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I. Introduction

I.1 Thesis Statement

The objective of my dissertation is to analyze why within the past decade the number of Merger and Acquisition (M&A) is on the rise in China. In addition, this project also intends to assess whether M&A is beneficial for corporations in China.

The discussions and recordings of this paper will be limited to the scope of the literature surveyed.

I.2 Objectives

The last six years has witnessed a number of business ventures promoted by foreign corporate companies in China. Multinational Companies (MNCs) like AMD, Ericsson, Hitachi, Luccent, Microsoft, Motorola, Nokia, Seagate Technologies, Mitsubishi Electric, Sony, Cannon, Dell Computer, Minolta, NEC, and Toshiba have expanded their investment in the form of production facilities of electronics and communication components (Kodama, 2004). Similarly, these companies employ high tech equipments to manufacture their products. This operational strategy implies that the companies have invested significantly in terms of opportunity cost to bring-in their technological and research equipments (Kodama, 2004).

> *"Many companies' stocks badly under perform the market after a big merger. The 30 largest deals of the past five years have on average underperformed Standard & Poor's 500 stock index.... Yet the trend is more complicated than that number suggests. It includes some spectacular successes … and some spectacular fumbles"-Greg Ip*

This report will address the following topics:

1. How does the M&A come about?
2. Why do foreign companies focus on conducting M&A in China? It also tries to examine why M&A is a popular approach to extend the market for company.
3. The project aims at employing some theoretical approaches of M&A and assess whether current practices in China is in line with the established theories.
4. How does M&A impact the Chinese economy? As Foreign Direct Investment (FDI) is a very significant part of China's economy, the trend would apparently result in a considerable effect that is worthy of academic exploration.
5. Why are foreign companies willing to take the risk of M&A in China?

I.3 Hypothesis and Theories

China's accession to World Trade Organization (WTO) on 11th December 2001, exemplifies the region's most significant economic development for several years (Drysdale & Song, 1). This transition has already witnessed China make significant strides towards dismantling commercial barriers (Drysdale & Song, 1).

Leaders have the option to consider many policies to increment the welfare of a country or an organization. These policies are targeted to increase employment, encourage the manipulation of technology to derive enhanced outputs and many others benefits as well. Technological change is a scientific approach to stimulating economic growth. Technological advancement refers to new production techniques that increment the output produced by any combination of capital and labor (Freeman, 1987 & Nelson, 1993). Interestingly, as technology matures with time it suggests that

at each stage will result in differential outputs. Technology and innovations are not perceived as flowing freely across country (or organizational) boundaries. Instead, technology and particularly the innovative process from which it arises and is applied are closely related to specific firms, networks and economic institutions (Freeman, 1987 & Nelson, 1993).

FDI between nations around the global is a significant index of territorial attractiveness. MNCs have perpetually protracted their activities across national borders to gain access to evolving markets, deficient physical resources, cheap and/or more capable labor or innovative technologies(Tenev, S., C. Zhang, et al., 2002). Countries are generally incisive to attract FDI from MNCs because it brings capital, employment and often technology and training, to enhance native potentialities (Tenev, S., C. Zhang, et al., 2002).

There are a few suspicions and theories underlying the alterations of China's FDI in-flows to high tech areas, which will be elaborated in this study.

The first one will be that the trend is a part of natural stage of FDI. According to new growth theory, FDI has been a critical factor propelling economic growth. [1] China's FDI increased significantly in the 1990s but the amount of investment varies considerably across the regions (Wu, 28).

The second hypothesis stated that the trend is, to a certain extent, promoted by Chinese government policies, which encouraged the FDI to flow into high tech industries (Tenev, S., C. Zhang, et al., 2002. Since 1985, the Chinese government had issued many policies, which has provided increased freedom and opportunity in high tech investments (Tenev, S., C. Zhang, et al., 2002).

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(1) For a review of the literature, see De Mello (1997) and Wu (1999).

The two underlying reasons have driven many MNCs to spread their wings through conducting mergers and acquisitions (M&A) to strengthen companies' presence in Chinese market (Tenev, S., C. Zhang, et al., 2002. The incredible number of FDI in China had placed the country into being the world's second largest country after the United States in terms of the total value of FDI. The large number of FDI in China is the result of the country's government reformation on investment policy that encourages foreign companies to strengthen their presence in a global scenario. World Investment Report (2003) informs that in 2000, $41 billion of investment flowed into China and, in the first ten months of 2001. FDI inflows incremented by almost twenty percent compared with the previous year. Concurrently, China's GDP growth rate has slipped only slightly, from eight to seven percent. It is apparent that the common practice to enter Chinese markets is through M&A that obviously promotes immense opportunities.

For some companies, a well-managed M&A is a significant part of a success formula. Despite potential benefits of conducting M&A, company acquisitions over rivals in the same industry are considered a way to reduce competition, combined managerial techniques and technology, taking advantage of intangible assets and thus increasing profitability and company's share of the market. These mergers and acquisition has been very popular among multinational companies despite cases of failure are also proven to be abundant (Harrison, et al., 5).

I.4 Methodology

In general, there are two approaches to research: Qualitative and Quantitative. Qualitative approaches are research that is carried out through interviews and observations. This type of research enables a researcher to examine closely on the individual perceptions of a phenomenon. Moreover, the use of observation methods in

a research is advantageous since it enables a researcher to observe what occurs in real-life situation. This method also helps us to reach an understanding about the perceptions of those who are being studied, in that situation.

Qualitative methods will be employed to assimilate data for this topic and does not involve direct interviews. We are retrieving more reliable data from expert analysis, journals and various publications from available media. Using the resources mentioned above, we are confiding to present an independent and objective analysis toward the contemporary issue.

Specifically, the following approaches are being employed in examining the research objectives:

1. The practice of M& A in China employing non-participant observation method, through data collection and analysis of qualitative information from books, academic journals, magazines, and other online materials
2. This paper examines the M& A of two types of companies
    - Two Chinese companies
    - A Chinese and one foreign company

Based on the above scenario the financial performances (e.g. balance sheets) in pre- and post merger period will be analyzed their in order to ascertain whether the M&A had beneficial impact on the companies under consideration.

I.5 Limitation

In this paper, I proposed to employ non-participant observation method especially by analyzing qualitative information from journals, books, magazines and many more reliable resources. However, the method does not involve direct interviews, which will slightly reduce objectivity and the accuracy of information.

I.6 Keyword

1. Merger and Acquisition (M& A)
2. Word Trade Organization (WTO)
3. Multinational Companies (MNCs)
4. Foreign Direct Investment (FDI)
5. Free in Board (f.o.b)
6. State-owned enterprises (SOEs)

II. Macro Economy of China

The dramatic parody of the Chinese economy during the last two decades of the twentieth century has had considerable impact on mankind in general and the Chinese people in particular. This is because of the fact that one-fifth of the earth's inhabitants dwell in China and that the majority of them have now climbed out of poverty (Wu, 1).

II.1 Market Evolution

The People's Republic of China was established in 1949. Its economic maturation over the past five decades can be divided into two periods: the post-reform and pre-reform periods (Wu, 1). The economic development was extremely volatile in the pre-reform period (1954-77), with the rate of growth ranging from 21.3 per cent in 1958 to -27.3 percent in 1961 (Wu, 1) .The figure II.1.1 captures this trend.

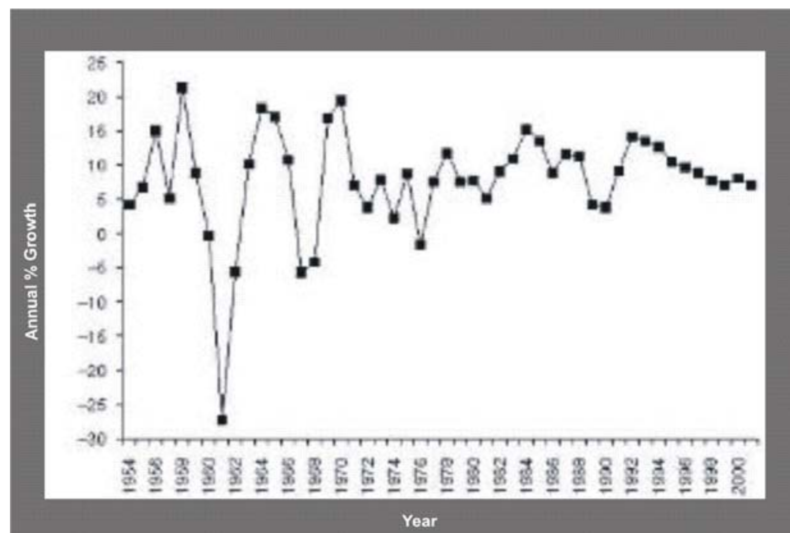

Figure II.1.1: The rates of growth of the Chinese economy, 1954-2001
Source: State Statistical Bureau (various issues)

Different authors have furnished detailed studies of the pre-reform period (e.g., Rawski 1979, Dernberger 1980, Chow 1987 and Lin et al. 1996). The above transparently illustrates that China savored sustained growth in the 1980s and 1990s.

Though this growth decelerated in late 1990s, it still achieved a rate of 7% in 2001 and is expected to reach 8% in 2002. This growth was predicted to continue in the coming decade (Economic Analytical Unit 2002 and Asian Development Bank 2002).

China's economic evolution in recent decades has been propelled by a number of significant elements such as the development of the rural non-farming sector, massive inflow of foreign capital, structural transformation, reform-induced efficiency improvement and promotion of trade. There are some special features associated with these factors (Wu, 1).

II.2 Chinese Market Reforms

China's economic reform commenced during the late 1970s in the farming sector. The reform was extremely flourishing and has led to dramatic betterment in efficiency (McMillan et al. 1989 & Lin 1992). In the early 1980s as productivity improved in the farming sector, surplus rural labor emerged rapidly. During this transformation, rural residents were disallowed from migrating to the cities due to the stringent household registration process. Consequently, farmers evolved their own industrial sector, which was termed as the rural township, village and private enterprises (TVPs). The growth and maturation of TVPs in China is discrete in the world and directly the result of rural-urban segmentation under the household registration system.[2] Ironically, the TVP sector was the most dynamic sector and fundamentally became the main driving force for China's economic growth in the 1980s.

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(2) For detailed studies on TVPs, see Byrd and Lin (1990) and Findlay et al. (1994). In terms of employment, the TVP sector overwhelmed the state sector in 1990.

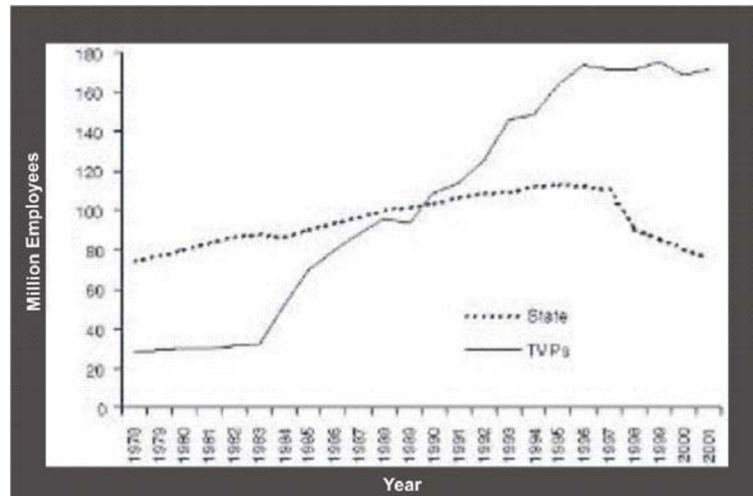

Figure II 2.1:Employment in Chinese State and TVP sectors, 1978-2001
Sources: State Statistical Bureau (various issues and 2002)

The salient growth of TVPs is illustrated in Figure II 2.1. In 2001, its size was more than twice as great as the state sector. Though individual TVPs vary in scale, some of them have become multinational companies such as Haier, a white goods producer based in Shangdong (Wu, 2).

Among the developing nations, China has for years been the most favorite destination for FDI. In 2002 China for the first time surpassed the United States as the world's largest recipient of foreign capital (Wu, 3). China's success in wooing foreign investment has captured the headlines in the press. It is apparent that foreign investment has played a crucial role in China's recent growth.

