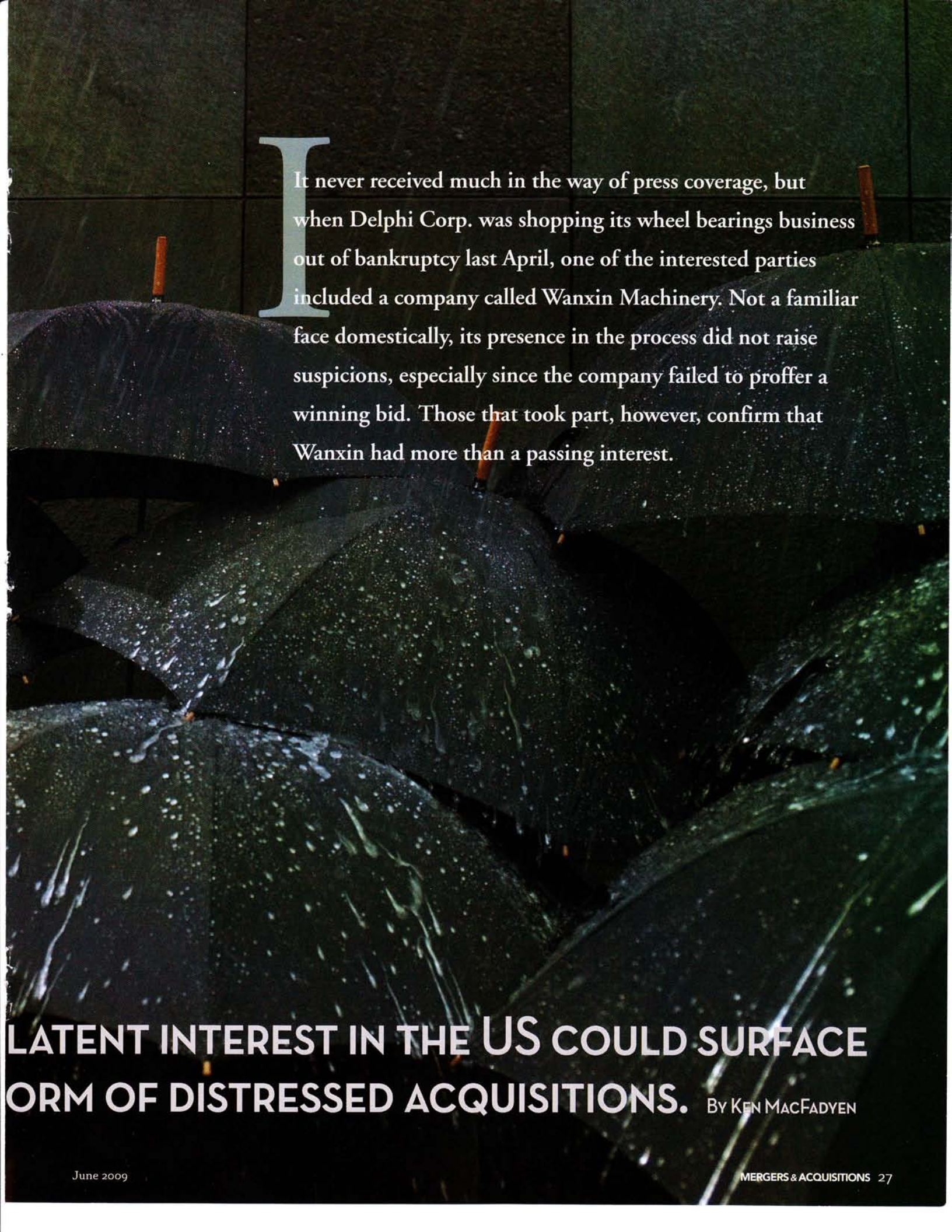
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OPPORTUNITY IN CRISIS

CHINA'S
IN THE F



It never received much in the way of press coverage, but when Delphi Corp. was shopping its wheel bearings business out of bankruptcy last April, one of the interested parties included a company called Wanxin Machinery. Not a familiar face domestically, its presence in the process did not raise suspicions, especially since the company failed to proffer a winning bid. Those that took part, however, confirm that Wanxin had more than a passing interest.

