Executive Summary

This project analyses the characteristics of China's merger and acquisition by applying theory and experience attained from the mature market. The analysis focuses on cases that occurred in Chinese stock market from 1994 to 1999. This project endeavours to present a practical understanding of the issues and to make some suggestions to players and administrators.

Globalisation, deregulation and new technology have pushed global M&A activity to a record high. Traditional theory may not be able to fully explain all these new characteristics of global M&A activity, however, together with experience throughout the world, it is a good framework to examine M&A in China, an emerging market with huge potential as well as challenges.

Compounded with global forces, the need to reform its State-Owned Enterprise and the need to establish market mechanism make China's M&A very distinctive. This paper examines the forms of M&A employed by firms, the ownership structure of the acquirer and the target, the strategic alternatives and issues about valuation, accounting and legislation. It ends with suggested solutions about some problems. Almost all the aspects of M&A in China are in their developing stage. However, the real business opportunities come from uncertainty.
Table of Content

EXECUTIVE SUMMARY ........................................................................................................ 2
TABLE OF CONTENTS ........................................................................................................... 3

PART I M&A THROUGHOUT THE WORLD ......................................................................... 4
THEORIES ................................................................................................................................. 4
Efficiency or Synergy Theory ............................................................................................... 5
Hubris Theory ......................................................................................................................... 5
Agency Theory ......................................................................................................................... 6
RULES FOR SUCCESSFUL M&A .......................................................................................... 6
SUMMARY OF EMPIRICAL TEST ON M&A PERFORMANCE .................................................. 7
CHARACTERISTICS OF GLOBAL M&A ............................................................................... 9
Record -- Growth ...................................................................................................................... 9
European Consolidation .......................................................................................................... 9
New Developments ................................................................................................................ 10
Hostile Take-over .................................................................................................................. 10
Challenge in Cross-Board Mergers ....................................................................................... 11
Post-Merger Problems ........................................................................................................... 11

PART II M&A IN CHINA ...................................................................................................... 13
BACKGROUND ...................................................................................................................... 13
China’s Fast Growth and the Future ..................................................................................... 13
Globalization .......................................................................................................................... 14
Economic Reform and Privatization ..................................................................................... 14
Development of Stock Market ............................................................................................... 14
REVIEW .................................................................................................................................. 16
1985 – 1996 Emerging M&A Activities ............................................................................... 16
1994 – 1999 M&A of Listed Companies .............................................................................. 17
CHARACTERISTICS OF CHINA’S M&A ............................................................................. 20
Types of China’s M&A ........................................................................................................... 20
Strategic Alternatives – Six Basic M&A Forms ..................................................................... 24
Asset Acquisition .................................................................................................................... 25
Investment for Majority Interest ........................................................................................... 26
Stock Acquisition by Agreement ......................................................................................... 27
Asset Exchange ....................................................................................................................... 29
Stock Acquisition through Secondary Market ..................................................................... 31
Restructuring State-Owned Shares ...................................................................................... 31

VALUATION AND PRICING ............................................................................................... 32
ACCOUNTING METHODS ...................................................................................................... 36
LEGISLATION ON INFORMATION DISCLOSURE ............................................................... 38
PROBLEMS AND SUGGESTIONS ......................................................................................... 39
Legislation ................................................................................................................................ 39
Asset Evaluation .................................................................................................................... 39
Government’s Role .................................................................................................................. 40
Information Disclosure ......................................................................................................... 41
Policies .................................................................................................................................... 41
M&A for Foreign Investors ..................................................................................................... 42
Risk Control ............................................................................................................................. 43
Financial Resources ............................................................................................................... 43
REFERENCE ............................................................................................................................. 45
Part I  M&A throughout the World

After peaking in 1988 and then declining to a low in 1991, merger activity increased to new highs from 1995 to 1997. As the world approached the end of 20th century, M&A in the world reached a new all-time high. 1998’s record of global M&A activities was $2.52 trillion; 1999 topped it by 36%, with total worldwide transactions announced in 1999 hitting $3.43 trillion. Based on 1st quarter data, the M&A market was still hot in 2000 and may top 1999 record. Globalization, deregulation and technology have been powerful forces. Business enterprises find that they must adjust to massive changes in their environments, in the nature of competition and in the relations with other players. The M&A subject takes on even greater importance.

1. Theories

Many individual theories for mergers and takeovers have been formulated. They can be summarized into three major categories (Berkovitch and Narayanan (BN), 1999): 1). Efficiency or synergy; 2). Hubris (Winer’s curse, overpay); 3). Agency problems or mistakes. Some redistribution elements such as tax, market power, etc also explain M&A, therefore, theory on redistribution should be viewed as another category.

1 Global mergers & acquisition explode Fay Hansen
1) Efficiency or Synergy Theories

The differential efficiency theory says that more efficient firms will acquire less efficient firms and realize gains by improving their efficiency; this implies excess managerial capabilities in the acquiring firm. Differential efficiency would be most likely to be a factor in mergers between firms in related industries where the need for improvement could be more easily identified. The related inefficient management theory suggests that target management is so inept that virtually any management could do better, and thus could be an explanation for mergers between firms in unrelated industries.

The operating synergy theory postulates economies of scale or of scope and that mergers help achieve levels of activities at which they can be obtained. It includes the concept of complementarity of capabilities. The financial synergy theory hypothesizes complementary between merging firms, not in management capabilities, but in matching the availability of investment opportunities and internal cash flow. A firm in a declining industry will produce large cash flows because there are few attractive investment opportunities. A growth industry has more investment opportunities than cash with which to finance them. The merger firm will have a lower cost of capital due to the lower cost of internal funds as well as possible risk reduction, savings in flotation costs, and improvements in capital allocation.

2) Hubris Theory

The winner’s curse concept has a long history in the literature on auctions. When there are many bidders or competitors for an object of highly uncertain value, a wide range of bids is likely to result.
Roll (1986) analyzed the effect in takeover activity. Postulating strong market efficiency in all markets, the prevailing market price of the target already reflected the full value of the firm. The higher valuation of the bidders (over the target’s true economic value), he states, resulted from hubris – their excessive self-confidence (pride, arrogance). Hubris is one of the factors that caused the winner’s curse phenomenon to occur.

3) Agency Theory

Agency problems may result from a conflict of interest between managers and shareholders or between shareholders and debt holders. A number of organization and market mechanisms serve to discipline self-serving managers, and takeovers are viewed as the discipline of last resort. Managerialism, on the other hand, views takeovers as a manifestation of the agency problem rather than its solution. It suggests that self-serving managers make ill-conceived combinations solely to increase firm size and their own compensation. The hubris theory is another variant on the agency cost theory; it implies acquiring firm managers commit errors of over optimism (winner’s curse) in bidding for targets.

2. Rules for Successful M&A

A.T Kearney study revealed that companies with successful mergers moved forward with a clear version, quickly determined management responsibility, developed synergies realistically, aimed for early “wins,” limited their risks and minimized cultural barriers and communications problems.
Anslinger and Copeland identified seven principles employed by successful acquirers (1996).