China started to receive its maiden offshore investment in the 1970s (see Figure II 2.2). Since then, foreign companies have invested more than US$568 billion into the Chinese economy (Wu, 3). Foreign capital generated substantial employment opportunities and contributed to a substantial dimension of China's exports. The major hosting regions (e.g., Guangdong, Shanghai, Jiangsu, Shandong & Fujian) in China tend to savor a high rate of growth. The trend of foreign capital flow seems to

coincide with that of China's high growth in the 1990s is illustrated in the Figure II 2.2.

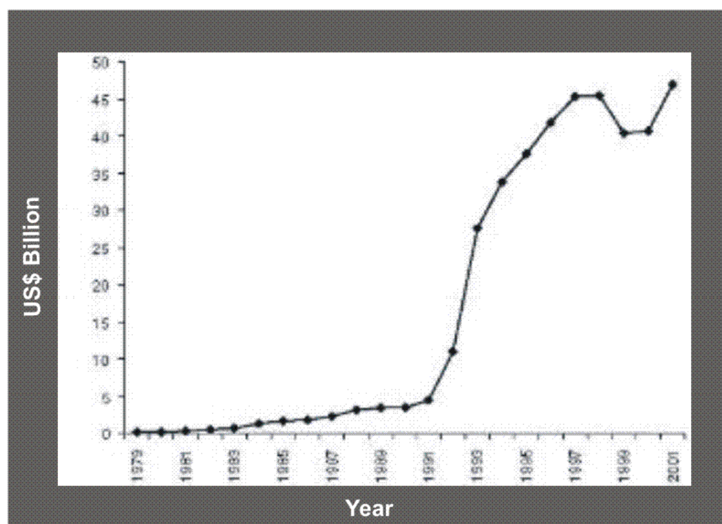

Figure II 2.2: Foreign direct investments in China, 1979-2001
Sources: State Statistical Bureau (various issues and 2002)

II.3 Functional Shift

In the past two decades accompanied by economic evolution there was rapid structural transformation in the Chinese economy. The trend is very analogous to the pattern of changes attempted by other countries (see Table II.3.1). It infers that as an economy evolves, the primary sector declines and the service sector expand in terms of both employment and income shares.

Year	**GDP**	**Employment**				
	I	II	III	I	II	III
1980	30.1	48.5	21.4	68.7	18.2	13.1
1990	27.1	41.6	31.3	60.1	21.4	18.5
2000	15.9	50.9	33.2	50.0	22.5	27.5
2001	15.2	51.1	33.6	50.0	22.3	27.7

Notes I, II and III represent the primary, secondary and tertiary sectors, respectively.

Table II. 3.1: Sectoral shares of GDP and employment in China (%)
Source: State Statistical Bureau (2002)

What is exceptional about China is that the employment share of agricultural sector falls relatively slowly. Once again, this position may be due to China's population policy, which for many years restricts rural out-migration (Wu, 3).

II.4 Advancements in Commerce

China has adopted the East Asian model of development by promoting foreign trade, in particular exports. Trade flourished rapidly in the past two decades, especially in the 1990s (Figure II.4.1). Trade and commerce not only rendered China's much-needed foreign exchange but also advanced technology transfer and ushered in competition in the former centrally planned system. China's total trade amounted to US$509.8 billion in 2001, being the sixth largest in the world. There is no doubt that trade has played an important role in China's recent growth (Wu, 4).

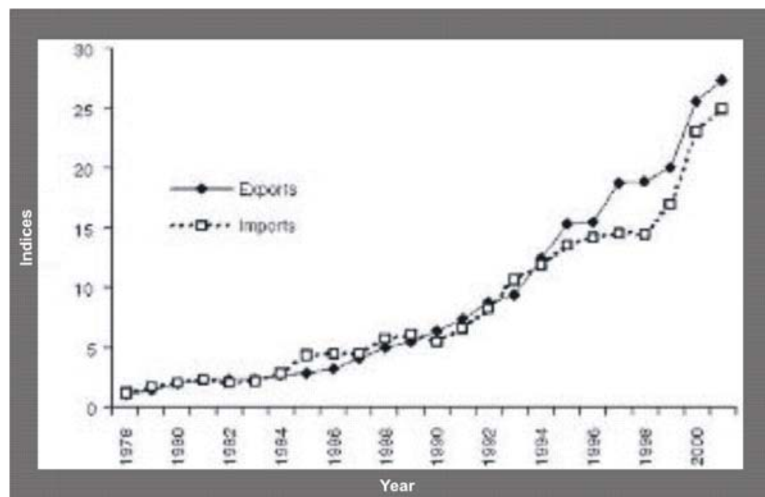

Figure II.4.1: Indices of China's exports and imports, 1978-2001
Source: State Statistical Bureau (2002)

In summary, China's growth immensely benefited from economic reforms initiated in the late 1970s. One of the key reform openings was the open-door policy. Under that policy, China adopted foreign trade and investment. With China becoming an official member of the World Trade Organization (WTO), the Chinese economy will become more liberalized and the Chinese market more accessible in the near

future. In the meantime, China will woo more foreign investment and Chinese firms will face more competition from foreign counterparts. These changes will impact China’s growth in the twenty-first century (Wu, 5).

II.5 FDI in China

Statistics from CRS Issue Brief for Congress (2006) reveals that China’s trade and investment reforms and inducements led to a surge in FDI. This inflow has been a substantial source of China’s capital growth. Annual utilized FDI in China rose from $636 million in 1983 to $61 billion in 2004 (it was estimated at $58 billion in 2005).

	Cumulative Utilized FDI: 1979-2004		**Utilized FDI in 2004**	
Country	**Amount ($ billions)**	**% of Total**	**Amount ($ billions)**	**% of Total**
Total	563.8	100.0	64.0	100.0
Hong Kong	241.6	42.9	19.0	29.7
United States	48.0	8.5	3.9	6.1
Japan	46.8	8.3	5.5	8.6
Taiwan	39.6	7.0	3.1	4.8
British Virgin Islands	36.9	6.5	6.7	10.5
South Korea	25.9	4.6	6.2	9.7

Table II.5.1: Major Foreign Investors in China: 1979-2004
Source: Chinese government statistics. Top six investors according to cumulative FDI from 1979 to 2004

The cumulative level of FDI in China stood at about $618 billion at the end of 2005. Analysts predict that FDI will persist to pour into China as investment barriers are reduced under China’s WTO commitments and Chinese demand for imports continues to increase (CRS Issue Brief for Congress, 2006).

II.6 China’s Major Trading Associates

Information from CRS Issue Brief for Congress (2006) indicates that China’s statistics on trade frequently alter significantly from those of its major trading partners. For statistical purposes, China considers the trade activities passing through Hong Kong as coming under its purview.

According to Chinese trade data (CRS Issue Brief for Congress, 2006), its top five business associates in 2004 were the European Union (EU), the United States, Japan, Hong Kong, and the 10 nations that comprise of the Association of Southeast Asian Nations (ASEAN) (see Table II.6.1).

Country	Total trade	Chinese exports	Chinese imports	China's trade balance	Trade Balance as Reported by Partner
European Union	177.3	95.9	63.4	32.5	-90.7
United States	169.7	125.0	44.7	80.3	-162.0
Japan	167.9	73.5	94.4	-20.9	-20.5
Hong Kong	112.7	100.9	11.8	89.1	-3.9
ASEAN*	105.9	42.9	63.0	-20.1	N/A

Table II.6.1: China's Top Five Trading Partners - 2004
Source: Official Chinese trade data

II.7 Prospects for China's Economy

The outlook for the Chinese economy looks encouraging. However, the prospects will be impacted by China's will to usher in reforms in the SOEs and the banking sector and also it WTO commitments (CRS Issue Brief for Congress, 2006).

Global Insight, an economic forecasting firm, proposes that China's real GDP will average 8.0% over the next five years, indicating that China could double the size of its economy in less than 10 years.6 The Economist Intelligence Unit projects that China will become the world's largest exporter by 2010 and the world's largest economy by 2020 (CRS Issue Brief for Congress, 2006).

III. Foreign Direct Investments

The rapid evolution in FDI has raised a number of policy issues at the national and international level (UNCTAD, 1999). During the 1960s and 1970s FDI and MNCs were normally treated with mistrust, as they were perceived to manipulate their economic durability to take advantage of developing countries. During the same period many developed nations ordained legislation to monitor and regulate the flow of FDI and the activities of MNCs. Their concern was less in the consideration of economic exploitation, but more in the context of economic sovereignty (UNCTAD, 1999).

The strategic direction of national and international business organizations lies at the core of wealth creation in modern industrial societies. Stephen Hymer (1976) formulated research on internationalization by recasting foreign direct investment (FDI) in micro analytic terms. Since Hymer's path breaking conceptualization of the MNC, a generic model of the international activities of firms has slowly maturated. While the model's derivation is multidisciplinary, it draws heavily on new industrial economics and new institutional economic theories of internalization, challenging neoclassical economic models of international capital flow.

Globalization and internationalization are frequently misconstrued and misused terms. Internationalization is the process of enhancing involvement in international operations, which requires adapting the firm's strategy, resources, structure and organization to international environments (Calof and Beamish, 1995). Divestment and exit, as well as growth and expansion, form part of internationalization. Globalization is a subset of internationalization. Globalization stems from interdependencies across the subsidiaries within an international firm. These dependencies need to be actively managed and where corporate dominates

subunit maximization. Internationalization and globalization vary from other growth strategies, such as product diversification, because they involve transacting in goods, services and know-how across national borders (Calof and Beamish, 1995).

III.1 Theory and Assessment of FDI

Different scholars have defined strategy and strategic management in different ways (Quinn, 1980). A common element of most definitions is that it is a pattern or plan that integrates an organization's major goals, structure, policies and sequences of actions into a cohesive whole. A firm's strategy supplies a sense of direction for the enterprise. It assists in coordinating the geographic, functional and product bases of the firm, minimizes intra organizational conflict and serves as a guide for decision making (Quinn, 1980).

Hill et al. (1990) in seeking to develop an all-encompassing theory, link the organizational structures, as described by Franko, Stopford and Wells and Bartlett and Ghoshal to mode choice. They argue that this choice will be determined by a strategic assessment of three variables: the degree of control offered by the mode; the resource commitment the mode requires and the risk the firm must bear. Control refers to authority over operational and strategic decision-making (Hill et al. 1990). The least level of control is offered by licensing and the highest by a wholly owned subsidiary. In the case of licensing, control is given to the licensee in return for monetary payments and a commitment to abide by any terms set out in the licensing contract. In the case of the wholly owned subsidiary, control over day-to-day operations and certain strategic decisions may be delegated to the foreign subsidiary but ultimate control always remains with the parent (Hill et al. 1990). In the case of joint venture, the level of control is dependent on the ownership split. Control is shared. Thus the

level of control of a joint venture falls between that associated with licensing and that of a wholly owned subsidiary (Hill et al. 1990).

Resource commitment refers to the extent to which the mode requires dedicated assets, tangible or intangible that cannot be redeployed to alternative uses without cost (Hill et al. 1990). In the case of licensing the licensee bears most of the cost of opening up and serving the foreign market. The resource commitment is therefore low. By contrast, a wholly owned subsidiary requires that the MNC bear all the resource cost. Once again, the level of resource commitment of a joint venture falls between these extremes, depending on the resource sharing between the venture partners (Hill et al. 1990).

Dissemination risk refers to the risk that firm-specific advantages in know-how will be expropriated. Technological and marketing know-how constitutes the basis of the competitive advantage of many MNCs (Casson, 1982; Caves, 1982). The MNC will not want to see firm-specific know-how disseminated as this reduces the future income flow.

III.2 FDI and Commerce

Recent efforts by international trade economics have led to the integration of the theory of the multinational corporation (MNC) into the theory of international trade (Hill et al. 1990). This is both an exciting and an important development. Prior to the last decade or so, analysis of the MNC was largely distinct from trade theory. The former was partial equilibrium in nature, while trade theory maintained the assumptions of constant returns to scale and perfect competition, which generally precluded any discussion of multinational firms by definition. Beginning about 1980, the industrial-organization approach to trade began developing general-equilibrium models with increasing returns to scale and imperfect competition (Hill et al. 1990).

Yet the multinational firm was generally missing, in spite of having precisely these characteristics. Although empirical work is still limited, results to date are extremely encouraging in that they give strong support to the empirical predictions of the theory (Hill et al. 1990).