**LATENT INTEREST IN THE US COULD SURFACE
FORM OF DISTRESSED ACQUISITIONS.** BY KEN MACFADYEN

“Distressed deals have a faster pace, not to mention the perceived legal and location risks.”

Fast forward 12 months, and a joint venture called BeijingWest Industries Co. is poised to do what Wanxin could not. The company agreed to buy certain assets of Delphi's global brake and suspension business out of bankruptcy in a deal valued at \$90 million. It's just one out of a handful of asset sales to come out of the Delphi bankruptcy, but some dealmakers believe it could be the most notable, at least to those tracking China's burgeoning interest in distressed assets.

“You're definitely going to see more [inbound] deals involving Chinese acquirers,” insists **Jack Chen**, the founder, chairman and CEO of **Transworld Capital Group**. Chen, who was recently appointed by the Beijing government as its international investment adviser, oversaw the BeijingWest deal. He tells *Mergers & Acquisitions Journal* that his firm has already captured several similar mandates.

The prospect of Chinese companies buying businesses domestically could hardly be considered novel. When International Business Machines sold its PC division to China's Lenovo Group in 2004, a \$1.75 billion deal, it served as a wakeup call to many that Chinese companies have both global ambitions and the wherewithal to pursue them. Deals that followed included Acer's \$710 million subsumption of Gateway, the purchase of Wham-O by Cornerstone Overseas, and Moulin Global Eyecare's acquisition of Eye Care Centers of America.

The track record for many cross-border deals, however, has left a lot to be desired. **Anil Gupta**, professor of strategy at the University of Maryland's Smith Business School and co-author of the book “Getting China and India Right,” describes that most of the cross-border activity in the past has revolved around attempts to move up the value chain through the acquisition of brands. The problem, he says, is that the buyers have been largely overmatched when it comes to integrating and managing the assets following the acquisitions, so few have been able to capture the values being paid. “Acquirers have not demonstrated that they have the capability to swallow the assets once they buy them.” Because of that, Gupta adds, the emergence of inbound Chinese M&A was

effectively stillborn.

Among the failures was TCL's misplayed efforts in Europe. The electronics company initiated a joint venture with France's Thomson in 2004, manufacturing televisions and DVDs, and soon after acquired Alcatel's cell phone business. The partnership with Thomson dissolved a few years later, forcing the company to digest a \$260 million loss, and it took three years following the deals before the company was able to show a profit again. Shanghai's BenQ had a similar experience when it acquired Siemens mobile phone divisions — assets that were eventually liquidated over eBay. And Lenovo's purchase of IBM's PC division was also considered a letdown, as the company's profits sank following the absorption of the unit.

It wasn't just post-merger integration that vexed Chinese buyers. For some, it was the acquisition process itself. Electronics maker VTech acquired Lucent Technologies' consumer telephone unit in 2000 for \$121.3 million. Not long after VTech took over the books, the company discovered unexpected inventories. VTech eventually brought its auditor, PricewaterhouseCoopers, to court and settled separately with Lucent after claiming fraud, resulting in a \$50 million refund.

“M&A is hard on its own, cross-border M&A is infinitely harder,” Gupta says, noting that literally a lot does get lost in translation. Also, cultural issues, in many of these deals, created a barrier that couldn't be cleared. Chinese businesses, Gupta says, inherently have a hierarchical culture. “They haven't shown that they can manage horizontally and they never had the opportunity to develop the skills necessary to manage across diverse groups of people.”

Gupta adds, though, the past four to five years have served as a training ground, and

he notes that Chinese companies are again looking at foreign acquisitions, albeit differently than in the past. In particular, companies are keen on buying smaller stakes that may not necessitate a full integration. And companies in the natural resources sector or technology, “where people aren't as critical,” are high on the list of what interests Chinese buyers, Gupta says.