1) Acquire companies with track record of innovative operating strategies.

2) Capable managerial talent is most important for creating values. If current executives are not capable of increasing value, look for managers within the organization who are not yet in leadership positions and or/ hire out-standing talent from other firms.

3) Use strong incentive compensation systems such as stock purchase programs so that top managers have holdings in the company that represent a large part of their net worth.

4) Link compensation incentives to future changes in cash flow.

5) Push the pace of change to make turnarounds happen within the first two years of the takeover.

6) Develop information and feedback systems that promote continuing dynamic relationships among owners, managers, and the board.

7) Acquiring firms must use executives with expertise and demonstrate successful experience as dealmakers. Their judgments are often critical to the success or failure of the transaction.


A large number of studies have been done, trying to answer three major issues: 1. Is true social value increased? 2. Does the restructuring result in operating performance
improvements that can be measured for subsequent years? 3. What are the industrial effects of M&A? Here are the summaries of these studies.

1) Empirical tests support the notion that value is created by M&A activities. The gains to acquiring firms around the announcement date are generally close to zero, which is the appropriate excess return in perfectly competitive markets for corporate control. The gains to target firms are more substantial. Returns to targets in merger transactions are in the 20 to 25% range while in tender offers the gains are in the 30 to 40% range. The difference in the returns between tender offers and mergers could be explained by the method of payment for the acquisition. Mergers usually involve stock transactions while tender offers are usually for cash.

2) The evidence for the total gains in M&A activity confirms that they are mainly positive and synergy appears to be the dominant driving forces. In mergers with negative total gains, agency problems and hubris are involved. The total value increase by M&A activity could be attributable to increases in market power and not to increases in efficiency, but empirical studies do not support the monopoly theory.

3) The gains from M&A activity seem to persist in the post-merger period. The industry-adjusted post merger performance of merging firms shows improvement. the improvements mainly come from better management of the assets and not from reductions in labor costs, capital investment, or research and development (R&D) expenditures. There is evidence that mergers are mainly concentrated in industries where performance was sub par compared with the economy as a whole. Factors that cause major adjustments in individual industries seem to drive the rate and timing of M&A activity.
4. Characteristics of Global M&A

1) Record-Growth

Global M&A activities in the first quarter of year 2000 reached $1.166 trillion, which easily surpassed the $1.086 trillion reported for fourth quarter of 1999 and was substantially higher than the first quarter a year ago. For the first quarter of 2000, the United States accounted for $600 billion or about half of all mergers and acquisitions. Europe is the second largest market, with $351 billion in M&A, and accounts for about 30% of the total.\footnote{source: Thomson Financial Securities Data Corp.}

M&A in the telecommunications sector almost doubled in volume to become the hottest industry sector followed by commercial banking.

2) European Consolidation

While M&A activity in the United States hit $1.75 trillion in 1999, up slightly from $1.63 trillion in 1998, M&A activity in Europe more than doubled last year. European M&A totaled $1.2 trillion in 1999, boosted by the UK's Vodafone Airtouch PLC's $203 billion offer for Germany's Mannesman AG, the largest deal ever.

In several industries in Europe, the M&A wave is part of huge land-grab by companies intent on buying up market share. In banking, utilities, media and telecommunications, a handful of leading companies in each sector is determined to expand their geographic reach and rapidly increases their customer base through acquisitions, with many of these
companies completing their M&A strategy. European unification at the level of the company will come as these companies attempt to integrate their acquisition.

3) **New developments**

The launch of the euro and other vehicles for integration paved the way for the merger wave in Europe, creating the truly European entities envisioned by the architects for European unification. Heavy M&A activity is forcing many European governments to rethink their business and labor laws, led by Germany that is considering eliminating taxes on sales of industrials. The tax break, which should become effective next January, will create a new surge of corporate restructuring and heighten M&A activity in Germany.

4) **Hostile Take-over**

Recent global M&A growth has been marked by an extraordinary rise in the number of hostile transactions. 1999 was the year of the hostile merger, with more than 14 percent of the value of all deals worldwide derived from hostile transactions-those where the target's board of directors reject outright the acquirer's offer. The mother of all hostile takeovers was the vodafone bid for Mannesmann, which pushed the value of the hostile deals in 1999 up to $487 billion, substantially higher than the $108 billion in hostile transactions reported for 1998. Hostile mergers and acquisitions are tough going, with only one in five companies engaged in a hostile transaction actually achieving control of their target.
5) **Challenge in Cross-Board Mergers**

According to John Nigh, a principal at Tillinghast-Towers Perrin and an expert in international M&A, problems with the valuation of foreign entities includes the following:

i. Regulatory and local GAAP financials are usually different from comparable U.S. financials.

ii. Stock prices tend to be more volatile.

iii. Recent instability or significant changes in governments make it difficult to project the financial impact of possible government actions.

iv. Current or recent economic uncertainty such as devaluation or high inflation creates additional uncertainties.

v. The lack of meaningful and credible industry or company statistics complicates the valuation process.

6) **Post-merger Problems**

Beyond the valuation and due diligence stage, cross-border mergers and acquisitions are subject to the same problems that beset domestic deals but with additional complications. Experts estimate that more than half of all mergers and acquisitions fail to produce any benefits for shareholders and may actually destroy value. According to a study by management consultants A.T Kearney, the first 100 days after the merger are the most critical for success. The study which examined multibillion dollar mergers throughout the world and across major industries, found that mergers are often derailed in the implementation phase by lack of speed in appointing top management, lack of specific
goals for the company's future and poor communications. The study also discovered that companies involved in mergers commonly failed to integrate their sales teams and take advantage of cross selling.
Part II  M&A in China

1. Background

1) China’s fast growth and the future

Today, China is the world's fastest developing nation, growing at rates unimaginable 50 years ago, a dramatic transformation no one predicted. Especially since 1978, China entered a new era of reform and gained fast growth. Deng's open-door policy released enormous energies and talents among the Chinese population. It also attracted foreign investments, brought in foreign technology, and increased exports and growth. Per capita income grew at an annual average rate of 8.3%, more than double the rate before 1978. China's share of global output doubled from 5% in 1978 to 11% in 1995. In the last 15 years, Annual GDP growth is over 8%.

From its current low base, economists predict that China's economy has the potential to grow at 5% to 7% a year over the next 20 years, moderating to 3% to 5% in the following 30 years. If it grows at an average of 4% to 6% annually, China will overtake Japan as Asia's largest economy by 2040. Further more, the huge population (over 1.3 billion) makes it the most potential market in the foreseeable future.

Its internal development and external environment determine China's sustainable growth. Internal development mainly comes from continual social, political and economic reforms. Restructuring state-owned enterprises is the key for economic success.

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3 Fortune September 29, 1999 China's Future
Integration with world economy will help China to liberate trade and to attract investment. Becoming a member of WTO will speed up China's growth.