Before beginning, a few stylized facts are in order. These are discussed in much more detail in Markusen (1995). Two terms are used to classify types of direct investment: horizontal multinationals are firms, which produce the same goods and services in different locations; vertical multinationals are firms, which geographically fragment the production process by stages (Markusen 1995).

1. Firm characteristics: multinationals are firms intensive in the use of knowledge capital. Physical capital intensity and plant level scale economies do not explain multinational features.
2. Country characteristics: most direct investment occurs among the high-income developed countries. Outward direct investment is associated with a high level of human capital.
3. Most direct investment is horizontal, although it is admittedly hard to separate horizontal and vertical investments in the data.
4. Are trade and direct foreign investment (DFI) substitutes? At a superficial level they look like complements. More recent, formal empirical work suggests that they are indeed substitutes at a fine level of disaggregation, but DFI in a four-digit industry may be complementary to imports in a different four-digit industry.
5. There is only weak evidence that trade barriers and/or tax avoidance contributes to explaining direct investment.

III.2.1 A Knowledge Capital Approach

For a firm to become a multinational, it must have offsetting advantages. A limited but very useful organizing framework for inquiring into the nature of these advantages was proposed by John Dunning (1977; 1981; 1993). Dunning proposed that there are three conditions needed for firms to have a strong incentive to undertake DFIs.

- Ownership advantage: the firm must have a product or a production process such that the firm enjoys some market power advantage in foreign markets.
- Location advantage: the firm must have grounds to establish production abroad rather than concentrate it in the home country, especially if there are scale economies at the plant level.
- Internalization advantage: the firm must have a reason to want to exploit its ownership advantage internally, rather than license or sell its product/process to a foreign firm.

III.3 Outsourcing Jobs and Enterprise Level Bargaining

Foreign direct investment (FDI) is similarly controversial. FDI has grown more rapidly than trade over the past decade (Lawrence, 1996). In addition, FDI may have labor market effects that, at least in the short- and medium-run, may well dwarf the effects of trade. Unfortunately, the effects of FDI on labor markets are hard to gauge. The analysis of FDI has all the same problems that plague attempts to relate trade flows to labor market effects. FDI involves additional difficulties. For instance, FDI generally involves changes in competitive conditions in commodity markets as well as endowment effects (Lawrence, 1996). Conventional models of FDI treat multinational corporations as firms with some kind of competitive advantage that

permits them to enter foreign markets. The growing global nature of firms in particular sectors of the domestic economy surely must also have non-trivial labor market effects(Lawrence, 1996).

III.4 FDI and the Structure of Home Country Production

The effects of foreign direct investment (FDI) on the home countries of multinational corporations (MNCs) have been discussed for several decades, but the topic has attracted renewed attention in the international debate during the past few years. The global liberalization of trade and investment flows agreed upon in GATT’s Uruguay Round and the regional integration processes in Europe, the Americas, and the Asia-Pacific region are important reasons for this resurgence of interest (Lawrence, 1996). The reduction of trade and investment barriers at the global as well as regional level is creating new, large markets and removing restrictions on where plants can be located. One of the consequences is a marked increase in cross-border mergers and acquisitions as MNCs are adjusting to the new environment, particularly in the EU where formal integration has reached further than in other parts of the world (Lawrence, 1996). It is likely that these processes of globalization and rationalization will change the pattern of international investment, with consequences for both home and host countries (Lawrence, 1996).

IV. Merger & Acquisition (M&A)

IV.1 Mergers Vs Acquisition –The Subtle Variation

The terms "merger" and "acquisition" are often disconnected and used interchangeably by business and financial executives (Galpin et al., 1999). At the superficial level, the divergence between a merger and an acquisition is not a concern because the net impact is often the same: Two companies (or more) that had separate ownership begin operating under the same ownership and management, normally to incur a strategic or financial target (Galpin et al., 1999).

Yet, the financial, tax and strategic even cultural impingement of such deals may be very contrasting depending on whether the transaction is structured as a merger, which typically pertains to two companies coming together (usually through the exchange of shares) to become one, or an acquisition, which typically refers to one venture (the buyer) purchasing the assets or shares of another (the seller) either with cash, the securities of the buyer or other assets of value to the seller (Galpin et al., 1999).

In an acquisition that is accomplished as a stock-purchase transaction, the seller's shares are not inevitably combined with the buyer's existing company; instead, the shares are often kept separate, to become a fresh subsidiary or operating division (Galpin et al., 1999).

When the acquisition is operated as an asset-purchase transaction, the seller's assets become supplementary assets of the buyer's company. The desire and outlook is that, with the passage of time, the value of the assets that have been purchased will outmatch the price paid for them, thereby enhancing shareholder value as an impact of the strategic or financial benefits of the transaction (Galpin et al., 1999).

IV.2 M&A - What does it Connote?

What has propelled the merger-mania of recent years? What elements have aided the current resurgence of merger and acquisition activity? And how are these recent mergers and acquisitions different from those conducted in the M& hysteria of the 1980s? Although there are no straightforward answers, common themes and trends exist in M&A transactions (Galpin et al., 1999).

Recent M & A are transparently motivated by strategy than their 1980s counterparts. Jobs are often being added, not lost, as a consequence of these deals. Companies are being established, not busted-up (Galpin et al., 1999).

The funding behind recent M&A deals is more sound and certified than ever before. Buyers are utilizing their stock as currency and sellers are accepting this mode of payment in lieu of or in addition to cash, which forces both parties to operate together on a post-closing basis to truly heighten shareholder value (Galpin et al., 1999).

In many cases, M& A are being impelled by a key trend within a given industry. Trends most impacting specific industries include (Frankel, 2005):

1. Rapidly altering technology in the software industry
2. Stiff competition in the telecommunications and banking sector
3. Altering consumer predilections in the food and beverage industry
4. Pressure to ascertain costs in the healthcare industry

Some deals are motivated by the need to transmute corporate identity following a crisis (Frankel, 2005). Many deals are propelled by the demand to spread the risk and cost of developing new technology (especially in the communications and aerospace industries); of researching new medical discoveries (as is the case in the

medical-device and pharmaceutical industries); or of gaining access to new sources of energy (such as in the oil and gas exploration and drilling industries) (Frankel, 2005).

Globalization has compelled many companies to explore mergers and acquisitions as a means to develop an international presence and expanded market share. This market-penetration strategy is often more cost-effective than attempting to establish an overseas foothold from scratch (Frankel, 2005).

Many recent M& A have been propelled by the demand for a total product or service line to stay competitive or to balance against seasonal or cyclical market trends. Transactions in the retail, hospitality, food and beverage, entertainment and financial-services industries have been in response to consumer demand for "one-stop shopping." (Frankel, 2005).

The technology and Internet IPO boom of the late 1990s conduced to the merger and acquisition frenzy. The proceeds from these IPOs created large pools of cash that had been appropriated for acquisitions, and sellers became more willing to take the buyer's stock as currency in the transaction (Frankel, 2005).

IV.3 Synergy in M&A

Many well-intentioned entrepreneurs and business executives have embarked into M& A that they later came to regret (Frankel, 2005). Such an outcome is often the consequence of classic mistakes, such as a lack of adequate planning, an overly aggressive timetable to closing, a failure to really look at possible post-closing integration problems or, worst of all, sought-after synergies that are surreal and unachievable. The premise of synergy is that the "whole will be greater than the sum of its parts." (Frankel, 2005).

But the pursuance for synergy can be very elusive, especially if there is lack of communication between buyer and seller, which normally leads to a misapprehension

over what the buyer is really buying and the seller is really selling. Everyone informs that they want synergy when doing a deal, but few take the time to evolve a transactional team and a joint mission statement of the objectives of the deal, or to solve post-closing operating or financial problems on a timely basis in order to accomplish it (Galpin et al., 1999).

IV.4 The Motivation Factor

Sherman (2001) in his article "What Drives the Urge to Merge: Motivation" explains the motivating factors behind M&A.The findings are outlined below:

As a leader of an emerging-growth business, it is likely that at least one acquisition will be part of a company's growth strategy. Therefore, it is critical that the management not only has a clear comprehension of the company's business objectives as it pursues an acquisition, but it also must have insight into what a seller seeks to accomplish through the transaction.

IV.4.1 What Motivates Acquisitions?

As the buyer in an acquisition transaction, the motivators are likely to include one or more of the following (Sherman 2001):

1. Diversification into new products and services.
2. Revenue improvement
3. Cost simplification
4. Vertical and/or horizontal operational and financial synergies
5. Growth concerns from investors
6. Under utilized resources
7. Abbreviating the number of competitors (increasing market share)
8. Establishing a foothold, into new domestic and International markets (especially if current markets are saturated); or

The seller's motivation in an acquisition transaction can include (Sherman 2001):

1. The inability to compote as an independent entity
2. The desire to obtain cost-savings and access to the greater resource of the acquiring company; or
3. The need for an exit strategy, either due to the nearing retirement of the owners or for some other reason.

IV.4.2 What Stimulates Mergers?

As explained earlier, a merger differs from an acquisition. As a result, the motivators for a merger will alter from those for an acquisition, and typically include (Sherman 2001):

1. The demand to enhance process engineering and technology
2. The hope to increment scale of production in existing product lines
3. The desire to adopt capability to produce subassemblies internally
4. Need to find added uses for existing management talent
5. A way to re deploy excess capital into profitable/complementary uses; and
6. A mode to obtain tax benefits.

In a classic merger, there is not a buyer or a seller (though one party may be directing the transaction or may have initiated the contact). Therefore the culture and spirit of the negotiations are dissimilar from those of a classic acquisition. In a merger, information assimilation and due diligence are mutual, with each party positioning its contribution to the post-merger entity to justify its respective equity share, management and control of the post-merger company (Sherman 2001).

IV.5 Planning for an Acquisition

Business strategists often inform that it is cheaper to buy than to establish a business (Galpin et al., 1999). This attitude, together with the low interest rates and the large pools of capital that have flowed into large and medium-size companies through initial public offerings both in the United States and abroad, has created acquisition frenzy that is likely to continue well into this century. Notwithstanding all of the excitement, the purchase of an existing business is a complex and challenging project (Galpin et al., 1999).

One of the overriding objectives of the acquisition plan is to constrict the field as much as possible. The first step is to prefer acquisitions as a growth strategy to alternatives such as franchising or strategic alignments (Galpin et al., 1999). The decision is narrowed again by picking out the targeted industries, and narrowed further by the development (and enforcement) of specific criteria to screen the possible candidates. This narrowing process in most cases, if cautiously abided by, will yield a small but viable field of attractive candidates whom the management can approach as acquisition targets. Other gains to having a well-prepared acquisition plan include (Galpin et al., 1999):

1. Furnishing a road map for your company's leadership to follow
2. Intimating shareholders of key objectives
3. Abbreviating professional and advisory fees
4. Mitigating the risk of executing a transaction
5. Distinguishing post-closing integration challenges well in advance; and
6. Informing sellers of plans for the company on a post-dosing basis.

In today's marketplace, with the trend toward roll-ups and integration strategies, it is especially critical to the seller to comprehend, accept and respect the

acquisition strategy and growth plans for the consolidated companies on a post-closing basis (Galpin et al., 1999).

A carefully considered acquisition plan should also distinguish the value-added efficiencies and cost-savings that will result from the proposed transaction and answer the fundamental question: How will the company's professional management or brand equity increment the functioning or profitability of the seller's company? (Galpin et al., 1999)

IV.6 Risks Associated with M&A

M & A present risk managers with new risks, novel issues and new pressures. The concentration issues normally associated with M& A are listed below:

IV.6.1 Maturation of Post-merger Identity

The idea of identity has been discussed and researched within the M&A literature in relation to the sense of lost identity which employees encounter at the time of acquisition and the process by which both employee groups form a new social and organizational identity. In terms of the individual's response to M&A, a equivalence is frequently drawn between the experience of acquisition and that of bereavement in that employees grieve the loss of their organization and its identity (Schweiger, Ivancevich, & Power, 1987). Schweiger et al. (1987) likened the intensity of the feelings of loss encountered by acquired employees to the loss of a close family member, and Holmes and Rahe (1967) rate M&A as a highly significant life event in terms of its impact on stress and health. Determinations from a co relational study analyzing the factors linked with employee trust post acquisition, conducted in Greece (Nikandrou, Papalaxandis, & Bourantes, 2000), suggest that the extent to which employees have confidence and trust in management may influence their reactions to the M&A event. The process by which members of merged organizations form new

identities has been studied within the context of Social Identity Theory (SIT) (Tajfel & Turner, 1979).

