The Economist

Chinese takeovers

Being eaten by the dragon

What it feels like to be bought by a Chinese firm

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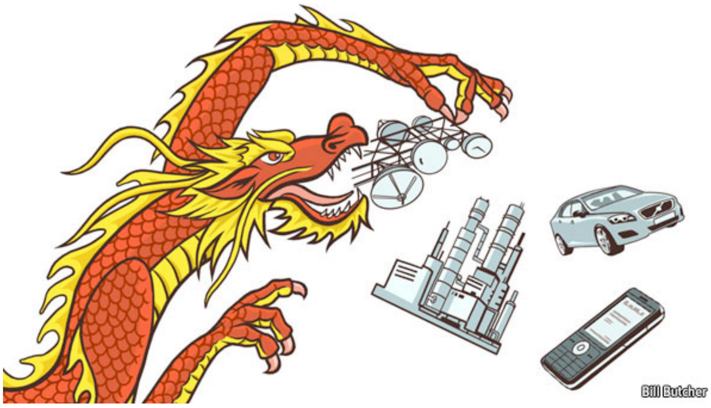


A FEW years ago two executives of an international oil company were working late in its otherwise deserted office in England. A stunning young Chinese woman arrived at reception. "She was very attractive, decked out in Gucci," one of them says. She delivered a letter from Sinopec, one of China's giant, state-controlled energy firms, proposing a multibillion-dollar takeover. The executive adds, a little wistfully, that she then disappeared into the night in a car with local licence plates, never to be seen again.

His firm was soon bought by another Chinese company. Since then Western bosses have been tapped by Chinese firms at conferences in Toronto and Cape Town and received walk-in offers in Scandinavia. Companies across Europe have solicited Chinese investment. Bankers all over the world have touted lists of Western takeover candidates among China's big firms. This year buyers based in China and Hong Kong have accounted for a tenth of global deals by value, including investments in oil and landmark takeovers in industry, such as Geely's purchase of Volvo, a Swedish carmaker. A decade ago China urged its companies to expand under the slogan "go out". Now it is really happening.

The first fiery breaths

More deals are inevitable, given China's rise. Control of the world's stock of foreign direct investment (FDI), which includes takeovers and companies' greenfield investments, tends to reflect a country's economic muscle. Britain owned 45% of the world's FDI in 1914; America's share peaked at 50% in 1967. Today China, including Hong Kong and Macau, has a share of just 6% (see chart 1). Listed Chinese firms, which are largely state-controlled, are already some of the world's biggest, and account for over a tenth of global stockmarket value. Most are still mainly domestic outfits.

China's high savings will also spur deals. Companies often have surplus cash and banks surplus deposits. Today those savings are recycled into rich countries via sovereign-wealth funds and the central bank, which act as portfolio investors, buying mainly bonds. But China may and probably should diversify. That shift will be accelerated by China's political aims: to acquire inputs, such as raw materials, labour and land; to build up technical and commercial expertise; and to gain access to foreign markets.

Public announcements of such deals are something of a charade. Wooden Chinese executives insist they are acting on purely commercial grounds. Western bosses hail a new era of co-operation. Yet these transactions are tricky partly because of cultural differences and partly because of the role of the Chinese state. There have been fiascos. In 2005 CNOOC, a Chinese oil firm, withdrew a bid for Unocal, a Californian producer, after American politicians kicked up a stink. In 2009 Rio Tinto, an Anglo-Australian mining firm, withdrew from a deal to sell a series of minority stakes to Chinalco, a Chinese metals firm. Rio's shareholders opposed the sale but many reckon that the Australian government did, too.

The Economist has interviewed, anonymously, executives past and present at 11 Western companies that have been bought by or have sold stakes to Chinese firms, or have been in negotiations to do so. Ten of the deals discussed were worth more than $1 billion. What these people say provides an insight into both China's capacity to expand its companies abroad and the opaque workings of its state-backed firms. The impression they give is a mixture of awe at China's ambition and technical skill and a far more qualified assessment of Chinese companies' ability to run international businesses.

The meat of the negotiation often has two parts: marathon sessions at an investment bank's offices, often in London, and visits by target firms' executives to mainland China or Hong Kong. There they may be expected to make epic PowerPoint presentations to giant audiences, and to attend banquets and intimate discussions, often in hotels owned by the bidder.

Most visitors are impressed by Chinese firms' technical nous. Both sides try to make friends: "Emotion and trust matter," says a Briton, because authority within Chinese firms is opaque and arbitrary. Chinese negotiators often use booze to break down barriers—and to try to get the upper hand. This is a well-known tactic, says a European of hazy days he spent in a hotel dealing with the fine print. "They would bring in people to try to get you drunk…At one point I was sure they'd brought in a lady from the switchboard."

Most targets of Chinese takeovers need an interpreter. It pays to be wary. The head of a mining firm grew fond of his, but jokes, "She was clearly an internal spy." Most executives say they trusted their hosts. But not all. A European says, "They knew everything about me," and adds, "I had 52 hits from China on my home computer." Another boss negotiating a controversial natural-resources deal found the atmosphere sinister. "You had to take your battery out of your mobile phone. You were told the rooms were bugged."

