

PERFORMING DUE DILIGENCE IN PRIVATE EQUITY TRANSACTIONS IN CHINA

By Paul B. Edelberg, Esq.
Murtha Cullina LLP

Performing due diligence for any type of investment or acquisition transaction in China can be difficult. Strategic buyers have struggled with this task for a number of years as U.S. multinationals and private companies have invested in plants, projects, and joint ventures in China. A new wave of investment is about to pour into that country: private equity. Several of the major private equity players in the U.S. are already flexing their financial muscle in China, as Blackstone and Carlyle have shown over the past year. This is a precursor to a new U.S. growth industry.

Why is the due diligence process different for private equity investing? The process is actually quite similar, but the dynamics are different. This article will explore some of the issues private equity firms will face.

General Considerations:

Because private equity investing is more financially driven than strategic investing, the due diligence process has a different focus. Private equity often lacks the efficiencies or cost savings generated from a strategic fit. Private equity firms are looking to streamline existing processes and implement more efficient processes, cut waste, implement or introduce innovation and create value out of the existing business. Every aspect of the target business must be analyzed.

While Chinese companies are becoming more accustomed to foreign due diligence processes, most businesses still do not have the record-keeping, the operational analysis, and the controls in place to conduct the level of due diligence to which foreign private equity firms are accustomed.

Chinese companies are slowly becoming accustomed to the due diligence process. The word “due diligence” is translated in Chinese to mean “authoritative investigation” and is not received by the Chinese favorably due to that negative connotation. Rather, one should approach the subject as learning more about the target’s business so as to create a dialogue.

Chinese culture also does not lend itself to the type of openness which occurs in the U.S. There is a reluctance to disclose information. Confidentiality agreements carry only so much importance.

Nurturing trust and developing a relationship is critically important to doing business in China and should be one of the most important objectives during the due diligence process. Time spent in relationship-building with the key players in the Chinese target company is always worthwhile.

Because the due diligence process is less transparent in China, investors should look beyond the company and its records. Speak to contacts in the industry that might have dealings with the target company. Verify the credibility of the target company's advisor. Identify and contact counterparties, customers and suppliers of the target company.

Financial Due Diligence:

With the exception of some of the larger companies, the books and records of many Chinese companies are not accurately kept or well maintained. It is common practice to keep a second set of books. Chinese companies are accustomed to being asked for both sets of books. The private equity investor should consider sending its accounting team onsite to conduct an onsite audit and to review actual results.

Those companies that do maintain a good set of books often do so in accordance with Chinese GAAP. While investors should be comfortable with companies that use Chinese GAAP, adjustments must be made to conform to U.S. GAAP or to International Financial Reporting Standards (IFRS). Some of the differences between Chinese GAAP and U.S. GAAP/IFRS include the lack of recognition of fair value under Chinese GAAP, the treatment of pre-operational expenses, timing differences, depreciation methods and the failure to use the lower of cost or market inventory valuation method. Investors also should verify that financial accounting entries have been properly made under Chinese GAAP and that related party transactions and off-balance sheet items have been fully disclosed.

Legal Due Diligence:

Legal due diligence can be particularly difficult. Lawyers are not as widely used in China, and many transactions and asset acquisitions are poorly documented. It is not uncommon for a company not to have legal title to assets it is using or for ownership to be unclear. Fortunately, the legal industry in China is growing and taking on more importance. While there is still a wide gap in the quality of legal services, there are a number of quality law firms in China. Nonetheless, due to the nascence of the legal industry, U.S. lawyers can still play a significant role in

monitoring the legal due diligence process, in spotting issues and in retaining and working closely with Chinese legal counsel.

Chinese businesses are heavily regulated. What often can be done in the U.S. unilaterally requires a series of licenses and approvals in China. To form a business, first the form of organization must be chosen and must be approved, a process which can take up to 90 days. A business plan and the amount of equity and debt (“registered capital”) must be approved, and a business license will not be granted until the registered capital is contributed in accordance with the approval. A business license must then be obtained. That business license will cover the scope of work that the new venture will be allowed to conduct. Capital must be maintained in accordance with the approval, and the scope of the business cannot expand beyond the license. The investor must make sure that the target business has all appropriate approvals and licenses and that it is acting within the scope of its licenses. If the business is to be expanded, or if additional capital is to be infused or capacity is to be increased, the investor must determine what additional licenses and approvals are needed.

Operational Due Diligence:

A successful integration plan begins with the due diligence process. Operational due diligence will help determine whether the Chinese company is conducting its business in accordance with best practices and in compliance with all relevant workplace laws. It will help assess whether the company has the capabilities it claims it does and whether it has the capability to produce at the level contemplated after the investment is made.

Private equity investing shares some of the same issues in this regard as does strategic investing. Business is conducted in China differently than in the U.S. In a typical Chinese company, there is one titular head of the company and fewer layers of authority underneath that. Employees are loyal to the one titular head. That person must be on board with the operational changes and layers of control that the private equity investor will implement. Otherwise, there will be resistance to the changes, and implementation will not occur smoothly or at all. This impediment may be more severe for private equity investing than strategic investing since operational changes may be a key to creating the value that the private investor is trying to create.

Certain operational aspects will be readily ascertainable in the due diligence process. Others, such as sourcing from related parties and family members and other side transactions, may be harder to discover. There may be reasons for perceived resistance to the investor’s changes that will not be apparent on due diligence.

Investing in state-owned enterprises that are being privatized in part or full creates its own set of issues. Housing, retirement benefits, social security and

other employee-related expenses unrelated to the business are often provided by SOEs and either must be separated from the target or must be somehow accommodated in the financing structure. Moreover, the existing management in state-owned enterprises is often less motivated than management in privately owned companies in China because of the way the system works. The performance of the existing management team must be scrutinized carefully.

It is crucial to spend time with the target company's senior management team to develop trust, to evaluate their competence, to discuss and understand the parties' respective goals and to discern their willingness to follow your standards and operational model. Ironing out differences and reaching consensus on operational changes during the due diligence process is essential to a successful integration process.

Integrity Due Diligence:

The need for integrity due diligence cannot be overemphasized. It is essential to know with whom one is dealing. Integrity due diligence should include:

- Background checks on the principals of the target company;
- The relationships these principals maintain;
- What other entities they and their relatives control; and
- Their relationships to the government.
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- First, businesses and family relationships are often intricately intertwined in China. The principal and/or his relatives may have other entities that are doing business with, benefiting from, or even competing with the target company. The investor needs to have an understanding of the entire picture. For example, if the principal is not happy with the new venture, he or she could divert business to one of the other entities.
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- Because China is a Communist state, many company officials, particularly in state-owned enterprises, may in fact have a dual role as a government official or be related to one. Not knowing this information could inadvertently result in a violation of U.S. laws, such as the Foreign Corrupt Practices Act.
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- There is scanty public information on most businesses and individuals. A good investigative firm will discreetly conduct private investigations.
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- Conclusion:
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- Thorough due diligence can avoid problems later. However, an investor is dealing with a company halfway around the globe, with a different and unfamiliar

culture and with a system that is not transparent. Investing in China is not for the lighthearted. One of the best precautions is to spend substantial time upfront building relationships. This will lead to more open disclosure and a more cooperative relationship and better understanding.