IV.6.2 Human Resource Management Practices

According to a considerable number of researchers (e.g., Cartwright & Cooper, 2000) post merger performance is adversely impacted by lowered morale, which is often connected to perceptions of unfair treatment. Employees' perceptions of justice or fairness concerning how they are treated with regard to pay, promotion, and individual consideration have vital consequences for organization performance more generally (Colquit, Conlon, Ng, Porter, & Wesson, 2001) and have become an important focus of psychological research (Gilliland & Paddock, 2005).

IV.6.3 Trust and Communication

The M&A literature has persisted to stress on the importance of communication throughout the three stages of the process; that is, pre merger, the time the merger actually happens, and throughout the post-merger integration process (Marks, 1997). Characteristically, employees involved in M&As report dissatisfaction with the quantum of communication they receive (Napier, Schweiger, & Kosglow, 1993). In the absence of sufficient information, employees are considered to be 'too smart' to believe that nothing will change and so create their own meanings to fill the void (Shearer, Homes, & Runge, 2001). It is argued that extensive and realistic communication can significantly reduce resistance to change, influence the adoption of new practices and cultures, dispel rumors and minimize uncertainty and employee stress (Appelbaum, Gandell, Yortis, Proper, & Jobin, 2000).

IV.6.4 Emotional & Behavioral Outcomes

M&As have long been associated with a range of negative emotional and behavioral outcomes, including lowered morale, job dissatisfaction, increased stress, unproductive behavior, acts of sabotage, petty theft, increased staff turnover, and absenteeism (Marks & Mirvis, 2001).

IV.6.5 Executive Turnover

A growing number of studies (Buchholtz, Ribbens, & Houle, 2003) have illustrated that M&As result in increased levels of executive turnover among acquired companies, compared with matched non-acquired organizations over the common time periods.

IV.7 Experts Perspective on M&A

Sudi Sudarsanam is an expert in corporate restructuring, M& A and corporate strategy. He is one of the leading authorities on mergers and acquisitions in Europe and author of the standard work in this area. Sudi's perspective on the various factors associated with M& A is furnished here to substantiate the grounds for this dissertation.

In the last ten years numerous proposals to reform and strengthen the board as an effective monitor of corporate management have been devised and implemented in different countries (Sudarsanam, 1995). Among the extrinsic disciplinary mechanisms is the market for corporate control or takeovers. Takeovers, especially hostile takeovers, can play a role in eliminating incumbent managers of under performing companies and thereby chasten managerial failure (Sudarsanam, 1995).

Contrary to the common perspective, hostile takeovers produce higher value for shareholders than friendly ones and thus seem to accomplish their role as an effective managerial disciplinary device. Yet, hostile takeovers have encountered

much bad press and in many countries are vehemently dissented by various interest groups and politicians (Sudarsanam, 1995). There is a case for reassessing hostile takeovers and the demand for the regulatory regimes in different countries to be ameliorated so that obstructions to hostile takeovers are eliminated and a freer market for corporate control is created (Sudarsanam, 1995).

IV.7.1 Appraising Managerial Performance Failure

In general, managerial failure is bankruptcy to gratify the anticipations of the stakeholders of the corporation over the long term. Stakeholders of a corporation encompass shareholders, managers, employees, suppliers, customers and the community (Sudarsanam, 1995).

Pursuits of different stakeholders in a company often converge particularly over the long term but can also be in dispute. Stress on long term shareholder value is critical not only for current shareholders but also for the future well being of millions of other stakeholders such as employees or pensioners whose savings are invested in stock markets through financial institutions(Sudarsanam, 1995). Thus, long-term value creation for shareholders may be considered as a legitimate criterion to appraise corporate performance. Failure to affirm or create shareholder value often meditates failure to fulfill other stakeholders as well. On the other hand, success in satisfying other stakeholders is an essential, but not a sufficient, condition of successful shareholder value creation (Sudarsanam, 1995).

IV.7.2 Managerial Failure and Corporate Supervision

Failure may arise from poor strategy, inability to envision emerging competitive threats, inability to adjust their organizations to meet these threats, inability to spot new chances, weak organizational structure and poor alignment of managerial and shareholder interests. Failure may be induced or facilitated by

deficient corporate governance and dearth of external disciplining mechanisms (Sudarsanam, 1995).

IV.7.3 External Mechanism for Corporate Monitoring

The different internal monitoring devices endure from several disabilities. For example, the true independence of non-executive directors may not always be ascertained (Sudarsanam, 1995). The practical potency of classifying CEO from Chairman is yet to be conclusively established. It is also well documented that target shareholders encounter substantially larger wealth gains in hostile than in friendly deals. Thus, overall, the value produced may be larger in hostile than in friendly deals (Sudarsanam, 1995).

IV.7.4 Why do Hostile Acquirers Outperform Friendly Acquirers?

Let us deliberate the odds against hostile bids succeeding in terms of shareholder wealth creation. In hostile bids, transaction costs are much elevated due to the longer duration of the bid and higher levels of fees to advisers such as investment banks, lawyers and accountants (Sudarsanam, 1995). As we have noted earlier, bid premium to target shareholders is much elevated in hostile bids. Thus synergies, if any, are more arduous to accomplish. High target management turnover in hostile acquisitions escalates costs through golden parachutes, compensation for loss of office etc (Sudarsanam, 1995). In addition to all these, the opportunity cost of bidder management time in engaging a hostile bid is, though difficult to quantify, not inconsiderable. Significant traits of a flourishing implementation process include clarity of purpose, better leadership, rapid pace of alteration and integration, improved communication and better compensation and incentive structure for managers and employees. It may be that hostile acquirers usher these qualities to the implementation process in a larger measure than friendly acquirers (Sudarsanam, 1995).

IV.7.5 Are Hostile Bids Disciplinary?

A ground on the pre-bid performance of targets does not indicate to any pronounced underperformance by targets. Thus it is not altogether true to state that hostile bids are targeted at inefficient managers. However, inefficiency can be conceived as mistakes of commission as well as errors of omission(Sudarsanam, 1995).

There is some empirical evidence that hostile bids lead not only to higher top management turnover than friendly bids, but also to importantly more sales of the acquired firms' assets. Such asset disposals indicate to sub optimal exploitation of the targets' assets in the pre-acquisition period and the failure of the target management to put them to the highest value use (Sudarsanam, 1995).

IV.7.6 Impact of Regulatory Regimes on Hostile Takeovers

The evolving takeover regulatory regime may be uncongenial to hostile bids. Given that hostile acquirers seem able to produce more value than friendly acquirers such a regime will be less than ideal from the shareholders' perspective. Since hostile acquisitions only account for less than 20% of all acquisitions of public companies, the underperformance of friendly acquisitions is indeed concerning. Less faith, rather than more, in the comparative virtues of friendly acquisitions is needed (Sudarsanam, 1995).

In adjudicating whether hostile takeovers should be alleviated or hindered this criterion needs to be given due significance. On current evidence, any overzealous or over emotive attempt to hinder or eliminate hostile takeovers to serve the very short term interests of some groups may result in long-term value destruction to the damage of all stakeholders. It is critical to sustain hostile takeover as a significant managerial

control device specifically given the lacuna of many alternative control mechanisms (Sudarsanam, 1995).

V. M & A in China

V.1 Background

Of late China has witnessed rapid developments in M& A activities. It is pertinent to note that this type of business operation were unheard a decade ago. However, currently, China's economic growth is propelled by a spate of M&A happening across different sectors.

The M&A mechanism now extend external investors a feasible process of establishing their presence in the Chinese markets. China's economic reforms and vigorous development have propelled the M&A activity. The sustained durability of the Chinese economy has aided investors to manipulate the M&A mode for investments in new projects.

V.2 Legal Frame Work

China has persisted to reform its state-owned enterprises (SOEs) since the adoption of the Open Door Policy at the end of the 1970s (Peng 1997). The aim of the government is to expose SOEs to market pushes to enhance skillfulness and competitiveness (Child/Tse 2001). Organizational alteration plays a vital role in accomplishing the transition from the old style Chinese SOEs to modern competitive operators in the global marketplace (Lim/Sziraczki/Zhong 1996, Benson/Zhu 1999).

The biggest SOEs are under the control of Chinese Government. Also, numerous small or mid sized SOEs are closely held by local governments. A number of the SOEs have been integrated in recent years as joint stock companies (Child/Tse 2001). The central or local governments' ownership rights were formalized as shareholdings. Others companies are under the control of anonymous bureaucratic establishment. Historically, the central ministries and local governments frequently interpose directly in the daily activities of SOEs. The endeavourer of the Central

government strategy has been to delink the state's ownership operations and claims from management (Child/Tse 2001). This has given to mixed results. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was formulated to control state-owned property in the year 2003.[3]

V.3 Common Regulations

International M&A furnishes the criteria for overseas investors to investors take on the rights of domestic enterprises in accordance with the Chinese laws and regulations (The M&A Provisions, 2003). Despite any shape an M&A takes, it is assumed to be property dealing between foreign investors and domestic participants; it should be executed in accordance with the rules of civil and commercial law. Also, the concerned parties have the right to opt for the applicable law(s) unless the law provides otherwise. This is a specific trait of M&As in private law. China has a legal framework for such transactions established on its General Provisions of Civil Law,[4] Company Law,[5] Contract Law,[6] Security Law,[7] and three basic laws and enforcement stipulations for the FIEs,[8] that framework explicates the legal ambience in which the parties of international M&As can deal with their transactions.[9]

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(3): For detailed information, see www.sasac.gov.cn/news 10/01/2003, "Chinese government decided to set up SASAC to manage the state –owned properties".
(4) See LIN Ping, "Merger Control Regime in China," p. 4. Available at http://www.ln.edu.hk/econ/staff/plin/Merger/pdf.
(5) For detailed information, see www.sasac.gov.cn/news 10/01/2003, "Chinese government decided to set up SASAC to manage the state –owned properties".
(6) Refer to General Principles of the Civil law of the PRC. Adopted at the fourth Session of the NPC on April 12, 1986.
(7) Refers to Company Law of PRC adopted by the Standing Committee of the NPC on 29/12/93. First amended decision adopted in 1999, and second amendment was made in 2004.
(8)Refers to Contract Law of PRC issued by the Standing Committee of the NPC, effective from 01/10/1999.
(9) Refers to Securities Law of PRC issued by the Standing Committee of the NPC 29/12/1998.

V.4 Government Regulations

In the absence of any specific regulations on international M&As, China has ushered in a gamut of stipulations to make good the gap. Most of the prevailing stipulations on M&As in China, as listed in Table V.4.1, are adopted because the government proposes to woo and modulate FDI (The M&A Provisions, 2003).

<table>
<tr><th>Title of Law</th><th>Issuing Date</th><th>Target Enterprise</th><th>Category</th></tr>
<tr><td>Interim Provisions on Asset reorganization of SOEs by Using Foreign Investment</td><td>14 Sept. 1998</td><td rowspan="2">SOE or SOC</td><td rowspan="2">□</td></tr>
<tr><td>Interim Provisions on Restructuring SOEs by Using Foreign Investment</td><td>8 Nov. 2002,
effective 1 Jan. 2003</td></tr>
<tr><td>Measures on the takeover of the Listed Companies</td><td>28 Sept. 2002</td><td rowspan="2">Listed company</td><td rowspan="2">□</td></tr>
<tr><td>Circular Regarding the Transfer of State-Owned Shares and Legal Person Shares of Listed Companies to Foreign Investors</td><td>4 Nov. 2002</td></tr>
<tr><td>Several Provisions concerning Changes in Equity Interest of Investors in FIEs</td><td>28 May 1997</td><td rowspan="2">FIE</td><td rowspan="2">□</td></tr>
<tr><td>Provisions on Mergers and Divisions of FIEs</td><td>1 Nov. 1999
rev. on 22 Nov. 2001</td></tr>
<tr><td>Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors</td><td>7 Mar. 2003</td><td>Domestic Enterprises</td><td>□</td></tr>
<tr><td>Catalogues for the Guidance of Foreign Investment Industries</td><td>21 Feb. 2002</td><td colspan="2">All the Foreign Investment</td></tr>
</table>

Table V.4.1: China's regulations on FDI-related M&As

Source: The M&A Provisions, 2003

V.5 Problems/ Solutions of International M&As In China

Despite the enormous implication that the M&A activity has ushered in China these laws and stipulations do have some provisions for fair competition, they mainly target at modulating FDI (The M&A Provisions, 2003).

