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## Helping China's companies master **global M&A**

*As they go global, their hardest challenge is to integrate the management of their domestic and foreign businesses.*

### **Article at a glance**

Chinese companies are making acquisitions abroad to win access to technology, raw materials, brands, and new markets.

They have been fairly successful in the developing world but are struggling to turn around their sometimes loss-making assets or second-tier brands in Western markets.

One of the hardest challenges is to integrate the management of domestic and acquired businesses.

The keys to success include hiring a chief executive in the local market of the acquired company and actively managing the differences between Chinese and Western business cultures and practices.

**Martin Hirt and Gordon Orr**

**While multinational corporations** continue to expand in China, Chinese companies are going overseas: they are making acquisitions and forming alliances to win access to raw materials, technology, and consumer brands, as well as new markets that could help them realize their growth aspirations.

So far, the quest to acquire foreign mining, oil, and gas assets has dominated the buying spree. Chinese companies have picked up a wide range of assets, though often at sizable premiums, and run them successfully, particularly in emerging markets. But Western markets have been harder to crack. Some Chinese bids to take over raw-material assets and consumer goods companies have failed, partly because of opposition from Western stakeholders. By contrast, China Mobile Communication's last-minute exit, after months of negotiations, from a deal to purchase Millicom International Cellular highlights the difficulties Western companies face in making deals with their Chinese counterparts. In some of the deals that *have* gone through, Chinese acquirers are clearly struggling—though it is still early—to turn around the sometimes loss-making assets or second-tier brands they have bought. The Chinese home electronics company TCL, for instance, attributed its net loss of 320 million renminbi (\$40 million) in 2005 to acquisitions in France during the previous year, when it bought most of Thomson's TV unit and Alcatel's mobile-phone unit.

Although some skeptics question whether Chinese businesses can succeed in their forays into Western markets, they do have some advantages—including cheap finance from Chinese state-owned banks—in competing with Western bidders. They also often have a good position to cut costs at acquired companies if they can shift the manufacturing to mainland China.

Against these pluses are a number of sobering challenges. Turning around troubled assets is tough even for experienced acquirers with first-

class M&A skills and deep local knowledge; Chinese companies lack both. With little international experience to guide them, they must not only select the right partners or acquisition targets but also manage often skeptical regulators, unions, and other stakeholders before, during, and after a deal. They also have to globalize their branding, supply chain, and go-to-market skills and get to grips with unfamiliar environments where business issues and solutions often differ from those prevalent in China.

When we talk with seasoned Chinese business leaders, they mention all these challenges. But the question at the top of their minds is often how to integrate the management of an acquired company to bridge the geographical and cultural gaps between it and the Chinese corporate center. Mastering integration is a prerequisite for success because much of the value in many acquisitions comes from combining China's advantageous cost position with the brand, technology, and other assets of a Western business.

The doubts of some market watchers are understandable. We, however, believe that Chinese companies can bridge the gap between East and West. Those capable of accelerating the process will dramatically increase their chances of long-term success in global markets.

**Going global—a strategic imperative**

The computer maker Lenovo's \$1.35 billion acquisition of IBM's personal-computer unit, in May 2005, made Lenovo the world's third-biggest maker of PCs. This move has caught the greatest degree of attention in what is still a relatively small tide of outbound Chinese direct investment (exhibit). But the official data—\$5.5 billion in 2004 and an estimated \$7 billion in 2005—do not include investments (such as the IBM acquisition) made by Chinese subsidiaries listed in Hong Kong or overseas exchanges. We estimate that actual outbound foreign direct investment is two to three times higher than the official figures. China is therefore a material, if not yet massive, new force in the global market for business assets.