2) **Globalization**

As a powerful instrument for distribution of economic resources, M&A plays an important role in the process of globalisation. Cross-border M&A deals have been numerous and large during the 1990s (Subramanian, Ebrahimi, Thibodeaux, 1992) and are expected to reach new highs due to international privatization trends, reduction in cumbersome industry regulations and redtape, and development of uniform accounting standards by many capital starving nations (Zuckerman, 1993). This tendency gives an idea of where competition for Chinese assets is likely to come from, as well as an indication of the opportunities that are being capitalized on by firms from various regions of the world.

China’s entry to WTO is on the road; it could be a huge potential market and a valuable partner in the global supply chains of multi-national players. Meanwhile, the upcoming competition from foreign competitors forces it to organize and foster its own competent ability through restructuring the existing state-owned companies. On the heels of the dramatical regulatory changes in industry policy, taxation, accounting, and M&A rules, there will be a huge wave of M&A and restructuring in China.

3) **Economic Reform and Privatization**

Started more than twenty years ago, China is continuing its economic reform. The core of the reform is restructuring state-owned companies, including changing the ownership,
industry structure and administrative system. China plans to convert most of China’s 305,000 state companies into shareholding-company by opening them to foreign and domestic investors. Its control will be on strategic industries, such as telecommunications, petrochemicals, high-tech electronics, steel, and aviation. The Chinese Government has selected 1,000 state-owned companies to form the core of China’s modern business conglomerates (Clifford et al, 1997). Traditional unproductive industry needs to enter a new field, and the emerging one needs to enhance their business. Also, China needs to reform its financial system. SOEs(State-owned Enterprises) currently owe about four-fifths of outstanding loans in the state-owned banks; a large part of which is non-performing. While restructures its SOEs, it needs to restructure its SOBs(State-owned Banks) and to establish a new links between the capital users and capital providers.

The basic principle is that economic activities rely on market mechanism rather than on government orders. Through reform, China would have completed three transitions--from a planned to a market economy, from a mainly agrarian to an industrialized society, and from a centralized to a more participatory system of governance.

4) **Development of Stock Market**

The establishment of two stock exchanges (Shanghai Stock Exchange and Shenzhen Stock Exchange) was the symbol of the start of the Chinese Stock Market. In December, 1999, the number of listed companies was 973, the number of trading securities was 1,100, the capitalization of entire stock market was 2.433 billion yuan (trading capitalization is 851 billion yuan, and the daily trading volume was 13.4 billion yuan and
1.8 shares. The stock market provides a good place for M&A transactions, where the value of a company can be very easy to estimate.

One of the features of this emerging market is that the listed companies are restrictive to large and well-performing company. (Most of those are state-owned companies.) This greatly aggravates the competition for “shell” resources for those companies who desperately needs capital. From the viewpoint of business, the listed company is viewed as a kind of precious resource. A new stage for M&A players will appear in China. Shenzhen Stock Exchange is planning a second board exchange that will open mainly for medium and small-sized corporations, especially for high-tech companies. Second Board Exchange will be designed by learning the mechanism from NASDAQ, and is planned to be operating in the beginning of 2001.

2. Review

1) 1985 – 1996 Emerging M&A Activities

Between January 1st of 1985 and December 31st of 1996, 180 M&A transactions with a total value of over $5.3 billion took place in China (Even though 346 transactions took place in the period studied, only 180 of these reported the value of the transaction). Foreign companies were responsible for over 62% of these transactions. Between 1985 and 1990, M&A totalled only $32.1 million; in the last six years (1991-1996) they totalled a remarkable $5.27 billion. Furthermore, over 26% of the total value of M&A transactions took place in 1996. This trend is likely to continue as China continues to
grow and develop (forecasts indicate that the Chinese economy will grow by 8.8% in 1997 and 8.0% in 1998).\footnote{Securities Data Co.Inc}

A sectoral breakdown of M&A transactions indicates the predominance of the manufacturing sector. Just under half of all M&A activity was concentrated in that sector. It was followed in relative importance by the financial sector (18.9%) and services (17.7%).

Two forms of transactions have dominated the sample: acquisition of majority interest (35%) and acquisition of partial interest (34.4%). A relatively low volume of asset acquisitions and mergers in the region can be explained by the transition characteristics of China, as well as legal issues.

2) \textit{1994-1999 M&A of Listed Companies}

The Chinese stock market provides a stage for M&A players. In 1994, Baoan’s acquiring Yanzhong starts M&A activities of listed company. These activities have more economic
meaning than unlisted companies. Comparing to unlisted companies, especially to SOEs, listed companies have some new economic characteristics:

i. All of them abide by general accounting principles, which are very similar to that accepted by business throughout the world;

ii. Most of them are restructured from SOEs, and are trying to pursue profit according to market mechanism, which is different from that followed by SOEs.

iii. All the listed companies are shareholding companies. The ownership structure of these listed companies are completed and are very similar each other. Shares are divided into state-owned shares, preferred shares and common shares. For most companies, state-owned shares are the major part in the ownership structure; and The State-owned Asset Management Institute, which is usually called The Bureau of State-owned Asset Management (BSAM), holds these parts. There are two levels of BSAM, provincial and state. SOEs, other shareholding companies, and private or foreign investors usually own preferred shares. The most distinctive characteristic is that state-owned shares and preferred shares cannot be traded in the stock market right now. Exchange of this kind of shares is accomplished by agreement only. Only common shares can be traded in two stock exchanges.

iv. Most of the listed companies have good performance records and are the leading players in their own industries or in their own provinces. Since The Chinese Stock Market is still in its testing and emerging stages, listing is strictly for good-performance and well-restructured companies. The strict listing rules make “shell” resources precious for those companies that desperately need capital to fund their business.
v. Government still has a great affect on these companies’ activities, not only indirectly through industry policy, tax policy and accounting principles, but also directly through its role as a major shareholder in most listed companies. The Chinese Government view listing is a good way to establish modern entrepreneurial mechanism and to modify debt structure of its SOEs. From a macroeconomic viewpoint, it also hope the market forces and the function of stock market can help to distribute the resources. So the government shadow can be seen everywhere all over the stock market.

Statistics show that, in 1997, 210 listed companies accomplished 270 M&A deals; in 1998, the number of M&A cases in stock market is 624, participated by 389 listed companies; which accounts for half of all the listed companies that year. In 1999, the deals increased to 1,012, an 80% increase from 1998. The M&A wave has been a major characteristic of the emerging Chinese stock market.
3. Characteristics of China’s M&A

1) Types of M&A

According to M&A theories in mature market, Chinese M&A also can be grouped into three categories: horizontal mergers, vertical mergers, and conglomerate mergers. This classification is based on whether M&A is taken place at the same level of economic activity—exploration, production or manufacturing, wholesale distribution, or retail distribution to the ultimate consumer. The element of relatedness is also important in defining economic categories of mergers.

i. Horizontal Mergers

A horizontal merger involves two firms operating and competing in the same kind of business activity. The advantage of horizontal merger is: 1. A large firm may have the benefit from economies of scale. 2. It is a better way to acquire market shares. The disadvantage of horizontal merger is: 1. It may have negative effect on competition. 2. A firm may overly concentrate on a single industry, which may increase the industrial risk. Horizontal mergers are good methods of restructuring some of Chinese industries, such as automobile, motorcycle, electrical equipments, beer and pharmaceuticals. Most of these industries are uneconomic of scale, over competitive, and structurally irrational. For example, the Chinese automobile industry has 110 manufacturers, 600 re-formulating makers and more than 3,000 parts makers. Most of them have no economies of scale, and cannot reach their full capacity. In 1996, Chinese automobile capacity was 2.5 million, but the actual output was only 1.46 million vehicles, about 58.25% of its full capacity.
Two noticeable cases that illustrate horizontal mergers are M&A of Yunnan Baiyao (0538) and Konka (0016). In 1996, Yunnan Baiyao acquired three pharmaceuticals that produce the same products as it did, forming Yunnan Baiyao group. Its strategy reduced the number of competitors and extended market shares. Konka’s purpose is to penetrate the local market by taking over several local TV makers. Its market shares increased from 9% in 1995 to 13% in 1996.