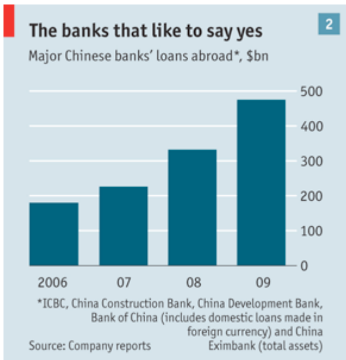
Chinese companies' power structure is a bit of a mystery to outsiders, even the handful of Westerners on the boards of big state-backed companies. A popular theory is that they are controlled by a parallel hierarchy of Communist Party officials. The most senior party man in a firm, the general secretary, is not necessarily the most senior executive. Although one Western executive says this distinction was evident ("There were party people and people who did stuff"), most are just overwhelmed by the volume of bodies. One arrived, alone, in London to be faced with 30-40 people from the Chinese side. "I was shocked," he laughs. Meetings in China can be attended by vast audiences, with people coming in and out continually. A core of people ask good questions, but even they, many visitors say, seem to lack the authority, or desire, to make decisions.

Power behind the chair

The opacity of power is also reflected by the role of the titular heads of Chinese firms. One boss found his counterpart to be an autocrat, surrounded by minions: "You feel the deference towards this guy. There are no interjections when he speaks." Yet most visitors to China talk of charming figureheads, for example at Sinopec: "There are two chairs in the middle where you and he sit…You say prepared remarks into the microphone and then everybody claps…Girls serve tea…The big chief doesn't negotiate. He just blesses the deal." Another executive says the head of Huawei, a telecoms-equipment firm, was "a great gentleman" who "relied on his lieutenants for information". A natural-resources boss says the head of Minmetals, a big Chinese mining firm, was just there "to keep protocol".

Who, then, calls the shots? A lieutenant who has lived outside China may lead the talks with the target's top brass. Chinalco, says a Westerner, has used the same 40-something bilingual hotshot on several deals: he was "very, very good". But with one exception, those interviewed thought the state was in ultimate control. "You can feel it," says one. "In China you're dealing with the government," says another. "In India you're dealing with companies."

However, the state is far from being a predictable monolith. Often, more than one Chinese firm has sniffed out the same target. They compete for the Western firm's affections and "preferred bidder" status with officials back home. The process can be chaotic. A chairman says he negotiated for months with a Chinese mining firm, including site visits by hundreds of their staff, only to see the deal collapse because it lacked political consent.



Likewise, China's government-controlled banks, which have been expanding abroad (see chart 2), are often described as indiscriminate financiers of China's overseas conquests. Yet the same chairman recalls going to Cuba to meet a senior official of China Development Bank (whose father had, apparently, been an acquaintance of Fidel Castro's) and receiving a clear signal that a deal was in doubt. Another executive says a deal with ZTE, a maker of telecoms equipment, that included state-bank financing struggled to win official approval. ZTE's bosses, he says, held little sway with the central government.

Once a preferred bidder has been picked, however, there can be a flood of cheap cash. Someone involved in the Rio deal recalls meeting a bank in China and being staggered by their indiscipline. "They said, 'How much do you want: $10 billion, $20 billion?' It was unbelievable." The preferred firm's negotiators often have some latitude to alter the terms of a deal, but refer big decisions to Beijing. During the auction of a Western oil company, a Chinese state-controlled energy firm "went back to the ministerial level to raise its bid", says an executive of the target.

At key moments, though, this apparently fiddly hierarchy can be decisive. One oil executive ran an auction of a firm that ended with an Indian and a Chinese bidder (both were state-controlled). The Indians had "no concept of materiality", he says, and were mired in nit-picking. In the final stages they returned the draft contract riddled with amendments. The Chinese firm returned it clean, and won.

Although to set up a foreign bid a Chinese firm has to jump through lots of hoops, once it has done so it enjoys formidable advantages. It has access to cheap finance. It can ignore its share price, since its majority shareholder, the government, is onside. Politicians may also work to smooth the waters. PetroKazakhstan, a Canadian firm with assets in Central Asia, was coveted by a Russian company. Its takeover by CNPC of China was eased by a state visit by the president, Hu Jintao, to Astana, the Kazakh capital.

China's state-backed system also has disadvantages. One is that foreign governments are becoming increasingly wary of Chinese takeovers. These include those of Canada and Australia, previously two of the most open markets for corporate control in the world. Another is more subtle: that the style of decision-making can lead Chinese companies to overpay and to struggle to integrate their purchases.

Some executives felt that their Chinese suitors had bargained astutely. Someone who has sold four mining firms says the Chinese compared well with Western buyers. Others are less complimentary. To get to the point of executing a takeover, a Chinese company must build up a huge head of steam. Some say they struggle to rein in their investment bankers. "They lost control of the situation," says a European chief executive. In future, "I hope for their sake that they do a better job at negotiating."