V.5.1 China's M&As Regulations- Issues & Relevance

The core issue that the M&A stipulations only apply to M&As by foreign investors and fail to furnish for M&As transactions among domestic enterprises or their acquisitions by extraneous investors. Also the M&As Provisions is mute on under what conditions prior rules and regulations that govern M&As transactions of all types, FDI related or otherwise, shall apply (The M&A Provisions, 2003).

Domestic Manipulation

"National Treatment," which is a critical element of the WTO regime, infers that foreign investors are eligible to the same rights as the domestic investors in the host country. This is despite the fact there is no 100% "same" treatment with the national since every country has its personal restrictions on foreigners. After China ascension to the WTO, all the foreign investors are also eligible to this treatment in China (The M&A Provisions, 2003). On the contrary from the 1980s up to its accession to the WTO in 2001, China had extended two types of treatments to foreign investors which Chinese scholar have termed as "super national treatment" and "inferior national treatment."[10]

Asset Grading Limitations

In China, the state-owned shares and legal person shares in the listed company, which are not allowed to trade on the stock market, constitute 2/3 of the completed assets of the listed companies. Also, foreign investors are not permitted to purchase publicly transferable shares on the Chinese stock market (The M&A Provisions, 2003).

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(10): For a discussion of the terms, see, for example, GAO Ershen, International Economic Law (Beijing: Law Press) 1998, pp. 18-32.

Therefore, the optimum mode for foreign investors to secure the M&A of a listed company is to acquire non-tradable shares by agreement. The process of determining the transfer price of those non-tradable state-owned shares is a cumbersome task (The M&A Provisions, 2003).

Despite the fact that M&As Provisions regulates that the transaction price should not be lower than the net value of the assets, and that an asset evaluation must be executed, Art. 8 of the M&A Provisions are not specific enough to satisfy the M&As parties. This is due to the fact that it only provides that the parties of the M&As may opt an asset evaluation institution formulated within the territory of China which shall execute asset appraisal by embracing internationally acknowledged evaluation methods (The M&A Provisions, 2003).

Anti-Monopoly and Competition Factors

The Chinese government has discerned the demand to formulate an advanced merger control and anti-trust process with the advent of transactions associated with M&As. There is an absence of an all-inclusive anti-monopoly law to regulate M&As dealings in China. Most of the prevalent M&As guidelines in China are established on the government's hope to woo and modulate FDI. Of these laws, three comprise competition purveys (The M&A Provisions, 2003).

Victuals on Mergers and Divisions of the FIEs

The Provisions on Mergers and Divisions of the FIEs, was first proclaimed in November 1999 and subsequently revised in November 2001. This criterion furnishes that mergers and divisions of FIEs "must follow the principles of voluntary and equal transaction and fair competition, and shall not jeopardize public interest and the lawful interests of the creditors". [11]

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(11): See Art.5 Provisions on Mergers and Divisions of FIEs.

Interim Provisions on Restructuring SOE by Using Foreign Investment

Advance fair competition and forbid monopolization is one of the basic objectives of the Interim Provisions on Restructuring SOEs by Utilizing Foreign Investment (Article 6).

Interim Provisions on the M& As of Domestic Enterprises by Foreign Investors

The M&A Provisions is the most blanket regulations on M&As control in China to date. It is specifies that, as a general rule, M&As "shall not create excessive concentration, eliminate or hinder competition, disturb social and economic order or harm public interests."[12]

Offshore M&As Transactions

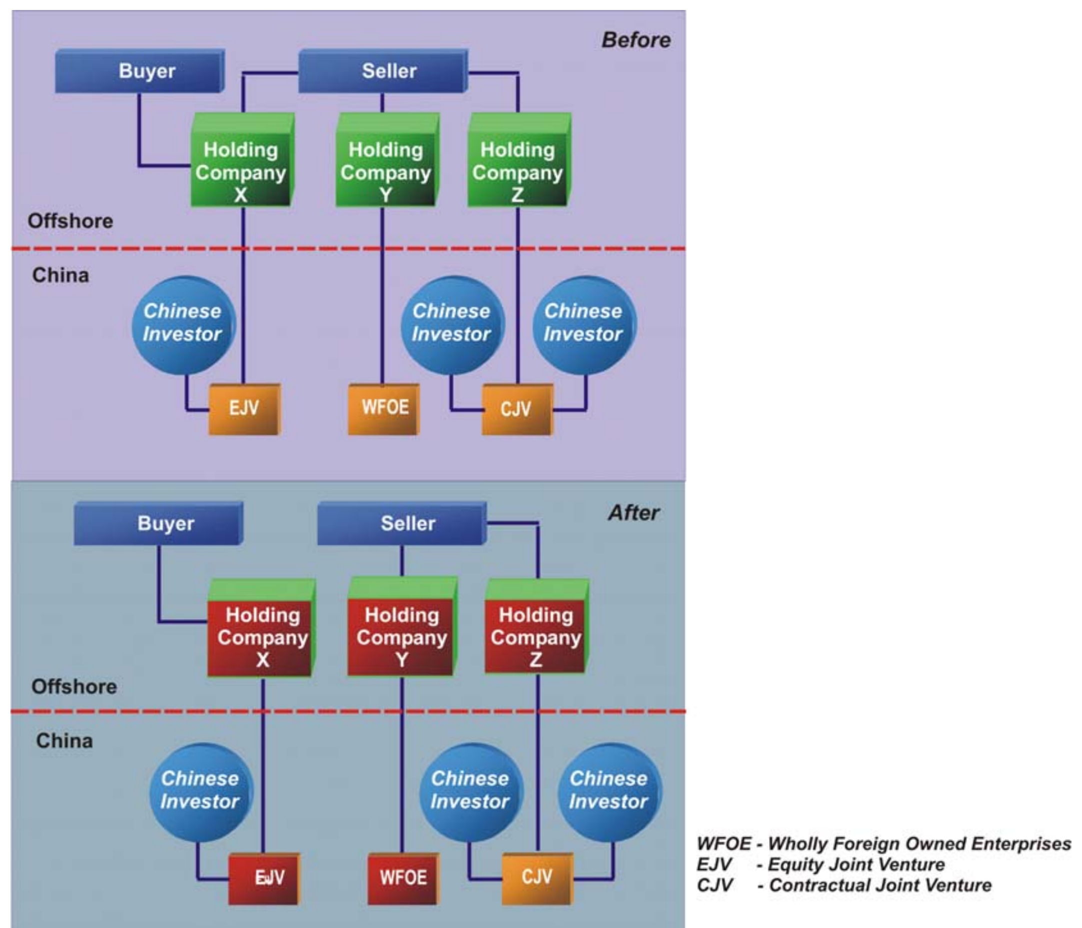

Figure V.5.1: China's regulations on FDI-related M&As

Source: The M&A Provisions, 2003

A number of foreign investors structure their holdings in China through intermediate offshore holding companies, often one for each FIE, precisely to allow this flexibility for subsequent transfers of their interests (The M&A Provisions, 2003).

By manipulating multiple intermediate offshore holding companies for various FIEs, corporate groups can also readily complete different forms of intra-corporate restructuring without becoming ensnarled in the Chinese regulatory system (The M&A Provisions, 2003).

Onshore M&As Transactions

Foreign investors have long been empowered to acquire B shares in the Chinese markets. On November 5, 2002, the China Securities Regulatory Commission ("CSRC") and the People's Bank of China ("PBOC") jointly published Provisional Rules on the Management of Investment in Domestic Securities by Qualified Foreign Institutional Investors (the "QFII Rules")

Exemptions

Certain types of transactions are relieved from the reporting demands after conforming to the specified thresholds (The M&A Provisions, 2003). These pragmatically set exemptions encompass transactions that may promote competition, restructure enterprises running at loss and ensure employment, introduce advanced technologies and management expertise and enhance the international competitiveness of the domestic enterprise or improve environmental conditions.[12]

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(12): See art.22 The M&A Provisions.

VI. Case Studies

VI.1 Background

In this dissertation, we will be examining two types of M& A in China as outlined below:

1. Cross Border M& A: The M& A of a foreign company with a Chinese venture
2. Domestic M& A: The M& A of two Chinese companies

VI.2 Research Methodology

A balance sheet evaluation model will be utilized for this dissertation .A balance sheet summarizes the financial position of a business at a point in time. It lists all of the assets and all of the liabilities of the business as of a certain date (Solomon, 7). More formally, a balance sheet (or statement of financial position) is a report that shows the financial position of the business at a particular moment of time, including the business's economic resources (assets), economic obligations (liabilities), and the residual claims of owners (owner's or stockholders' equity).

Balance sheet valuation models utilize the following components:

1. Book Value: the net worth of a company as shown on the balance sheet (Solomon, 4).
2. Liquidation Value: the value that would be derived if the firm's assets were liquidated (Solomon, 128).
3. Replacement Cost: the replacement cost of its assets less its liabilities (Solomon, 149).

VI.3 Assumptions and Theoretical Basis

The conclusions are valid only if the inference of significance relies on the following assumptions (Solomon, 121):

1. The gap between the definitions of financial statement elements and their recognition in those statements has proved to be one of the most troublesome in the whole area of accounting policy. The term recognition in accounting is a simple one. It is "the process of formally recording or incorporating an item into the financial statements of an entity" as one of the elements already listed. Recognition attempts to represent or depict in financial statements the effects on an entity of real-world things and events.
2. Among the most important is the uncertainty that the expenditures, when incurred, will result in future benefits; the alleged lack of a causal relationship between the expenditures and benefits; and the difficulty of measuring the probable benefit. What must be noted, for our present purpose, is that an item that satisfies the definition of an element of a financial statement may yet not be included in the statement because it does not satisfy the tests for recognition.

VI.4 Cross Border M& A

The primary objective for cross-border M&A is to produce shareholder value. Public firms' assessment of enhancing shareholder is mainly reflected in their stock price .If the MNE's share price is a combination of earnings and the market's opinion of those earnings, the price to earnings multiple, then management should strive to grow both.

Apart from the desire to evolve, MNEs are motivated to attempt M&A activity for other factors. These drivers are normally macro in scope, the global competitive

environment, and micro in scope, the variety of industry and firm-level forces and actions driving firm value.

VI.5 Mergers and Acquisitions in the Brewing Industry

Despite the far-reaching implications of globalization the brewing industry has long fell behind and persisted to be disconnected. Globalization in the beer sector has prolonged at a much sluggish tempo than in many related ventures(Benson-Armer et al, 1999). Management consultants apprehended that "Even today's most global brewers are relatively small and vulnerable to takeovers, perhaps by other packaged goods companies aiming to extend their food brands or distribution" (Benson-Armer et al, 1999). Thus, during recent years pioneer enterprises like Heineken and InBev (former Interbrew) have commenced internationalizing their activities in order to continue growing and expanding in view of saturated home markets (Todd, 2004). In recent years the brewing industry has been experiencing an unprecedented push for consolidation primarily impacted through a series of high profile mergers and acquisitions. Thus, internationalization in the beer industry is now progressing at a rapid pace.

VI.6 Anheuser-Busch's Acquisition of Harbin Brewery

VI.6.1 Anheuser-Busch (AB)

Anheuser-Busch (A-B) is the leading competitor within the alcoholic beverage industry. It is the major producer of domestic brews in the U.S., with a market share of 49.6%.

A-B has numerous brands including all of the popular brews within the Budweiser and Michelob Family. The company also has a 50% vested interest in Grupo Modelo, the producer of the number one U.S. imported beer, Corona (AB Annual Reports).

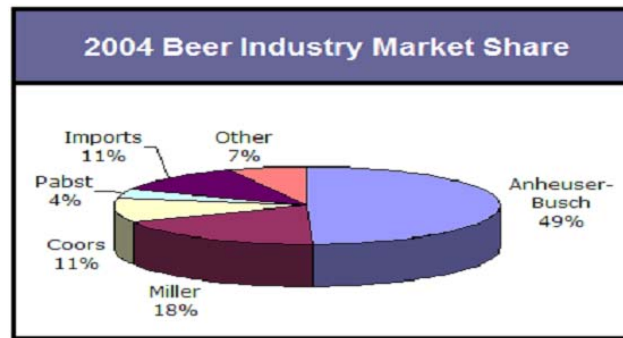

Table VI.6.1: Ranking of the world's biggest brewers
(Source: Data compiled from annual reports)

Apart from its core operations in domestic beer sales, A-B has subsidiary operations in international beer sales, packaging, and entertainment (AB Annual Reports).