**Cases of Horizontal M&A in Chinese Stock Market**

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>M&amp;A Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>0013</td>
<td>Shenzhen Petrochemical</td>
<td>1996.10</td>
<td>Acquired Nanshan Petrochemical</td>
</tr>
<tr>
<td>0039</td>
<td>China Int Marine Container</td>
<td>1994-96</td>
<td>Investing 45.3 m to acquire 61.89% of Nantong container (1994); Acquired Xinhui Dali container co. (1995.12); Acquired 30% of shares of Shanghai Pudong Container co. (1996.10)</td>
</tr>
<tr>
<td>0047</td>
<td>SZ Overglobe Development</td>
<td>1996.08</td>
<td>Acquired 75% of Hongkong Qiming Real Estate Co.</td>
</tr>
<tr>
<td>0538</td>
<td>Yunnan Baiyao</td>
<td>1996.08</td>
<td>Invested and owned 51% shares respectively in 3 pharmacies: Dali, Wenshan and Lijiang manufacture.</td>
</tr>
<tr>
<td>0553</td>
<td>Hubei Sanonda</td>
<td>1996.09</td>
<td>Acquired Qichun pharmacy and Jiangling Pharmacy.</td>
</tr>
<tr>
<td>0559</td>
<td>Wanxiang Qianchao</td>
<td>1996.10</td>
<td>Acquired 60% of Zhejiang Wangxiang co.</td>
</tr>
<tr>
<td>0570</td>
<td>Changhai co., Ltd</td>
<td>1994-96</td>
<td>Invested and Controlled Changyin, Changwan, Changchun and Changhai Qifu co., Ltd</td>
</tr>
<tr>
<td>0596</td>
<td>Anhui Gujing Distillery</td>
<td>1996.11</td>
<td>Acquired 80% of Anhui Doublehappiness vine Co., Ltd.</td>
</tr>
<tr>
<td>Code</td>
<td>Company</td>
<td>Year</td>
<td>Action Description</td>
</tr>
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<td>-----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>0705</td>
<td>Jiezhang Zhenyuan</td>
<td>1997.07</td>
<td>Acquired Saoxing Pharmacy</td>
</tr>
<tr>
<td>0766</td>
<td>Tonghua Goldhorse</td>
<td>1997.07</td>
<td>Acquired shenzhen Tongan Pharmacy by dominating 66.25% shares</td>
</tr>
<tr>
<td>600600</td>
<td>Qingtao beer</td>
<td></td>
<td>Acquired Xian Hands Beer Co. and Yangzhou Beer Co., Ltd</td>
</tr>
<tr>
<td>600614</td>
<td>Shanghai tape</td>
<td>1996</td>
<td>Acquired Wuhan Tape Co., Ltd (1996.05) and Nanchang Tape Co., Ltd</td>
</tr>
<tr>
<td>600623</td>
<td>Shanghai Tie</td>
<td>1996.12</td>
<td>Invested 19.3 million to acquire Haiko tie Co., Ltd</td>
</tr>
<tr>
<td>600688</td>
<td>Shanghai Petrochemical</td>
<td>1996-97</td>
<td>Acquired Shanghai Jinyang Co., Ltd (1996.08) and Jiezhang Co., Ltd (1997.06)</td>
</tr>
<tr>
<td>600818</td>
<td>Shanghai Yongjiu bicycle</td>
<td>1996.02</td>
<td>Acquired Suzhou bicycle Co., Ltd</td>
</tr>
<tr>
<td>600844</td>
<td>Shanghai Hero</td>
<td>1996.12</td>
<td>Acquired 28% of Yongshen Co., Ltd</td>
</tr>
</tbody>
</table>

ii. Vertical Mergers

Vertical mergers occur between firms in different stages of production operation. There are many reasons why firms might want to be vertically integrated between different stages. There are technological economies such as the avoidance of repeated transaction costs. Transactions within a firm may eliminate the costs of searching for prices, contracting, payment collecting, and advertising, and may also reduce the costs of communicating and of coordinating production. Planning may be improved due to more efficient information flow within a single firm. The efficiency and affirmative rationale of vertical integration rests primarily on the costliness of market exchange and contracting.

Shenzhen Zhenye Co., Ltd, a leading real estate firm in Shenzhen, in 1997, acquired vertically two construction companies, Tehao Construction Co., Ltd and Jianye
Cases of vertical M&A in Chinese Stock Market

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>M&amp;A Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>0006</td>
<td>Shenzhen Zhenye</td>
<td>1997.03</td>
<td>Acquired Tehao Construction Co., Ltd and Jianye Construction Co., Ltd.</td>
</tr>
<tr>
<td>0058</td>
<td>ShaiGe Shares</td>
<td>1996.11</td>
<td>Acquired 30% shares of Zhongkan Glass Co., Ltd.</td>
</tr>
<tr>
<td>0510</td>
<td>Jinlu Group</td>
<td>1995.10</td>
<td>Took over Deyan Electricity Co., Ltd.</td>
</tr>
<tr>
<td>0596</td>
<td>Gujinggong</td>
<td>1996.11</td>
<td>Took over Double Happiness, Xuedi and Penglai vine Co., Ltd.</td>
</tr>
</tbody>
</table>

iii. Conglomerate Mergers

Conglomerate mergers involve firms engaged in unrelated types of business activity.

Among conglomerate mergers, three types have been distinguished. Product-extension mergers broaden the product lines of firms. These are mergers between firms in related business activities and may also be called concentric mergers. A geographic market-extension merger involves two firms whose operations have been conducted in non-overlapping geographic areas. Finally, the other conglomerate mergers involve unrelated business activities.

Advantages of conglomerate mergers are 1. Risks are reduced by diversifying business. 2. Costs are reduced to entry a new industry. 3. Profits may be increased by finding new growth opportunities. 4. One way of efficiency of internal resource. The backward of conglomerate mergers are 1. Facing the challenging of uneconomies of scale. 2. Maybe higher administrative expenses. 3. Taking the risk of entering a new industry.