Chinese firms also risk political fallout if they fail. Their sense of mission makes them "transparent", says one European executive of his experience selling a firm. "They cannot take the chance to lose the deal." Another European boss says his Chinese suitor struggled to deal with Western stockmarkets. Their disclosure rules mean slip-ups are made public, and disparate institutional investors are unpredictable. As a result Chinese buyers prefer targets with a single big shareholder who can negotiate bilaterally. However, buying such firms can be costly because they command a scarcity premium.

The price China pays is often dismissed as inconsequential: what are a few billion in the grand scheme of things? But even for rich countries, systematically overpaying for foreign assets is a bad idea. After a binge in the late 1980s and early 1990s, Japanese firms retrenched.

I love you. Tell me your name

Integrating an acquisition is just as important as price. Once the deal is done—a text message from China confirming a higher offer is not unknown—there may be a signing ceremony in the target firm's country and then a banquet in China, attended by central bankers and government ministers. More grog is compulsory. "You will leave the dinner completely drunk," says a survivor. The bought firm's bosses may be asked to linger in well-paid but largely symbolic roles.

Those interviewees who experienced Chinese firms' integration efforts mostly reckon they began well. "They had done their homework," says one. Their approach was "very clever" at first, recalls another. The buyer's message that it would keep all staff "was extremely simple and well received", he says. Usually the acquired company keeps some autonomy, with its own legal status and name. Only one executive, at a North American firm, felt this initial group hug was insincere: the Chinese took over "the day I walked out of the building…Critical positions were replaced instantly." An ex-colleague disagrees, saying the Chinese just took firm control.

Over time, though, business plans change. Natural-resources firms can become captive suppliers to China, rather than selling on the open market. An executive of a Latin American mining company recalls a blazing row between the two groups of geologists which was resolved when the Westerners realised their new objective was to maximise production, not profits. In the longer term the DNA of Chinese corporations—a sense of mission, consensus, deference and opacity—can cause difficulties. These can be compounded by a dearth of English-speaking managers familiar with working outside China. An architect of a failed deal says, "There would have been some great opportunities—and some really big problems."

The former boss of a European firm now owned by a Chinese giant says he liked his new colleagues but adds that the lack of open discussion caused friction. "Nobody contests what their immediate superior says. Never, never, never…The decisions are taken somewhere else." The firm's engineers became "frustrated" as plans were sent to China and amended. It is difficult for Chinese firms to run foreign ones, he says: "It is a very stratified society." Another veteran of the same firm jokes about the "Beijing effect" and says that "having sold a business to them and worked for them for a year I don't really have a clue how they work." He adds: "Virtually all of the senior management have left and at the next level down people are looking [for new jobs]."

This isn't true of all deals, but nor is it unique. The former boss of another European acquisition says of the integration plan: "On paper it looked quite good but it failed totally." Decisions took months for "even the simplest things". He says that "almost all the key people left" and adds that "there is no company left" at the headquarters, just a shell.

The Chinese way

Does any of this matter? After all, Western takeovers can be brutal, too, and a buyer is by and large entitled to do as it pleases. Several mining and oil bosses also argue that a healthy process is at work, in which China buys firms and the capital and skilled people thus released are recycled into new start-up companies. Yet from Chinese firms' perspective an inability to retain staff is a problem. Technical and local expertise accounts for much of a company's value. And as China moves beyond digging stuff out of the ground—at which it is fairly adept—to more complex consumer industries, let alone creative ones, better management will be essential. In this, companies from other emerging markets, such as India and Brazil, have the advantage of private-sector credentials and more cosmopolitan cultures. The most durable multinational firms, such as Nestlé or Unilever, often transcend nationality.

A pessimistic view is that China will have to find other ways of "going out". It could make passive equity investments through China Investment Corporation, a sovereign-wealth fund. Executives from two firms attest that its representatives take a back seat at board meetings. Joint ventures are another option. The boss of an oil firm with a Chinese partner says that "its motivation is not to take control" and that the relationship is harmonious.

Alternatively, Chinese companies could grow without buying. Until the wave of cross-border deals in the 1980s most firms went global by building operations from the ground up. Chinese firms are becoming good at this. One of them, COSCO, has a concession to run part of Greece's biggest port. Chinese construction firms have won contracts across Africa and eastern Europe. Huawei has developed without making large acquisitions.

For all that, it is hard to believe that China's companies and politicians want to operate with one arm tied behind their backs. And although many of the country's big firms may never resemble Western ones, with diffuse private shareholders and independence from the state, they may have to edge more towards this template in order to succeed at large cross-border deals. In a speech this month a senior Chinese official emphasised the role abroad of China's "private" firms, which typically have less overt state direction. To address other countries' concerns about political control, China may also have to loosen its hold on its giant state-owned companies and ensure that their power structure is more transparent.

Most of the executives interviewed by *The Economist* also felt that the next generation of Chinese executives, in their 30s and 40s today, with more international education and experience, would prove far more effective than the present cohort of chiefs. Over the past two decades the old guard has taken a rusting industrial base and from it made gleaming corporate giants. Yet if those firms are to achieve their full potential abroad their creators may have to relax their grip.