VI.6.2 Harbin Brewery Group

The Harbin Brewery Group was a dominant player in the Northeastern part of China, and the fourth largest brewer in China, with a 4% market share for the country. Harbin held a 76% market share in its home city of Harbin City, as well as a 43% share in the Heilongjiang region (Thunderbird, 2005). Harbin was publicly traded, with its initial listing on the Hong Kong Stock Exchange in 2002. The Harbin Brewery Group was a dominant player in the Northeastern part of China, and the fourth largest brewer in China, with a 4% market share for the country. Harbin held a 76% market share in its home city of Harbin City, as well as a 43% share in the Heilongjiang region (Thunderbird, 2005).

Harbin was publicly traded, with its initial listing on the Hong Kong Stock Exchange in 2002. ``Tsingtao Beer'' is a celebrated brand of beverage in China and overseas. It is manufactured in Qingdao City, Shangdong province, employing the high quality mineral water in the region (Thunderbird, 2005).

Company	Output	Company	Output
1. Tsingtao Brewery	1,862	6. Sichuan Lanjian Brewery	467
2. Beijing Yanjing Brewery	1,411	7. Shenyang China Resources Brewery	419
3. Zhujiang Brewery	739	8. Chongqing Brewery	406
4. Henan Jin King Brewery	518	9. Hubei Jin Long Quan Brewery	381
5. Harbin Brewery	470	10. Hui Quan Brewery	316

Table VI.6.2: China's Leading Breweries based on Output (Thousands of tones)
(Source: Cash securities cash.com.HK)

The financial statements are furnished below for reference.

Assets	**2000**	**2001**	**2002**	**2003**	**2004E**
Cash and cash equivalents	74	61	168	266	221
Accounts receivable	37	115	133	112	149
Inventories, net	122	238	261	328	435
Deposits and prepaid	35	48	110	99	129
Current assets	268	462	672	805	934
Fixed assets	531	1,167	1,386	1,630	1,834
Intangibles and goodwill	22	114	158	151	143
Other assets	4	33	60	7	7
Total Assets	825	1,776	2,276	2,593	2,918
Liabilities & Stockholder Equity					
Short-term bank loans	184	168	126	161	161
Loans from shareholders	-	54	-	-	-
Dues to JV partners	17	48	27	27	27
Convertible notes	-	22	22	-	-
Accounts payable	76	163	150	189	252
Accruals and other liabilities	128	253	324	322	427
Taxes payable	6	7	9	9	9
Current liabilities	411	715	658	708	876
Long-term debt	66	564	640	690	690
Dues to JV partners	-	102	28	28	28
Minority interest	14	55	143	130	142
Total liabilities	491	1,436	1,469	1,556	1,736
Share capital	-	-	345	460	460
Retained earnings and reserves	334	340	462	577	722
Total stockholder equity	334	340	807	1,037	1,182
Total Liabilities & SE	825	1,776	2,276	2,593	2,918

Table VI.6.3: Harbin Brewery Group Ltd,
Consolidated Balance Sheets (million Rmb)
(Source: "Harbin Brewery Group Ltd.," Morgan Stanley Equity Research, April 23, 2004, p. 7)

(Million HK$)	2000	2001	2002	2003	2004E
Net sales	586	845	1,147	1,413	1,867
Cost of sales	(304)	(456)	(644)	(791)	(1,044)
Gross profit	282	389	503	622	823
Gross margin	*48.1%*	*46.0%*	*43.9%*	*44.0%*	*44.1%*
Operating expenses	(166)	(238)	(293)	(433)	(522)
Operating profit	116	151	210	189	301
Operating margin	*19.8%*	*17.9%*	*18.3%*	*13.4%*	*16.1%*
Net interest	(17)	(33)	(49)	(50)	(47)
EBT	99	118	161	139	254
Income taxes	(14)	(34)	(35)	(17)	(61)
Income before minority	85	84	126	122	193
Minority interests	-	(4)	(15)	(8)	(12)
Net income	85	80	111	114	181
Return on sales	*14.5%*	*9.5%*	*9.7%*	*8.1%*	*9.7%*
Wtd avg shares out	660	660	789	977	1,003
Earnings per share (HK$)	0.129	0.121	0.141	0.117	0.180
Effective tax rate	*14.1%*	*28.8%*	*21.7%*	*12.2%*	*24.0%*

Table VI.6.4: Harbin Brewery Group Ltd., Consolidated Income Statement, 20002004E
(Source: "Harbin Brewery Group Ltd.," Morgan Stanley Equity Research, April 23, 2004, p. 6)

VI.7 Acquisition Process

AB had taken a small minority interest in Tsingtao Brewery of China in 1993. In 2002 AB and Tsingtao had agreed to a strategic alliance to share best practices, as well as an increment in AB's investment in Tsingtao. AB's investment in 2004 had risen to 9.9% of Tsingtao, with an agreement to increase this stake to 27% by 2007. Anheuser-Busch also owned 97% of the Budweiser Wuhan International Brewing Co. Ltd. in Wuhan, China, which produced the Budweiser brand (AB Annual Reports).

Description	Allocation
Working capital deficit	$ (27.9)
Property, plant and equipment	173.1
Identifiable intangible assets	59.8
Goodwill	613.8
Long-term debt assumed	(118.4)
Net other liabilities	(6.6)
	$ 693.8

Table VI.7.1: Anheuser-Busch Beer Volume
(Source: Anheuser-Busch Financial Overview Report -2004)

The Wuhan brewery continued to expand production and increase its market share in that region. AB's new interest in Harbin was purportedly in agreement with Tsingtao's interests. (Anheuser-Busch Annual Report, 2004).

VI.8 Analysis of the Acquisition

The balance sheet of the companies under consideration is analyzed to comprehend the implication of the acquisition of Harbin brewery group by Anheuser-Busch (A-B).

Pre Acquisition Period

Starting from 2001, Harbin Brewery Group went through a numerous ownership changes. The Harbin City government had a major control over this company (Thunderbird, 2005). However, the remaining shares passed through different promoters. In June 2002, Harbin Brewery Group Ltd first went public eventually having a complete 41% of its ownership publicly floated. An additional 29%, however, passed from CEDF of Ireland (a publicly traded equity fund in Ireland) to SABMiller in June 2003 in a highly controversial investment. Gardwell- a financial investment company that was 95% owned by SABMiller and 5% Harbin Brewery management completed the actual purchase. This 29% equity position was not controlling, and SABMiller accorded to a five-year standstill agreement preventing it from acquiring additional shares (Thunderbird, 2005).

The Acquisition Process

Harbin announced on March 23, 2004, that it had formulated an accord to trade all of its shares to Global Conduit Holdings (GCH). However, it restrained to divulge the background of GCH. On May 2, AB announced that it would purchase the 29% interest now held by GCH for $139 million (HK$3.70/share). In the following weeks, AB acquired an additional 6.9% from a small investment group, Capital International,

and an assurance from Harbin's management team to tender their option shares (Thunderbird, 2005).

Implication of the Acquisitions

Anheuser-Busch core objective of enhancing shareholder value has been the motivating factor for this acquisition (AB Annual Reports 2004).

1. Beer Volumes

By completing this deal AB has increased its international beer segment presence. The company's reported beer volume for the three years ended December 31,2004, is summarized in the following table (millions of barrels):

	2004	2003	Change
Domestic	103.0	102.6	▲ 0.4%
International	13.8	8.4	▲ 64.8%
Worldwide A-B brands	116.8	111.0	▲ 5.3%
International equity partner brands	19.3	18.8	▲ 2.7%
Total brands	136.1	129.8	▲ 4.9%

	2003	2002	Change
Domestic	102.6	101.8	▲ 0.8%
International	8.4	8.0	▲ 5.0%
Worldwide A-B brands	111.0	109.8	▲ 1.1%
International equity partner brands	18.8	18.1	▲ 4.0%
Total brands	129.8	127.9	▲ 1.5%

	2002	2001	Change
Domestic	101.8	99.7	▲ 2.1%
International	8.0	7.5	▲ 5.4%
Worldwide A-B brands	109.8	107.2	▲ 2.3%
International equity partner brands	18.1	17.2	▲ 5.3%
Total brands	127.9	124.4	▲ 2.8%

Table VI.8.1: Anheuser-Busch Beer Volume
(Source: Anheuser-Busch Financial Overview Report -2004)

International beer volume escalated by 5.4 million barrels, or 65%, to 13.8 million barrels in 2004 due to volume growth in the company's three largest markets, Canada, China and the United Kingdom, and the addition of Harbin volume.

2. AB Sales Figures: 2004 vs. 2003

The company recorded enhanced sales from all other major business segments. International beer segment sales escalated to $173 million due to volume gains in Canada, China, and the United Kingdom and the impact of Harbin in the second half of the year.

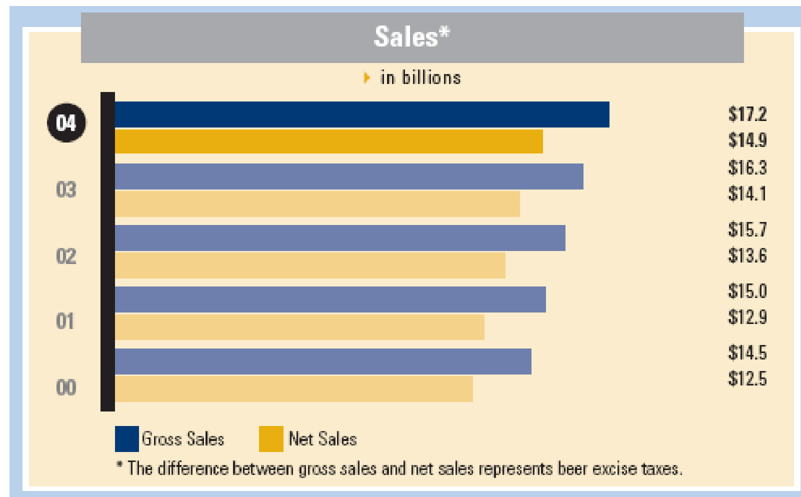

Table VI.8.2: Anheuser-Busch Sales Figures
(Source: Anheuser-Busch Financial Overview Report -2004)

3. Cost of Sales

International beer encountered escalated costs linked with increased beer volume plus the effect of incremental cost of sales associated with Harbin volume.

4. Income Before Income Taxes

International beer segment pretax income reinforced 44% for the full year versus 2003.

This was principally due to volume and profit growth in China, Canada, and the United Kingdom; the impact of Harbin in the second half of the year; and the gain on the sale of CCU.

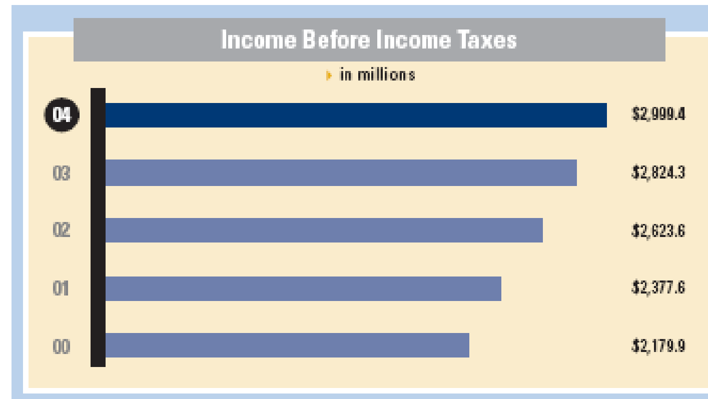

Table VI.8.3: Income Before Taxes
(Source: Anheuser-Busch Financial Overview Report -2004)

5. Employee-Related Costs

The changes in employee-related costs primarily reflect normal increases in salaries, wages and benefit levels plus the acquisition of Harbin in 2004.