Shenzhen Jintian Co., Ltd. (0003), primarily focused on real estate, trade and textile, took over Grayhound Buse line Co., Ltd in 1996 and acquired Linzou Electricity Co., Ltd in
1997. This conglomerate mergers allows Jintian Co., Ltd to step into the transportation and infrastructure industry.

**Cases of Conglomerate M&A in The Chinese Stock Market**

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>M&amp;A Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>0003</td>
<td>Shenzhen Jintian</td>
<td>1996.12, 1997.05-08</td>
<td>Acquired 50% of Greyhound; took over Linzou Electricity Co., Ltd and Qinghai Electricity Co., Ltd</td>
</tr>
<tr>
<td>0009</td>
<td>Shenzhen Baoan</td>
<td>1996.08</td>
<td>Acquired dominating shares of Longzhou shares Co., Ltd.</td>
</tr>
<tr>
<td>0048</td>
<td>Kangdaer</td>
<td>1996.08</td>
<td>Invested 80 million to acquire 90% shares of Shenzhen Mawan Electricity Co., Ltd.</td>
</tr>
<tr>
<td>0691</td>
<td>Huandao Industrial</td>
<td>1996.12</td>
<td>Acquired Shanya Yalongwan Ocen world Co., Ltd</td>
</tr>
</tbody>
</table>

So far, horizontal and vertical mergers are the main types of Chinese M&A activities. As China is opening to the world, conglomerate mergers will be a good way to form Chinese Conglomerates to compete with multi-international companies.

2) **Strategic Alternatives - Six Basic M&A Forms**

Chinese M&A transactions fall into six basic categories based on the changes of ownership of the firm: asset acquisition, investment for majority interest, stock acquisition by agreement, asset exchange, stock acquisition through secondary market, and restructuring. These forms are slightly different from that of M&A in a developed market. They are mainly determined by the distinctive ownership structure of the Chinese listed firms. To form and implement M&A strategy, the pros and cons of each form in a context of both Chinese economy development stage and a specific business cycle must be understood.
Also, each of these transactions has different consequences with respect to legal obligations, acquisition procedures, and tax liabilities. While the exact nature of these consequences differs from case to case, knowledge of the types of transactions that normally gives managers a better idea of what to be prepared for when contemplating a M&A transaction.

i. Asset Acquisition

In an asset acquisition, an acquiring company purchases part or all of the assets of the target. The target remains legally in existence after the transaction, although it may be liquidated after a major asset sale to return money to the shareholders.

The advantage of asset acquisition is that the target firm becomes a branch or a subsidiary of the acquiring firms. The acquiring firms avoid interference from other shareholders to integrate and restructure the target firm. The disadvantage is that the merger and post-merger require more funds. This is not a cost effective method. Once the integration fails, the risk is very high. Asset acquisition is suitable for the following situations. 1. The target firm is small and the price of M&A is relatively low; 2. The acquiring firms have plenty of funds. Their strategy is to achieve the land or other resources and planning to invest heavily; 3. The acquiring firms have a specific plan to restructure a target firm and transform it to a whole-owned subsidiary; 4. Constraints for the payment of this deal is not so severe.

The typical case is Guangdong Meiya paid $16.6 million to take over Changsha Textile co., Ltd at the end of 1996. The price is the value of total assets of Changsha Textile co., Ltd.

**Cases of Asset Acquisition in Chinese Stock Market**
<table>
<thead>
<tr>
<th>Symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>M&amp;A Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>0003</td>
<td>Shen Jintan</td>
<td>1997.05</td>
<td>Acquired Linzhou Electricity. Inc</td>
</tr>
<tr>
<td>0039</td>
<td>Shen Zhongji</td>
<td>1995.12</td>
<td>Takeover Xinhui Dali Container Co.</td>
</tr>
<tr>
<td>0059</td>
<td>Liaotong Chemical</td>
<td>1997.01</td>
<td>Acquired Jinci Natural Gas Co.</td>
</tr>
<tr>
<td>0508</td>
<td>Qiong Minyuan</td>
<td>1996.10</td>
<td>Acquired Beijing Kachi Telecom Co.</td>
</tr>
<tr>
<td>0510</td>
<td>Sichuan Jinlu</td>
<td>1995.10</td>
<td>Acquired Deyan Electricity Co.</td>
</tr>
<tr>
<td>0529</td>
<td>Yue Meiya</td>
<td>1997.01</td>
<td>Acquired Hunan Textil Co.</td>
</tr>
<tr>
<td>0553</td>
<td>Shalongda</td>
<td>1996.09</td>
<td>Acquired Qichun Pharmacy Co.</td>
</tr>
</tbody>
</table>

ii. Investment for Majority Interest

Investment for majority interest is a cost-effective M&A strategy. The acquiring firm’s investment becomes equivalent to the shares of the target firm. The purpose of this investment is not to gain from the investment but the ownership of the target firm. The nature of this strategy is: 1. Target’s ownership in the new firm is determined by the value of target firm’s net assets; 2. Acquiring ownership in the new firm is determined by the value of new investment in the new firm; 3. After mergers, the target becomes the subsidiary of the acquiring firm; or acquiring firms own majority shares of the target.

A good example is Konka’s M&A strategy. Konka invested $18 million, accounting for 60% shares; and Mudanjiang Tv Co. invested $11 million in the forms of land, plant and equipment, accounting for 40% shares. Through investment, Konka acquired the target and benefited in the majority interest of the new firm.

The advantages of investment for M&A’s: 1. It is a cost-effective M&A strategy. By investing relatively small funds, the acquiring firm can enjoy the majority interest of the target; 2. Shareholders of the target usually have a very good relationship with local business agents and local government; this helps the new business to run locally and
smoothly. The disadvantage of this form is that there are more constraints from various shareholders than in asset acquisition, where the ownership structure is very simple.

**Cases of Investment for Majority Interest**

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>Portion of shares</th>
<th>M&amp;A Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>0009</td>
<td>Shen Baoan</td>
<td>1994.12</td>
<td>53.85%</td>
<td>Acquired Mayinglong Pharmacy Co.</td>
</tr>
<tr>
<td>0013</td>
<td>Shen Petochem</td>
<td>1996.10</td>
<td>51%</td>
<td>Acquired Nanshan Petrochemical Co.</td>
</tr>
<tr>
<td>0016</td>
<td>Konka</td>
<td>1997.07</td>
<td>40%</td>
<td>Invested to Form Ankonka Co.</td>
</tr>
<tr>
<td>0538</td>
<td>Yunan Pharmacy</td>
<td>1996.08</td>
<td>51%</td>
<td>Invested to three Pharmacy</td>
</tr>
<tr>
<td>0571</td>
<td>Suchangcai</td>
<td>1996.09</td>
<td>60%</td>
<td>Invested to establish Changwang Co.</td>
</tr>
<tr>
<td>0578</td>
<td>Qinbai</td>
<td>1997.06</td>
<td>90.6%</td>
<td>Invested 50 million to control Qinghai Security Co.</td>
</tr>
</tbody>
</table>

iii. Stock Acquisition by Agreement

Stock acquisition by agreement means that the acquiring firm acquires part or whole shares of the target through an agreement between both sides. Shares in such kind of transactions mainly refer to state-owned shares and preferred shares.