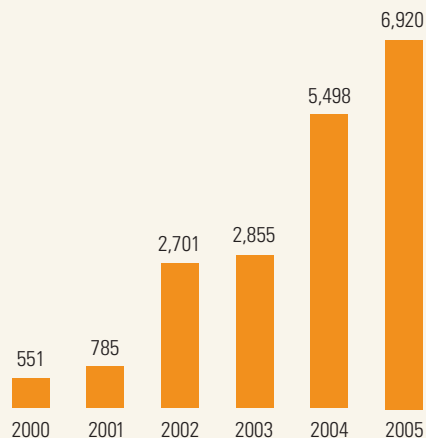
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Exhibit

### Underestimated

Official figures for Chinese outbound foreign direct investment (FDI) from China's Ministry of Commerce,<sup>1</sup> \$ million

CAGR,<sup>2</sup> 2000–05 = 66%



#### Outbound FDI is underestimated

- China's Ministry of Commerce
  - Estimate based on outbound investment projects approved by the ministry
  - Not all investments from private sector captured
  - Investments <€280,000 may not be captured, as they require approval only at local-government level
  - Investments by Chinese companies' overseas entities not captured (eg, Wanxiang's 2003 acquisition of Nasdaq-listed Universal Automotive Industries, in United States)
- United Nations Conference on Trade and Development (UNCTAD)
  - Estimate based on inbound direct investment from mainland China to destination countries
  - Outbound investment via Chinese companies' Hong Kong subsidiaries not captured
  - Capital outflows financed or generated by foreign capital inflow not captured

<sup>1</sup> Excludes investments by overseas subsidiaries of Chinese companies in locations such as Hong Kong, British Virgin Islands.

<sup>2</sup> Compound annual growth rate.

Source: China's Ministry of Commerce; UNCTAD; McKinsey analysis

Without doubt, the 66 percent compound annual growth rate (CAGR) of official outbound Chinese foreign direct investment during the past five years underlines the determination of Chinese companies to succeed. Their progress has been followed with keen interest by foreign executives and investors. In the 2005 annual member survey of the American Chamber of Commerce in China, two-thirds of the respondents reported that Chinese companies would be "somewhat of a competitive threat" or "a serious competitive threat" to their businesses globally in five years. Yet global investors see opportunities too: they are increasingly prone to take advantage of these trends by investing either in Chinese companies that are making acquisitions in foreign markets or in the potential acquisition targets of those Chinese companies (see sidebar, "Opportunities for global investors").

Many factors drive the overseas expansion of Chinese enterprises. China's government has loosened foreign-currency controls, streamlined the approval process for overseas investments, and encouraged banks to provide capital. Private

equity firms, mainly from the West, are offering access to additional capital and proposing investment opportunities to Chinese business leaders. Acquisition targets are increasingly available, particularly among the developed world's many midsize (and often low-performing) manufacturing companies that lack the scale and skills to develop operations in China themselves and thus struggle to compete against its products.

Strategic considerations are the most important ones, however. Chinese business leaders increasingly believe that international expansion is an essential stepping-stone for growth. Asked about their motives, they most frequently cite the need to acquire raw materials, technology and engineering skills, access to new customers, and brands.

#### Securing raw materials

Large state-controlled enterprises that extract basic materials or fuels believe strongly that they must acquire foreign assets to sustain the country's phenomenal economic growth. China has, for instance, more than doubled its

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consumption of steel in five years and is quickly building domestic production capacity to satisfy its future needs. Because the country lacks quality iron ore at home, it has to be imported.

Mining, minerals, and oil and gas have historically accounted for one-third to one-half of China's overall outbound investment. One of the biggest deals was the China National Petroleum Corporation's (CNPC) \$4.18 billion acquisition of Petro Kazakhstan (PK), in Kazakhstan (in 2005). This trend will very likely continue to be a major force in raising Chinese foreign direct investment.

Since China became a net importer of oil and gas, in 1993, CNPC's subsidiary PetroChina has built up a portfolio that now comprises some 50 projects in 20 countries, including Canada, Indonesia, Kazakhstan, and Venezuela. In this industry, a long-established model of joint ventures with foreign national energy companies has helped PetroChina to overcome its early lack of international management experience.