The distress currently facing the global markets,



Jack Chen

meanwhile, is providing another opportunity. Bankruptcy auctions, in particular, are being viewed as a potential entryway — one in which buyers aren't forced to sacrifice the balance sheet in the name of growth. Moreover, as opposed to buying brands, Chinese companies are more likely to be interested in assuming the intellectual property that allows them to improve their own products and move their own name higher up on the value chain.

BeijingWest, for instance, is a joint venture established by Chinese auto parts company Tempo Group, Chinese steel-maker Shougang Group Corp., and state-owned investment firm Bao'an Investment and Development Co. If the joint venture successfully acquires the assets, the plan isn't necessarily centered on capturing the company's US distribution network, which includes OEMs such as General Motors.

According to Chen, it's more about the technology. He cites previous efforts initiated by the chairman of Tempo Group, Tianbao Zhou, who in years past has relied on partnerships with Delphi to help build Tempo's business. For instance, he had previously arranged a licensing agreement with the parts maker to use certain IP related to braking systems. "They were immediately able to improve their product, which allowed them to grow revenue and margin tremendously," Chen says.

While BeijingWest intends to keep the employees and plants of the Delphi division, the underlying draw is again the technology, as it "bridges a gap" that will make the company an instant player in its market.

Of course, the relative strength of China's automotive market doesn't hurt either. Aided by the government's stimulus efforts, the country became the world's largest market for cars as of the first quarter of this year. While automotive sales are plummeting in the US, the Chinese market continues to experience growth. This is in part due to the growing middle class, but no less important are tax cuts for certain new car purchases and subsidies to farmers designed to spur the use of more fuel efficient autos and trucks. While the old standbys such as GM, Hyundai, Volkswagen and Toyota, benefit from this, it's the homegrown players such

as Shanghai Automotive Industry Corp. (SAIC), Chery Automobile Co. and Geely Automobile Holdings, who will likely reap the biggest gains.

Chen insists, however, that the goal of the Beijing-West deal isn't about gutting the company of its technology and shipping it to China. Rather, he expects that the buyers will try to complement the maturity of the US market with the growth inherent back at home.

This is a strategy that can likely be replicated by other manufacturers to various degrees, regardless of sector. But where it gets difficult is in the acquisition itself. In a traditional M&A process, for instance, sellers will usually take pains to ensure the highest bidder is made comfortable. A bankruptcy auction, on the other hand, isn't driven by a fiduciary duty to obtain the highest price. Value, obviously, is still important, but speed will often take precedence when it comes to dealing with all of the constituencies present in a Chapter 11. Efficiency, as it turns out,

is not typically considered a strong suit of Chinese acquirers. This is what made the BeijingWest deal such a triumph, as the buyers traversed jurisdictions in the US, Mexico, Poland, France, India and China, analyzing not only the intellectual property, but also the labor contracts and environmental considerations, not to mention the traditional business due diligence and machinery and equipment assessments that go into any industrial acquisition.

Phillip Torrence, a partner at law firm **Honigman Miller Schwartz and Cohn LLP** who worked on the deal, perhaps understates it when he says, "It took a lot of coordination."

For the naysayers, of which there are many, this is precisely why they don't believe foreign buyers, especially Chinese companies, will be active on the distressed front. As the cost of bankruptcy has climbed, companies and creditors are only that much more insistent on moving the process along at a faster pace.

Patrick Goy, co-head of restructuring and special situations for investment bank **Lincoln International**, describes, "The Chinese, generally speaking, are still very deliberate in M&A, and that works against them." He



Saul Burian

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“The Chinese, generally speaking, are still very deliberate in M&A.”

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adds that translating the confidentiality agreements, alone, can take “a long time to get through the system.”