Because most of the listed companies have state-owned shares, such transaction has an important effect in restructuring SOEs and is subject to severe regulations. For example, Current laws state: 1. Preferred shares are not allowed to be traded within three years; 2. Management’s shares are not allowed to trade within their tenor; 3. State-owned shares are not allowed to be sold to foreign investors; and 4. Other regulations. Therefore, such kind of transactions mainly occurred among listed companies and mainly between listed companies and other state-owned shareholders. The sellers want to cash out the no-traded shares, reduce debt, adjust investment structure and reallocate resources. The motives for buyers are: 1. The acquiring wants to achieve dominating shares and to restructure the
target. 2. The acquiring wants to buy the “shell” source and want to be listing. 3. Big shareholders are not satisfied with the performance of the target. For example, Eastern Computer, the first shareholder of Yongzhongyuan (0517), hopes to bring its management, technology, and sales channels to the target; In May 1996, Eastern Computer increased its shares to 28% by acquiring the preferred shares, and became the dominating shareholder of Yongzhongyuan.

However, a question has been raised due to its no-traded nature – how to value such kind of shares. Even though most transaction have already taken factors into consideration such as net asset per share, return on asset, return on investment capital, market price and PE ratios, the actual price is usually a little bit higher than that of the net equity. Because this approach of valuation ignores the value of brand name and of other intangible assets, most of the firms are greatly undervalued.

Cases of Stock Acquisition by agreement

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Target</th>
<th>Acquirer</th>
<th>Time</th>
<th>Pre-M (EPS)</th>
<th>Post-M (EPS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0008</td>
<td>Shen Jinxing</td>
<td>Shanmao Holding Co.</td>
<td>1997.04</td>
<td>- $0.23</td>
<td>$0.00</td>
</tr>
<tr>
<td>0504</td>
<td>Ganao Industrial</td>
<td>Hainan Guoban</td>
<td>1997.07</td>
<td>$0.01</td>
<td></td>
</tr>
<tr>
<td>0518</td>
<td>Susanshan</td>
<td>Shenzhen Century Co.</td>
<td>1996.12</td>
<td>Suspended</td>
<td>$0.10</td>
</tr>
<tr>
<td>0556</td>
<td>Qiongnanyan</td>
<td>Hainan Success Co.</td>
<td>1996.04</td>
<td>-$0.17</td>
<td>$0.304</td>
</tr>
<tr>
<td>600609</td>
<td>Yiqi jinbei</td>
<td>Yiqi</td>
<td>1995.02</td>
<td>-$0.261</td>
<td></td>
</tr>
</tbody>
</table>
iv. Asset Exchange

As a distinctive M&A forms, asset exchange usually occurs when listed companies exchange bad quality assets for equivalent good quality assets. It always happens between listed companies and their parent companies. Motives for this transaction is usually as following. 1. The parent companies want to keep the “shell” resources in order to continually raise capital through stock market. Because there is a very strict requirement for second issue, listed companies must have a performance improvement within a very short period in order to meet the requirements. Asset exchange is the best way to improve the profits. With such motives, there are some manipulating problems in the transaction. 2. Parent companies want to specialize in a certain industry. For example, Harbin Eastern Group sold its pharmaceutical, travel and manufacturing subsidiaries,
while buying several firms major in construction designing, construction monitoring and decorating. The purpose was to strengthen the value chain of its real estate business.

### Cases for Asset Exchange

<table>
<thead>
<tr>
<th>symbol</th>
<th>Abbreviation</th>
<th>Time</th>
<th>Target</th>
<th>Acquiring</th>
</tr>
</thead>
<tbody>
<tr>
<td>0503</td>
<td>Haihong Holding</td>
<td>1994.12</td>
<td>$10.4 million Preferred Shares</td>
<td>87.52% of shares of Dongtinghu Co.</td>
</tr>
<tr>
<td>600615</td>
<td>Fenghua Pen</td>
<td>…</td>
<td>Asset of Guanshenyuan</td>
<td>…</td>
</tr>
<tr>
<td>600810</td>
<td>Knight Industrial</td>
<td>1997.05</td>
<td>Shares of Shenma Carpet Co.</td>
<td>A project</td>
</tr>
</tbody>
</table>

Some listed companies also spin off their assets to improve their financial structure or to change business strategy. For example, Gongdong Jinman (0588) in November 1996 spined off its subsidiary Yaoping Develop Co., Ltd in $20.43 million. The purpose was to focus on its main business.

v. Stock Acquisition through Secondary Market

In order to compare to the acquisition through agreement, I will call this form as “Stock acquisition through secondary market” rather than as “hostile take over”. Stock acquisition started from September 1993, Shenzhen Baoan (0003) acquired Shangai Yanzhong (600601) by buying more than 20% its shares through secondary market.

Unlike a mature market, Stock acquisition through a secondary market is not the main stream in Chinese stock market. Compared with other kind of M&A forms, stock acquisition has the following disadvantage: 1. The cost is very high. It has to pay market
premium over the net equity. Due to the regulations, the acquiring has to make a public announcement after each 2% increase of shares. This always makes the market price very volatile. This is more expensive than stock acquisition by agreement that only pays a little premium over the net equity. 2. It is time consuming and makes integration difficult. Stock acquisition is very similar to hostile take over; it faces the possible resistance from the original shareholders and management. 3. Due to the nature of the ownership structure of most Chinese listed companies, only a few companies are eligible for taking over in secondary market. For most listed companies, the majority of these shares are state owned, while the common shares make up the smaller part. State-owned shares are not allowed to trade right now; the best way to buy them is to negotiate with the government or government agency. This is also why acquisition is more popular than take over through secondary market.

vi. Restructuring State-owned Shares

Restructuring state-owned shares is a very distinctive form of M&A in Chinese practice. It means that the government (usually the first shareholders) reallocates the asset from the target to the acquiring. The shares are state-owned. The purpose is to improve the efficiency of the performance of the acquiring firms. The most remarkable case is the establishment of China Petrochemical Group; it acquired four petrochemical firms that belong to different state-owned shareholders. They are Yizen Petrochemical Co., Ltd, Jinling Petrochemical Company, Yangtze Petrochemical Group, and Nanjing Petrochemical Company.

The advantages of this form are: 1. Bad performance firms can be restructured by bringing them into the management of giant state shareholding companies. Meanwhile,
this form of M&A can strengthen the competitive advantage of state shareholding companies and help to foster growth in the leading conglomerate. 2. Reallocating state-owned shares to another business entity can increase the value of state-owned asset, can reduce the risk and can improve the industry structure.

This approach is applicable for the following situations. 1. Shareholders of state-owned shares are the listed companies that belong to government. 2. There is a demand to form a giant state shareholding company. 3. The target is bad performing and badly needs the help from big company which has a good management, technology and business strategy.