### Acquiring technology and engineering skills

Another strategic rationale for expanding overseas is the need to acquire intellectual property and

### Opportunities for global investors

Investors such as mutual funds and private equity firms can take advantage of growing outbound Chinese investment in several ways.

One option is to invest ahead of the trend in sectors such as aerospace, automotive, and pharmaceuticals, where Chinese companies have only just begun their international expansion. Investors could take stakes in Western businesses that Chinese companies are likely to buy at a premium or invest in legal, accounting, and other businesses whose services will probably be in demand to help Chinese enterprises make their international moves.

A second opportunity would be to invest alongside leading Chinese companies in sectors that are just about to go global. This approach might be implemented through a joint venture to create the international arm of a Chinese business, with the foreign investor bringing global experience to help the Chinese partner's products succeed abroad. An alternative could be to bet on the parent company: the venture capital firm Warburg Pincus's investment in Harbin Pharmaceutical exemplifies the idea of making early bets on Chinese drug companies hoping to emulate the forays that their Indian counterparts are making in the global marketplace.

Investing in the listed part of a mainland Chinese enterprise that has already made inroads into foreign markets is a third path—a bet on both successful international expansion and the company's continued domestic success. One example: the investments in Lenovo (which is listed in Hong Kong) made by Texas Pacific Group and General Atlantic, two of the leading private equity firms operating in China. These moves encouraged mutual funds to buy Lenovo stock too.

A fourth way is to invest preemptively by seizing attractive turnaround opportunities before Chinese companies home in on them. Investors can target segments and companies likely to attract Chinese investments and then replicate what a Chinese enterprise would do: take advantage of the cost benefits of moving sourcing and manufacturing to China and combine them with the Westerners' international experience. One example is international private equity firm Crimson's investment in 2005 in Tyden Group, a US security equipment manufacturer. Crimson is now helping Tyden set up manufacturing of product identification and tracking equipment in China.

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sophisticated manufacturing expertise. China's enterprises acutely recognize the technology gap they must close to compete head-to-head with the multinationals. In the automotive sector, technology and skills have been brought into the country by several Chinese manufacturers, among them Nanjing Automotive, with the 2005 acquisition of MG Rover, and Shanghai Automotive Industry (SAIC), which in 2004 spent €400 million to acquire a 49 percent stake in the passenger car business of the South Korean company SsangYong Motor. In China's high-tech sector, at least part of the rationale behind TCL's acquisition of Thomson's TV unit and Alcatel's handset business was the need to accelerate its own development of flat-screen TV technology and to gain mobile-phone patents.

### Obtaining access to new customers

Perhaps the most challenging strategic aim, and one particularly common in China's consumer electronics and high-tech sectors, is reaching new customers abroad to bolster growth through international expansion. Local winners in China often achieve shares of 30 to 40 percent in their core product markets but find it hard to progress further. In some cases, annual growth rates have dropped from more than 20 percent to 10 or 15 percent. Many Chinese enterprises that attempted to diversify into new product categories at home have achieved only moderate success—or outright failure. Some of these companies couldn't differentiate their offerings; others misjudged how far their brands would stretch.

Chinese business leaders also understand all too well the increased effectiveness of their multinational rivals in the intensely competitive Chinese market. In the past, Chinese companies often fended off foreign competition because their products were better adapted to local needs and they had superior distribution and service delivery models, as well as privileged relationships with the government and local suppliers. This state of affairs is changing in many industries. Multinationals are adapting themselves to local conditions and rapidly expanding their businesses in China, challenging indigenous companies at home.

### Acquiring brands

Chinese businesses that want to sell in the international market recognize the challenge they face in building competitive brands. Chinese heritage brands are largely regarded as providers of basic value or as unknown names on a box. To capture the price points that Chinese companies believe to be merited by the quality of their products, many of them look to buy existing brand names. One example was TCL and its acquisition of Thomson.