Saul Burian, a managing director in the restructuring group at **Houlihan, Lokey, Howard & Zukin**, echoes this point, adding, “Distressed deals have a faster pace, not to mention the perceived legal and location risks, so there is a high barrier of entry. Most foreign buyers can’t react fast enough to participate meaningfully.”

Gupta, meanwhile, cites that many Chinese companies are well aware of “the cost of distraction.” He is referring to the efforts necessary to turnaround a problem asset, but it’s also true that executives may hesitate to spin their wheels on a bankruptcy bid if the odds are stacked against them.

Dennis Galgano, a managing director at **Morgan Joseph** and head of the firm’s international investment banking group, cites that the bankruptcy laws are too Byzantine for most foreign buyers, which gives US bidders “a significant advantage in a 363 sale.”

Still, few are willing to dismiss out of hand China’s interest in resuming its global acquisition push. The National Development and Reform Commission, for instance, forecast that China’s direct outbound investment would swell to \$59 billion in 2009, more than 13% over the 2008 sum.

Meanwhile, the Chinese government holds a roughly \$1.9 trillion stockpile of foreign reserves, a significant portion of which take the form of US Treasury Bonds. For this reason, the Chinese government is not a passive observer to the distress in the US.

In June, a delegation of over 400 business owners, executives and provincial governors are scheduled to participate in a 14-day tour of the US and Canada. According to a story in *Mergermarket*, the delegation, scheduled to arrive on June 10, was formed to explore the potential for distressed opportunities and first took root through a meeting at the G20 Summit between President Barack Obama and China’s Party Secretary Hu Jintao. The Ministry of Commerce and the China Council for the Promotion of International Trade reportedly organized the effort, which will include meetings with the American Chamber of Commerce as well as stops at Washington, New York, Chicago and Salt Lake City for various related events.

While a growing protectionist sentiment has been building in recent months, especially as the govern-

ment continues to pour money into financial institutions and select industries, few see Chinese interest in distressed assets as a potential cause for concern.

Lincoln’s Goy, for instance, who doesn’t anticipate a rash of Chinese distress deals, notes that if it happens, the fallout would not be akin to what was seen in the seventies and eighties when Japanese investors acquired Rockefeller Center or Pebble Beach. “The problems our country is dealing with today are much greater,” he says. “Japan Inc. was a much bigger story at the time.”

Moreover, as politicians and unions have bemoaned the transfer of manufacturing jobs overseas, the prospect of Chinese buyers coming in to save distressed assets, ironically, reflects that the trend has come full circle. Most of the pros *Mergers & Acquisitions* spoke with do not believe distressed deals, however, would necessarily spark a wholesale transfer of manufacturing capabilities to the Far East.

Gupta cites that as the technology transfer occurs, China will export more advanced products. “In the immediate term,” though, he says, “buyers won’t be shutting down US operations.”

“There’s this misconception that when a foreign company buys the assets that workers are hurt,” Chen says. “But the crisis forces people to be realistic. If the buyer of last resort is frustrated in their efforts, then everyone

loses.” He adds that buyers may cut overhead, but he reiterates that these are in fact distressed deals in need of a turnaround.

In the meantime, much of this still depends on whether or not Chinese companies can follow BeijingWest’s lead and navigate through the bankruptcy process. **James Decker**, who heads restructuring at Morgan Joseph, notes that the key for China-based buyers is “to get in early” and start the dialogue.

“The earlier buyers get involved, the better their chances to minimize the time constraints,” he says.

Chen, meanwhile, adds that in the case of the BeijingWest deal, the buyer had between seven and eight consultants on the payroll. Moreover, it didn’t hurt that the buyer was the last option left for Delphi. “The PE groups walked in and promptly walked away. We were the last guy left, so the alternative for the sellers was very clear,” Chen describes, alluding to a dynamic that could certainly help the cause of foreign buyers. **MA**

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They haven’t
shown that
they can
manage
horizontally.”



Lenovo learned you can’t buy your way up the value chain.