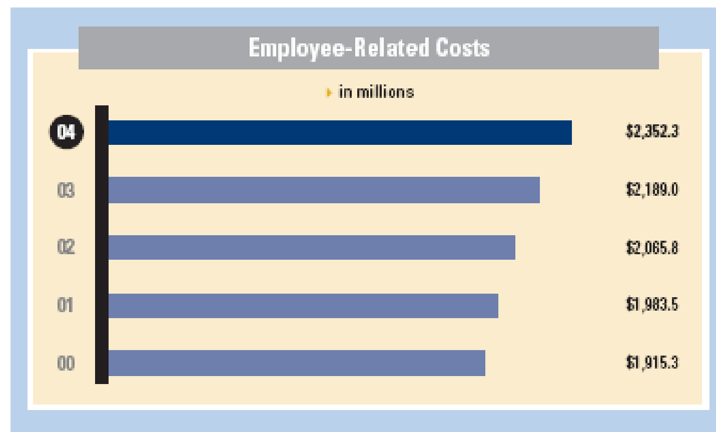

Table VI.8.4: Employee Related Costs
(Source: Anheuser-Busch Financial Overview Report -2004)

The company had 31,435 full-time employees at December 31, 2004, including 8,077 Harbin employees.

6. Return on Capital Employed

The company's rate of return on capital employed was 18.4% in both 2004 and 2003. Return on capital employed in 2004 excluding the impact of Harbin was 19.0%, a 60 basis point increase versus 2003.

7. Intangible Assets

Balance at December 31, 2003	—	989.9	221.3
Domestic beer wholesaler acquisition	—	—	10.6
Disposition of domestic beer wholesaler equity investment	—	—	(40.1)
Domestic beer wholesaler purchase price allocation	—	21.2	—
Harbin acquisition	44.4	613.8	15.4
CCU disposition	—	(126.0)	—
Amortization of international distribution rights	—	—	(1.8)
Foreign currency translation and other	—	10.3	1.5
Balance at December 31, 2004	$44.4	$1,509.2	$206.9

Table VI.8.5: Anheuser-Busch Balance Sheet
(Source: Anheuser-Busch Financial Overview Report -2004)

VI.9 Discussion

Anheuser-Busch-owned operations in China became profitable in 2001. Since then, China has been the leading contributor to volume and profit growth for global operations. At the end of 2004, brewing capacity at Wuhan stood at 2.7 million barrels. In 2004, A-B acquired the Harbin Brewery Group, No. 4 brewer in China, for a total cost of $694MM. International beer volume escalated by 122.5% in the first half of 2005, most of which come from Harbin acquisition (Anheuser-Busch Financial Overview Report –2004). We anticipate A-B's worldwide acquisition will continue and partly offset its underperformance in domestic market.

In a pre-results announcement at a conference in the Anheuser-Busch executives informed that the year 2004 would reflect the sixth straight year of solid growth. In spite of the normal deceleration in expenditure related to consumer products in its world markets, the company informed that for the bottom line earnings per share for the full year are expected to grow approximately 11 per cent. The

company stated that this estimate encompassed dilution from its acquisition of Harbin (China boosts A-B's fortunes).

At the conference W. Randolph Baker, vice president and chief financial officer, spoke of Anheuser-Busch's international strategy, emphasizing its expanded participation in the Chinese beer market Harbin (refer article :China boosts A-B's fortunes).He goes on to add as follows:

"China is the world's largest beer market in terms of volume and growth. Over the past five years, the Chinese beer industry has grown more than 5 per cent annually. The country's relatively low per capita rate of consumption has been increasing and is supported by an expanding economy and rising disposable income."

The expansion strategy has become a reality owing to the investments in two leading Chinese brewers. Harbin is a good complement to Anheuser-Busch's successful Budweiser operations and Tsingtao partnership. Also the move has consolidated its strong market position in Northeast China (refer article: China boosts A-B's fortunes).

VI.10 Findings & Recommendation

Although many analysts believe that A-B paid a high price for the stake its value in strategic terms is said to be almost priceless. International acquisition is the critical value drive for A-B's future growth. This is due to the fact there is virtually limited space to advance domestically. China is so far the most desirable target segment, because of its huge population and vast potential in increase of the beer consumption per capita.

VI.11 Internal Mergers

Western-style mergers between two companies are feasible but are rarely seen in China. Current Chinese statutory mechanisms accredit two means of mergers: a

"merger by absorption" or a "merger by new establishment." A" merger by absorption" encompasses the absorption by one company of another pursuant to which the absorbed company is disbanded and its registered capital and assets merged into the surviving entity. In a "merger by new establishment," each of the pre-merger companies is disbanded and a new company is established holding an aggregate of the pre-merger companies' assets and registered capital. Normally, the post-merger entity would be a complete successor of the pre-merger entities in that it would assume all rights and liabilities of such entities. Yet, creditors of the companies to be dissolved are extended the option of having their claims repaid in full prior to the completion of the merger. Whether the merger is a "horizontal merger" or "vertical merger" (defined by the merged entities' market positions) does not have an impact on the Chinese regulatory process.

VI.12 Overview of Chinese Airline Industry

Until the 1980s civil airline services in China were controlled by the military. However, since responsibility was turned over to the CAAC, the market for passenger services and airlines in China has boomed (China Civil Aviation Report 1999). Growing internal demand for flight services, relaxed restrictions on international trade, a growing tourism industry and the return of Hong Kong to Chinese rule in 1997 have driven this boom. As the number of airlines has grown so China has become a major market for the aircraft manufacturers such as Boeing and Airbus. Leading airlines such as Cathay Pacific, Dragonair and China Southern Airlines are listed on the stock market and revenues have grown annually along with passenger numbers, cargo tonnage and routes (China Civil Aviation Report 1999). In tandem with this growth has gone the further development of China's aviation infrastructure with new airports under construction and existing ones being expanded. Growth is virtually assured as

the Chinese government has pledged to double the 1994 passenger and cargo totals by 2000 as part of the current Ninth Five-Year Plan (Access Asia Limited 2000).

China's domestic airline industry stands in stark contrast to the rest of the Asian players. As airlines such as Singapore Air and Thai find themselves struggling in the new economic reality, China's skies are becoming ever more crowded with a growing number of airlines. The current situation leaves China as the most dynamic passenger airline market in Asia at present (Access Asia Limited 2000).

Airlines	***RMB billion***
China Yunnan Airlines	200.9
Hainan Airlines	100.9
China Xinjiang Airlines	73.9
Xiamen Airlines	68.9
Shanghai Airlines	20.0
Shandong Airlines	15.4
Sichuan Airlines	8.0
China Southwest Airlines	-300.0
China Northern Airlines	-400.0
China Eastern Airlines	-481.0
China Southern Airlines	-543.9
Air China	-760.0

Table VI.12.1: Net profits/losses of china's major airlines 1998
(Source: Access Asia from airline data and CAAC)

China Southern dominates the domestic market in terms of passenger numbers with over 13.5 million carried annually. The nearest competitor is China Eastern with just over six million. China Southwestern operates 51 routes, some of which are international, from Chengdu. The airline has a relatively old fleet featuring planes from Antonov and Tupolev, the Russian manufacturers (Access Asia Limited 2000).

Air China is a major domestic carrier and provides a comprehensive route network. It remains the major internal carrier of non-Chinese (Access Asia Limited 2000).

China Eastern and China Southern have significantly grown their domestic passenger numbers, while China Southwestern and Air China have lost passengers over 1997-1998 (Access Asia Limited 2000).

The figures from the newly reporting airlines – Northwestern, Xinjiang, Yunnan and Shanghai – are all significant domestic carriers.

Number	1995	1996	1997	1998	1999
Air China	4,620,242	4,676,900	4,620,242	4,326,728	4,200,499
Cathay Pacific	n/a	n/a	n/a	n/a	n/a
China Eastern	4,499,550	4,276,545	4,474,649	6,053,758	6,749,656
China Northern	n/a	4,126,685	4,476,496	3,661,957	3,221,000
China Southern	8,372,312	12,869,402	12,727,364	13,566,560	13,251,965
China South Western	n/a	2,621,357	5,023,751	4,609,486	4,348,741
Dragon Airlines**	n/a	n/a	777,528	n/a	n/a
China Northwest Airlines	n/a	n/a	n/a	2,408,460	2,387,422
China Xinjiang Airlines	n/a	n/a	n/a	1,279,107	1,359,121
China Yunnan Airlines	n/a	n/a	n/a	2,300,751	2,400,567
Shanghai Airlines	n/a	n/a	n/a	1,121,884	2,102,416
Xiamen Airlines	n/a	n/a	n/a	n/a	60,235
TOTAL	17,492,104	28,570,889	32,100,030	39,328,691	40,081,622

Table VI.12.2: Total market by total number of passengers
Carried domestically by major airlines 1995-1999
(Source: China Contact from trade sources/airline information/IATA)

In late July 2000, it was officially announced that 10 Chinese airlines will be consolidated into three groups. This follows two years of speculation. The CAAC will bring the 10 airlines directly under its control restructured into three groups centred around China Southern, China Eastern and Air China. The restructuring has been forced due to continued losses at some smaller airlines and the impending ratification of the WTO agreement. The other seven airlines involved in the merger are China Southwest Airlines, China Northwest Airlines, China Northern Airlines, Xinjiang Airlines, Yunnan Airlines, Great Wall Airlines and Zhejiang Airlines (Access Asia Limited 2000).

VI.13 China Southern Airlines Acquisition of China Northern & Xinjiang Airlines

China Southern Airlines (CSA)

China Southern Airlines (CSA) is the airline operation of the Southern Airlines Group, or SA Group and provides passenger services throughout China, Southeast Asia and international destinations. The airline was founded in January 1991. CSA operates a total of 361 routes serving 90 destinations within China and 40 internationally (including Beijing-Nanjing, Guangxi-Hanoi) plus some regional routes. CSA also provides cargo and mail services within China as well as flight training, aircraft maintenance and catering. The fleet includes 102 aircraft, principally Boeing 737, 757, 767 and 777s as well as a number of Airbus aircraft. 80 are narrow body jets. China Southern still uses Tupolev 134s for the Vietnam route (Access Asia Limited 2000).

RMB million	**1998**	**1999**
Turnover	11,840	13,290
Operating profit/loss	(585.6)	332.5
Turnover growth (%)	-	12.2

Table VI.13.1: China South Airlines- Financial Results
(Source: Company Information)

CSA is keen to focus on the domestic market, which is growing rapidly, and expanding CSA's market share on major routes between Guangzhou and other major Chinese cities (Access Asia Limited 2000).

China Northern (CNA)

CNA was established in 1990 and was the original seven carriers of CAAC. CNA serves over 150 domestic and international destinations. Destinations include

Hong Kong,Guangzhou, Harbin, Irkutsk, Beijing, Seoul, Dalian, Shanghai and Khabarovsk (Access Asia Limited 2000).

Xinjiang Airlines

Xinjiang is a 50:50 joint venture between CAAC and Xinjiang Province. The airline was originally established in 1985 by the CAAC and now employs 4,597 staff. The airline covers mostly domestic routes although some foreign routes such as Almaty, Moscow and Islamabad are included. The airline's fleet includes a mixture of Boeing and Russian-built aircraft. Xinjiang Airlines made a profit of RMB 73 billion in 1998 (Access Asia Limited 2000).

VI.13.1 Analysis of the Acquisition

The acquisition of the airline operations of China Northern Airlines Company and Xinjiang Airlines Company was approved at the general meeting of the Company held on 31 December 2004 (China Southern Airlines Annual Report 2004).

CSA acquired 16.91 billion yuan (US$2.04 billion) worth of assets from Northern Airlines and Xinjiang Airlines. The sale and purchase agreements were signed between the trio and China Southern Airlines Holdings Co (CSAHC). Both northern and Xinjiang airlines are totally owned subsidiaries of CSAHC, which is the controlling shareholder of China Southern with a 50.30 per cent stake. Accordingly, CS will assume their debts of 15.09 billion yuan (US$1.82 billion), which are related to their civil aviation businesses. The business and assets under acquisition consist of certain airline operations, other intangible assets and property such as planes, engines and spare parts. China Southern will finance the acquisition and assumption of the debts through its internal resources and short-term loans from commercial banks. The substantial gain will represent an attractive opportunity for China Southern to consolidate its already strong market position and improve its financial performance.

Both northern and Xinjiang airlines are leading carriers in their respective regions, an announcement on Friday revealed. Potential commercial benefits are expected to range from an increased fleet size and transportation capacity to reduced costs and enhanced overall efficiency. As the flight networks of the three airlines are highly diverse, the acquisition will also significantly broaden China Southern's flight network, it was claimed during the announcement. The carrier, based in Guangzhou, presently offers a very limited service in the nation's north and northwest. Northern Airlines, which is based in Shenyang, capital of Northeast China's Liaoning Province, is a dominant carrier with flights to South Korea and Japan. Xinjiang Airlines, based in Urumqi, capital of Northwest China's Xinjiang Uygur Autonomous Region, occupies a strong market position on domestic routes between Xinjiang in the west and other parts of China, in additional to its international routes that take it to Russia, the Middle East and Western Asia (China Southern Airlines Annual Report 2004).