### The integration challenge

Chinese business leaders who have taken on the challenge of cross-border M&A now realize that managing the people in acquired businesses effectively can have a significant influence on the eventual fate of global expansion strategies. They talk of three stages that have successively transformed their assumptions about running a global company.

Euphoria about getting the deal done characterizes the first stage. The members of the new global team get to know each other; everybody is friendly and anxious to avoid stepping on cultural land mines. The Chinese leadership, fortified by success in the intensely competitive home market, assumes it will prevail in Western markets too.

Growing discomfort marks the second stage. Unfamiliarity with Western markets inclines the Chinese leaders to let their Western colleagues keep running the overseas operations. But results usually don't improve as fast as predicted, and communication can be frustrating. There is an increasing sense that control has been lost because the international business is culturally and geographically outside the frame of reference that the Chinese leaders built in the local one. Often, the true extent of what must be done to turn around the acquired business becomes visible only during this stage.

In the third stage, many Chinese companies realize that strong and detailed direction from the corporate center is necessary. The leadership starts replacing managers more often and launching systematic improvement programs to reap the

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benefits of expansion. In some cases, companies take even more drastic action, such as inviting in private equity or other new investors with access to global talent, resources, and capabilities.

The details vary from one company to another—particularly the length of each stage, which can run from a few months to several years. But there does appear to be a broad consensus about the importance and difficulty of developing a high-performing international management system.

Strong, integrated management is critical because combining a Chinese cost structure with Western assets and intangibles often requires a substantial change in a company's business model and go-to-market approach. D'Long's acquisition of Murray Lawnmower, for example, foundered partly on the difficulty Murray's new management had in sustaining relationships with major US retailers. Other problems included the company's failure to grasp the challenge of extending its supply chain across the Pacific and to forecast US market demand well enough to avoid a large buildup of inventory. Manufacturing in China may be inexpensive, but Chinese companies must understand and manage their full system costs.

Many things make it hard to build an effective management system that can implement the strategy behind an international acquisition. One is the fact that acquired managers can be too stuck in their old ways to catalyze the needed business transformation, while the new Chinese managers often lack the necessary international experience. What's more, barriers of geography and culture (especially management styles and language problems) can stand in the way of smooth coordination and optimal cooperation between a headquarters in China and an acquired company elsewhere.

### **Managing management**

In our experience, three steps are essential for ensuring that Chinese companies succeed at M&A. They all force the acquirer to prepare for the task long before the deal is done and to move quickly

and decisively thereafter to take advantage of the brief window of time when employees of acquired companies expect change. Lenovo started planning systematically to integrate IBM's PC business almost a year before completing the deal. But some other Chinese businesses have made acquisitions without preparing any solid plans for "the day after."

### **Bring in new blood**

People working in the acquired company usually have little idea what to expect from its new Chinese owners. Keeping the entire acquired management team in place sends a strong signal that the order of the day is business as usual and that major changes should not be expected—often a fatal message for a business that needs a turnaround. Intra-European acquirers address this problem by putting one of their own top executives at the helm of the acquired business. Chinese companies, however, often find that their senior managers don't know how to run a US or European organization. They also face severe difficulties in forming strong relations with the employees and other stakeholders of the acquired company.

The answer, in many cases, is to bring in experienced local managers, and sometimes even a new chief executive, from outside the acquisition. This new leader should be an experienced and successful executive, respected in the local business community, who has a record of forging strong ties with employees, suppliers, and customers.

### **Bond the existing and acquired businesses**

Bridging the gap between a Chinese company and an overseas business it acquires is crucial, but it doesn't happen naturally—ties must be encouraged. The process tends to be less challenging if the acquired company already has a significant part of its business system in China, since its management will then be more familiar with Chinese companies and perhaps even its new owner. The Chinese acquirer of one company appointed a local senior manager with Chinese experience as its president, and he played the bridging role effectively in forming a management team.