The six M&A forms are mainly determined by the ownership structure of the target and the acquiring. As china’s economic reform continues, some new forms may appear. But in a foreseeable future, ownership is the most important factor in determining the M&A strategic alternatives. A good M&A strategy should not only deal with such complexity, but also find opportunities within the uncertainty.

4. Valuation and Pricing

There three approaches to value a firm in M&A practice: Comparable model, Discount model and the Option model. The most common used approach in china’s M&A practice is the discount model. Further, there are three forms for discount model: Dividend discount model (DDM), Free cash flow to equity (FCFE) and Free cash flow to firm model (FCFF). Here, I will take a two-stage FCFF model to describe the valuation of a firm.
Assume that company A is going to take over firm B. Firm B has an extraordinary growth in first five years and then the growth will decline to a constant rate. The valuation of firm B will follow these steps. 1. Estimate the free cash flow each year for five years and the terminal value at the end of year five; 2. Estimate weighted average cost of capital (WACC); in other words, it is the investor’s required return; 3. Calculate the present value of the cash follows and get the value of the firm; 4. Make a decision toward either cash acquisition or stock acquisition.

1) \textit{Estimate FCFF}

\[ \text{FCFF} = \text{EBIT}(1-\text{Tax rate}) - (\text{Capital Expenditure} - \text{Depreciation}) - \text{Change in working Capital}. \]

Suppose the sales for firm B is $1 million, and other inputs are following:

<table>
<thead>
<tr>
<th>Inputs</th>
<th>Year 1 – 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual growth of sales</td>
<td>10%</td>
</tr>
<tr>
<td>Profit Margin</td>
<td>20%</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>30%</td>
</tr>
<tr>
<td>Cap.ex -- Dep</td>
<td>20%</td>
</tr>
<tr>
<td>Change in Wor. cap</td>
<td>10%</td>
</tr>
</tbody>
</table>

\[ \text{CF1} = 100*(1+0.1)*0.2*(1-0.3) - (110 - 100)*(0.2+0.1) = 12.40 \]

As the same rules, we can get

\[ \text{CF2} = 13.64; \text{CF3} = 15.00; \text{CF4} = 16.50; \text{CF5} = 18.15 \]

2) \textit{Estimate Weighted Average Cost of Capital (WACC)}

1) Cost of debt
Kd = Cost of debt = Yield of debt * (1-Tax Rate) = 10% (1-30%) = 7%

2) Cost of equity

Ke = Rf + β(Re –Rf)

Where

Rf = Risk free rate
Re = Return on Market

β = Correlation Coefficient between the stock and the market
Re – Rf = Market risk premium

Suppose firm A and firm B has the same debt structure; D/(D+E) = 40% and E/(D+E) = 60%. Also β for firm A and firm B is 1.0 and 1.33 respectively. So

Ke of firm A = 10% + 1.0*(15%-10%) = 15%
Ke of firm B = 10% + 1.33*(15%-10%) = 16.7%. And

WACC of firm A = 10%*0.4 + 15%*0.6 = 13%
WACC of firm B = 10%*0.4 + 16.7%*0.6 = 14%

13% and 14% are the discount rate for firm A and firm B respectively.

3) Calculate the value of the firm

Use 14% as discount rate to calculate the value of firm B ($ Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>FCFF</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>12.40</td>
<td>10.88</td>
</tr>
<tr>
<td>2</td>
<td>13.64</td>
<td>10.50</td>
</tr>
<tr>
<td>3</td>
<td>15.00</td>
<td>10.12</td>
</tr>
<tr>
<td>4</td>
<td>16.50</td>
<td>9.77</td>
</tr>
<tr>
<td>5</td>
<td>18.15</td>
<td>9.43</td>
</tr>
</tbody>
</table>
The outstanding debt of firm B is $10 million, and then the price for the equity should be:

\[
\text{Value of the firm – Value of debt} = \$210 - \$10 = \$200.
\]

Firm B has 100,000 shares outstanding, and the value per share should be $20.

4) **Estimate the possibility of buying with cash**

Once the value of the target is decided, the following step is to estimate the acquiring firm’s capability to pay with cash. This capacity is determined by its capability to pay debt. For example, firm A’s total debt capability is $3 million, and the total debt of A and B is $1 million while the outstanding part is $0.5 million. The most capable cash payment for firm A is $2.5 million. In this case, Firm A can use cash to buy firm B. If its cash capability is not enough to pay $2 million, it may select to issue stock to acquire firm B.

This is a basic model to value a firm. In practice, there are so many factors to be considered that it is very difficult to price the firm. For example, anti-takeover and other resistance from the target always make the price greatly deviate from its intrinsic value.
5. Accounting Methods

China’s M&A practice also employs two most popularly used accounting methods – purchase accounting and pooling accounting, as well as following some specific rules recommended by China’s Professional Accounting Organization.

In purchase accounting, an acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed. All identifiable assets acquired and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition. Assuming a taxable transaction, the new stepped-up basis is depreciable for tax accounting. The excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill. This goodwill account is required to be written off, for financial reporting, over some reasonable period.

When purchase accounting is employed, reported net income is usually lower than under pooling of interests accounting. This is because of an increased depreciation charge or amortization of goodwill. However, cash flow will be higher under purchase accounting if any of the depreciation or amortization is tax deductible.

Pooling-of-interests accounting permits two companies merging in a stock-for-stock transaction to combine their balance sheets following consummation of the merger at
their existing book values and without creating goodwill as a result of the merger.

However, to achieve such results, a number of conditions have to be satisfied. This method of accounting has been deemed advantageous because it avoids long-term annual write-downs of goodwill, which, in turn, reduce reported corporate earnings. The accounting profession has been criticized because the same transaction economically will produce substantially different accounting treatment and different reported corporate earnings depending on whether or not the conditions for a pooling are met.

Most of China’s M&A activities occur in forms of assuming liabilities or investing net equity to the target. In order to regulate M&A accounting, Ministry of Finance of China in August 1996 issued “Regulations on M&A Accounting Methods”; some points are summarized below.

1) The value of the firm must be estimated by charted professional accounting organization.

2) The minimum price of the firm must be determined according to the value of defined net equity, and takes into account of other factors such as management, technology, employees, asset and financial statements.

3) If the target does not exist after merger, the excess of cost paid by the acquiring should be treated as goodwill and should be write-down annually. If the target still exists as a legal entity, the cost should be treated as long-term investment.

4) The funds from the selling of a firm and other gains from the transaction are owned, after meeting the transactions fee, by government or government agency. It can be used as reinvestment.
Currently, many SOEs have negative earnings and debt ratio is very high. Restructuring firms’ debt structure is the key for successful merger. For example, in dealing with the problems between the firms and the banks, a good way is to exchange banks’ debt for shares of the firm. This not only can help to resolve the troubles between firms and banks, but also can push forward M&A and improve firms debt structure.

6. Legislation on Information Disclosure

Information disclosure is mainly regulated by “Regulations on Stock Issue and trading” (1992) and “Securities Law” (1997).