Under the deal, China Southern fleet will grow from the present 139 planes to 214. And the increased economies of scale will contribute to a greater transportation capacity, higher operating efficiencies, lower operating and maintenance costs, and more flexible flight scheduling, in addition to other advantages. China Southern Airlines also reported that its passenger numbers were expected to reach 40 million in 2004, a record for the airline. The carrier increased its international services and expanded its domestic market share to almost 40 per cent last year after integrating Xinjiang Airlines and China Northern Airlines into its operations. A newly developed hub system at Guangzhou's new Baiyun International Airport also allowed the carrier to boost the efficiency of its flight services for both domestic and international destinations (China Southern Airlines Annual Report 2004).

VI.13.2 Findings & Recommendation

As per China Southern Airlines company limited annual report (2004) such acquisition provides a robust platform for the Group to consolidate its market leadership and financial results. It also brought in various benefits to the Group by expanding its flight service network, fleet size and transport capacity, as well as lowering costs and improving overall efficiency. Given the investment incentive policies such as "Go West" and "Revitalising the Old Industrial Bases in the North-eastern Region" promulgated by the PRC government, the economy in the western and north-eastern regions of the PRC is expected to grow at a rapid pace in the coming decades, which in turn provides substantial growth potential for the Group. Ultimately, the acquisition will strengthen the Group's position as the largest airline in the PRC and will create positive value to its investors. At present, the management of the Group focuses on harnessing the expanded business capacity and operation scale of the Group, and on enhancing its overall management standards through an integration of corporate cultures, innovation and development, thereby realizing the ultimate goal of the Group's reorganization.

VII. Conclusion

China's dramatic recent economic growth has created thousands of productive enterprises in a broad range of industries. As a result, foreign companies wishing to invest in China can now purchase operating Chinese businesses and are no longer limited to greenfield investments or new joint ventures (China venture capital Yearbook, 2003). The increasing maturity of the Chinese economy is also encouraging foreign companies to restructure their existing investments in China in ways - mergers, spin-offs, holding companies - that were simply not possible only a few years ago. The result is a rapidly expanding mergers and acquisitions market in China. China's accession to membership in the WTO will doubtless further stimulate this market (China venture capital Yearbook, 2003).

M& A persist to establish records in both volume and size. Acquisitions are a relatively rapid mode to grow compared to other options and, from the perspective of top managers; they are stimulating and often financially rewarding (Chen, 2002).

As outlined earlier the following aspects need to be kept in mind before embarking on a M& A (Chen, 2002).

VII.1 Capitalizing on Success and Avoiding Failure

M& A are ambitious under the best of circumstances. They are comparable to gambling in a casino in which the odds dramatically favor the house. However, some acquisitions are successful (China Mergers and Acquisitions Yearbook, 2003).

Due Diligence

Inadequate due diligence has been the reason of many failed mergers and acquisitions. Managerial arrogance can lead firms to do a poor job of due diligence or to ignore relevant information that might otherwise unravel a deal. Inadequate due diligence also can lead to the payment of excessive premiums to acquire a firm. Top

executives should deflect managerial hubris through ensuring a dynamic due diligence process (China venture capital Yearbook, 2003). Due diligence calls for a comprehensive analysis of all important target firm characteristics, including its financial condition, management capabilities, physical assets, and other intangible assets relevant to the acquisition. As a part of the process, acquiring firms should cautiously select organizations and individuals from whom to seek advice. Also, fees paid to investment bankers and other advisors by the acquiring firm should not be tied to acquisition price, because it might provide the wrong set of incentives (China venture capital Yearbook, 2003).

Financing

At present, nearly half the M&As are cash purchases and this percentage is likely to enhance after the turn of the century when pooling-of-interests accounting is eliminated (pooling of interests requires that a deal be financed primarily through stock). Cash transactions are popular, at least in part, because financial markets tend to reward these types of deals with more favorable stock price evaluations(Lin, 1998). Of course, higher than normal stock price adjustments are not common in acquiring firms, so market response really has the impact of penalizing cash transactions less than stock deals (Lin, 1998).

VII.2 Reciprocal Resources

A number of factors may account for the less-than-enthusiastic response of the market to acquisition announcements. Transparently, acquisitions are expensive for the acquiring firm. However, R&D and many other types of corporate activities are also expensive. The key is whether the benefits from an acquisition will offset the costs. When benefits outweigh costs, economic value is created (China Mergers and Acquisitions Yearbook, 2003).

Friendly/Hostile Acquisitions

Friendliness is another key to the foundation of economic value. Target firm resistance or animosity between acquiring and target firm executives can demolish value for the acquiring firm by increasing the premium paid, reducing the transfer of important data during due diligence and merger integration, and increasing a fair price from the outset, keeping negotiations private if possible, and avoiding hostile takeovers, including tender offers (Wang, 2002). Pursuing business ventures together prior to acquisition negotiations permits firms to become aware of each other's cultures, management styles, resources, strengths, and weaknesses (Wang, 2002).

VII.3 Creation of Synergy

Complementary resources and friendliness do not ascertain that synergy will be created, but they greatly elevate that likelihood. The four foundations to the creation of synergy are strategic fit, organizational fit, managerial actions, and value creation. Strategic fit refers to effectively matching organizational capabilities(Yang, 2001). Resource complementarily is a critical type of strategic fit, which can lead to synergy through amalgamating operations, R&D, marketing, or management. In general, economies of scale alone are not enough to absolve an acquisition (Yang, 2001).

Organizational Learning

Successful acquirers comprehend from prior acquisitions. Similarity of targets facilitates this learning process. For instance, higher financial performance is found in acquisitions in which the acquiring firm has repeatedly made acquisitions of targets in the same industry in which it operates (Lin, 1998).

For learning to occur, the learning process should be managed. Active acquirers should take deliberate steps to study and learn from their own acquisitions as well as the acquisitions of other companies, including competitors (Lin, 1998).

VII.4 Focus on Core Business

Most unrelated acquisitions are divested a short time after their purchase and the financial markets view these types of acquisitions unfavorably (Yang, 2001).

Stress on Innovation

Innovation success is vital to organizational competitiveness in the global economy. Companies that innovate enjoy the first-mover advantages of acquiring a deep knowledge of new markets and developing strong relationships with key stakeholders in those markets (Lin, 1998). Innovators are also able to solve many of the most challenging problems associated with changing environments. Organizational innovation can result from using skills and capabilities that are inside the firm (internal innovation) or by acquiring innovation skills or innovative products through purchasing other firms (Lin, 1998).

VII.5 Cross-Border M&As

The number and size of cross-border mergers and acquisitions is growing rapidly. The popularity of these types of transactions is fueled by the desire to gain increased market power, overcome entry barriers, reduce or share the cost of new product development, increase speed to market or increase diversification. Cross-border mergers and acquisitions may also be pursued in response to environmental threats or opportunities (Zhang, 2004).

Ethical Concerns/Opportunism

One of the great risks associated with all types of mergers or acquisitions is that the information received about a target is incorrect, misleading, or deceptive.

Perhaps no other factor can limit the success of acquisition more than ethical problems (Zhang, 2004).

In summary, financial success in mergers and acquisitions requires the careful combination of complementary or otherwise related resources, coupled with appropriate financing, a friendly negotiation climate, organizational fit, and managerial actions that help the combined firm realize potential synergies. Opportunism or other ethical problems, high debt, target firm resistance, or straying from the core business can erase potential financial gains. If these latter attributes exist, a merger or acquisition is often unwarranted. Organizations that are facing large hurdles associated with a merger or acquisition may want to consider other types of transactions, such as joint ventures, to accomplish some of the same strategic purposes (Zhang, 2004).

VIII. Appendixes

Appendix 1: Map of China

Map of China enclosed below:

<u>Figure VIII.1: Map of china</u>
(Source: www.mybeijingchina.com/ map/map_china.htm)

Appendix 2: The Five Forces of venture capital - a China perspective

The following figure focuses on the Chinese perspective of VC.

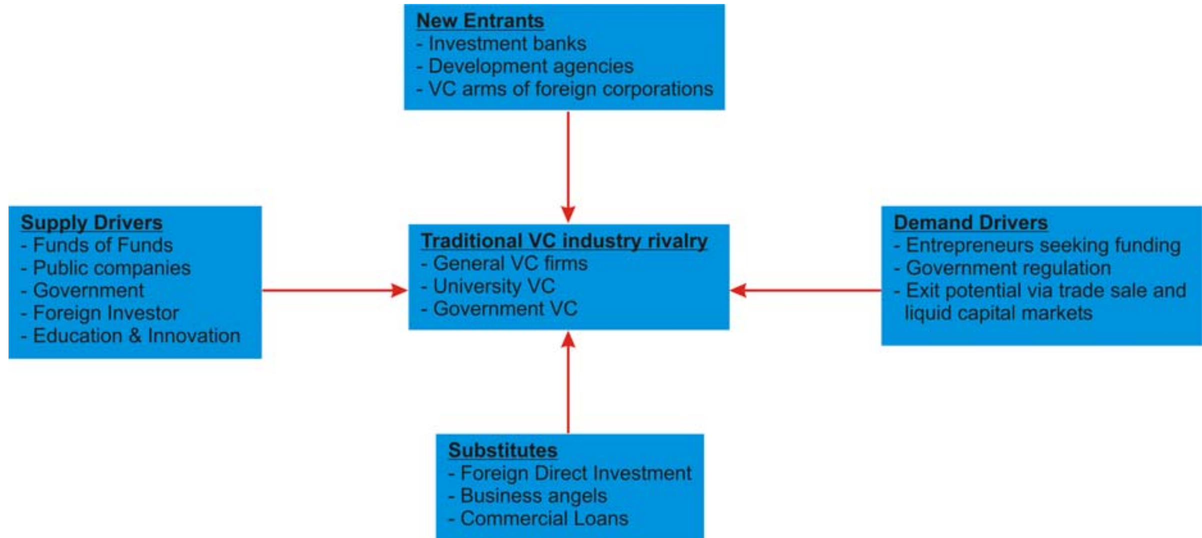

Figure VIII.2: The Five Forces of venture capital - a China perspective
(Source: China Focuses on Venture Capital and M&A, 2003)

Appendix 3: Differences between domestic and foreign venture capital firms in China

The following table discusses the differences that were identified between foreign and domestic venture capital investors operating in China on the Chinese perspective of VC.

Characteristics	DVC Firms	FVC Firms in China
Structure	Limited company setup, onshore.	Limited partnership, offshore
Access to capital	Low: by law, mostly backed by the state or public companies.	High: mainly foreign pension funds, insurance companies
Experience of team	Limited. Former Government officers or SOE managers	Good deal track record in home markets, highly professional
Origin of venture capital Team	Domestic team, mostly Chinese	Senior foreign investors, but localizing with returnees and overseas Chinese
Deal size	Typically smaller <$5m	Considerably larger, often $25-$75m
Deal stage	Mostly early stage, slowly moving to later stage	Later stage
Focus of market knowledge	Strong network relationships, but highly localized	Focus on industry and sector expertise
Deal due diligence	Sometimes unstructured process, many inexperienced players in the market. Top-down driven by general partners.	Tried and tested processes from the home market being adapted for China. Top-down and botton-up process.
Emphasis of value add to portfolio	Relationships and introductions, capital	Formal monitoring, guidance, overseas expansion routes
Capital convertibility	Not an issue.	Problem in capital repatriation. Offshore domiciling and exit preferred
Exit route	Domestic trade sale, some local IPOs, rarely overseas	Overseas IPO. Trade sale, preferably to Western buyer
Information access	High, often public disclosure required by regulators. Private information limited to trade secrets and proprietary knowledge.	Limited access, often low quality information. Triangulation and focus on unpublished information.

DVC - Domestic Venture Capital
FVC - Foreign Venture Capital
IPO - Initial Public Offerings

Table VIII.1: The Five Forces of venture capital - a China perspective
(Source: Research interviews, market research)[13]

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(13) According to market research published by China's National Research Center for Science and Technology (2003).

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