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The centralized decision-making style of many Chinese companies can be a major obstacle to strong and well-informed coordination. It works well at home, where business systems are relatively straightforward. But as Chinese companies send executives into global markets, decisions made at the center may be tardy and less well informed. Executives in the field believe that they must check with their bosses at home for final decisions—only to find that their bosses lack knowledge, context, and skills.

Chinese styles of decision making can't be adapted to a global business overnight. However, one effective approach is to dispatch "connectors": experienced Chinese managers, with good language skills, who join overseas operations to help them communicate with headquarters. The best connectors command respect in the Chinese organization and have the clout to make things happen in China; they might, for instance, forcefully promote the idea of using Chinese facilities to manufacture a new product for overseas markets. Connectors must have an important and visible management role in the acquired organization to make the career move attractive and to ensure that they don't sit outside line operations, with no real power.

Companies must also establish end-to-end responsibility. Sometimes, management tasks are fragmented: certain people at the Chinese headquarters are responsible for product development and others for manufacturing, say, while the overseas operation runs product planning, marketing, and sales. In such cases, failure is preordained: even if everyone executed well, it would be a sheer coincidence if all the priorities were aligned across functional, geographic, and cultural boundaries. The answer is to make one manager, in China or abroad, directly accountable, with end-to-end responsibility for introducing new products and fulfilling orders.

### **Bridge the cultural divide**

Differences in business culture and practices can complicate mergers even between US and European companies, which usually have relatively

similar business environments and management traditions. Chinese acquirers often face a still greater challenge because the culture gap may be wider and more difficult to bridge given their language difficulties and limited international experience; Chinese managers, for instance, may have a penchant for calling all-weekend meetings late Friday night or may expect their subordinates to attend Sunday evening dinner meetings. Some Chinese companies, realizing that seemingly trivial cultural complications can throw a wrench in the works of overseas expansion, have begun teaching managers to adapt their style to the local business culture, much as multinationals do in China.

A more serious problem is the fact that although Chinese organizations often have power structures that are well understood internally, those structures bear only a limited resemblance to the organizational chart. Western management teams, by contrast, tend to be paralyzed if the chart and the reality of power don't match. A European subsidiary faced a challenge when its Chinese owners kept the local general manager in his formal role but informally bestowed all his decision-making power on one of his direct reports. The Chinese viewed this arrangement as absolutely normal and didn't understand why it confused the Europeans, who, for their part, could navigate neither the Chinese nor the European power structure. Many people left the subsidiary.

While cultural gaps in management style and practice might never be fully overcome, they must be actively managed to blend (and make the most of) the skills on both sides. The more explicitly these differences are acknowledged and the more actively they are addressed in day-to-day operations, the less likely it is that they will seriously impede the building of trust and collaboration. One interesting way (now being tested by some companies) of promoting integration is to pair Chinese managers with local ones in, for example, sales and marketing roles immediately after an acquisition is completed. This approach can promote both connectivity and joint accountability and greatly enhances the transfer of skills in both directions.

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Finally, the use of top-quality *simultaneous* translation services might seem a trivial matter, but it isn't. Today the executive assistants of Chinese business leaders often take on the role of translator in business meetings. This kind of *sequential* translation often makes participants feel disconnected from the discussion—a feeling that can prevent effective problem solving. At one company that introduced expert simultaneous translations (conveyed wirelessly into earphones) managers told us that this move's importance could hardly be overestimated. Especially during the early discussions of the joint senior-management team after an acquisition, getting small matters like this right can have a huge positive impact.

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Chinese business leaders have taken their first steps on the long and arduous path to creating global businesses. They, like their Western and Japanese counterparts before them, must learn from their early mistakes and build the managerial and operational skills required for lasting success in international markets. *Q*

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