According to “Regulations”, investors who directly or indirectly own 5% of a listed company must make an information disclosure within three trading days. And also must make information disclosure whenever every 2% increase or decrease in this shares. In September 1993, Shenzhen Baoan acquired Shanhai Yanzhong. Professions criticized that 1) 5% and 2% benchmark was too low to make M&A time-consuming. And 2) The definition of term “Indirect or direct” was not clear. The explanation is that in the emerging stage, the regulation are trying to protect numerals individual investors, which give them more time to evaluate the information, especially under the situation that information communication is not so good.

The later issued “Securities law” increased the 2% benchmark to 5%; an investor must own shares of a listed company when it must make information disclosure. This greatly shortens the period from the announcement to tend offer. And it also quickens M&A process in the secondary market, especially beneficial for the acquiring. However,
“Securities Law” reserves the original regulations on reporting pattern and the pattern of information disclosure.

Another noticeable change is that “Securities Law” omits the regulation that individual investors are not allowed to own more than 0.5% shares of a listed company; and it also treats both shareholders of common share and shareholders of preferred shares as “Investors”, who have equal rights and must realize equal obligations.

7. Problems with and Suggestions on China’s M&A

1) Legislation

Even though China has several laws and administrative regulations to guide M&A practice, there are many problems that still need to be answered. Each department and each region has its own regulations, which make M&A lack an uniform pattern to follow. The bidding of 5 million preferred shares of Ningbo Huatong caused several lawsuits. “Securities Law” has demanded the avoidance of related beneficiary, but in practice, it is not fully conducted. Questions about government roles, the roles of investment banking and asset evaluation are still waiting to be answered. The need to further reform SOEs by employing shareholding mechanism and to development of the stock market require us to make specific laws on M&A as soon as possible.

2) Asset Evaluation

The determination of the value of the target firm is the key for a successful M&A. It is not only the sign of a fair trading, but also the indicator whether state-owned assets are
devalued. The major problems in asset evaluation are: 1. Evaluation lacks of common rules among different industries and among different regions. This affects the evaluations’ activity and fairness. 2. Merger between a listed company and its parent company is somewhat “unfair”; especially under the cases when parent exchange bad assets of listed company with good ones, when parent companies infuse good assets into listed company, and when parent companies go to list by borrowing the “shell” resources. 3. The evaluation agency sometimes undervalues or overvalues land and other intangible asset. 4. The target deliberately demands to undervalue the firm.

The most widely used approaches are the comparable model, the discount model and the option model. But evaluation should also take other factors into account, such as the industry, business cycle, management, employees, goodwill, and technology, etc. The evaluation agency should maintain objectivity, fair and independency. It should represent the benefit of the owner of assets, while not damaging other shareholders’ interest.

3) Government’s Role

Problems with the government’s role in M&A practice are: 1. The government actually controls state-owned shares. No matter whether listed companies either are the target or the acquiring, the government plays an important role in M&A practice; 2. Cross-industry and cross-region mainly come from different tax polices as well as regional and industrial protectionism; 3. Evaluation agency is usually nominated by governments; 4. “Support” from government for bad-performance firms generates unfair trading; 5. Government participate too much in areas such as payment, debt affair and surplus employee. In terms of an enterprise’s conduct, the major players should be the acquiring firms, the target and
intermediate. The government should be responsible for establishing regulations, to create a good environment and to provide services.

4) Information Disclosure

Information about M&A may cause the market price to be volatile. The major problems are:

1. M&A activities are accompanied by market manipulation. There are signs that institutional investors take advantage of the trading by manipulating M&A information;
2. Rumors are diffused in the market before the public announcement of the information. Sometimes information are false;
3. Information about related trading is not sufficient;
4. Individual investors are not rational enough to scrutiny the information.

Listed companies should abide by the requirements on time, range and pattern to disclose information; and investors should be trained to be reasonable and rational.

Monitoring is the key to keep the fair in stock market.

5) Policies

In order to push forward M&A activities of listed companies, Local and state government should design a series of policies to encourage listed company's M&A activities. These policies include: industry policy, tax policy, policy on restructuring and policy on social support system. The most important are policies concern industry, debt restructuring and social insurance.

i. Industry policy plays a very important role in M&A activities. Horizontal merger and vertical merger are the main stream in current M&A practice. It can help to form conglomerate and leading company in a certain industry; and it should have
the following tendency in encouraging mergers. 1) Select industrial leading companies to list in forms of merger and in forms of conglomerate; 2) Encourage listed companies to acquire medium and small size firms, thus improving industry structure and the efficiency of the firms. 3) Allow listed company to secondly issue to raise the capital for merger; 4) Give some privilege to some industry in terms of tax rebate and loans.

ii. The target usually has a bad debt structure. Exchanging the debt for shares is a good way to restructure the debt and this paves the way to merger.

iii. Policy on social insurance. China currently does not have a completed social support system to protect from unemployment due to economic reform and industrial and firm restructures. From the viewpoint of M&A players, this not their task, they believe it should be taken care of by the government and by the country.

6) M&A for Foreign Investors

Foreign capital can buy "B" shares and "H" shares, which are available to foreign investors only; but it is banned from buying "A" shares and acquiring preferred shares of a listed company. Two cases occurred in China's stock market. In July 1995, Japanese Auto Maker - Suzuki acquired 40.02 million shares, about 25% of shares of Beijing Travelcar co.Ltd; 1996, French Spank Group acquired 25% of Fuzhou Glass Co., Ltd. These two cases raise a lot of questions for foreign investors about acquiring listed company and these questions still don't have answers.

Here are some suggestions. 1. In appropriate time, allow foreign funds to buy state-owned shares and preferred shares while forbidding them to become the dominating
shareholders. 2. Encourage foreign investment to merge with the subsidiaries of listed companies.

7) Risk Control in M&A

Listed Company must monitor and control the risk in M&A. Once the deal fail, the shake is huge. As a main instrument of asset management, M&A is a strategic decision and should get management involved early and fully. 1. Fully understand the business and market of the target and have an enough reasons to align the target with its own strategy. 2. Have a specific plan about the business strategy of the target, integration, reallocation of the management and talent and financial restructuring. 3. Investment banking is the expert. Listed company should rely on investment banking to select the target, establish merger patterns, define the price, find opportunities, and set integration plan, etc. 4. Try to use subsidiary to merger with the target.

8) Financial Resources

There is a conflict in the function of stock market that reallocates the resources; on one hand, there is a strong need to reallocate state-owned assets through M&A; on the other, most listed companies have a high debt ratio due to bad performance. Meanwhile, the profits of listed companies are imbalanced throughout the industries. For example, steel, automobile, textile and real estate generally have a low profit margin. So to raise financial resources, creativity is needed.

i. Allow listed company to issue new shares, common debt and convertible debt to raise capital for merger;
ii. Encourage listed companies to conduct leveraged buyout, which was commonly used by American M&A in 1970s. It is using debt to buy the target and then repays the debt with the cash flow from the target.

iii. Encourage listed company to restructure state-owned shares. The benefit is that it can improve the debt structure of state-owned enterprise, while raising funds for M&A.
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