I am looking to buy a Chinese company. There is so much advice out there; so many checklists and warnings highlight the particular sensitivity of due diligence in China. What are the key areas that I should really concentrate on to avoid making the mistakes made by many multinationals and foreign companies?

What are the 3 most common mistakes made when acquiring a Chinese company?

The financial advisor perspective

1. Looking in the wrong places and with unrealistic expectations

The saying that no deal is better than a bad deal is very valid. However in China, sometimes, too many transactions are lumped into the "bad deal" category. The failure rate for deal completion is very high, at around 50% to 60% for multinationals, despite a high demand for acquisitions. Based on an InterChina survey of approximately 200 multinationals, over 80% have considered acquisition as part of their growth strategy. However, there are a lot of wasted efforts in conducting potential acquisitions where in the end nothing gets done. Hence, wasted resources and, more importantly, missed opportunities.

The wrong reasons for a deal not to be completed include failure to identify the right target, lack of skills in resolving problems and negotiating better terms, inability to assess risks in the right context and, most significantly, wrong expectations. As a result, deals that could have been salvaged get killed instead.

2. Neglecting the relationship

Trust and chemistry with the owner and its senior team are absolutely crucial. It is relatively easy for a domestic acquirer to build rapport with a potential target. For foreign companies, because of language and cultural issues, this is more difficult. Extra effort is therefore required to build the relationship. The roots of many disputes and post-acquisition issues arise from these shortcomings since the acquirer and the company being acquired can't effectively function as one team. The lack of continuity due to the relationship being built more with the deal leader rather than the business leader can cause long-term problems.

3. Poor integration

There is a strong tendency to over-integrate by the multinational. The damage can be shown in post-acquisition cost overruns. This burden of upgrading includes added compensation costs, IT, facility and many others. Another side effect is that it creates problems for management retention. An overly-hasty change can cause tension and discomfort to the existing management team. On the other hand, under-integration also creates problems such as channel conflicts and compliance issues that can lead to bigger problems at a later stage if left uncorrected. A gradual approach often works better.

Flawed expectations

Mini me: Multinational clients often seek to acquire a target with a product portfolio entirely mimicking their global portfolio, sticking to their core competence. This strategy screens out good candidates in related sectors, missing targets that otherwise might have great potential. This syndrome also applies integration (see mistake 3).

Finding the best: Searching for the biggest and best candidates which are often unavailable, instead of the most suitable candidates.

Fair value: Expecting to find bargains and valuations at parity with the home market.

Process: Expecting the deal process to be clearly laid out, with a controlled agenda similar to deals in the US and Western Europe, and treating the process as more mechanical and functional.

Deal logic: Acquirers in China are often seeking to acquire market access, local brands, lower cost platforms, management and growth in scale. Platform acquisitions are often used to fill in services or products gaps, and the rationale for a deal can be lost in the process.

Being clean: Expecting to find a spotless target. Because of the unique environment in which private Chinese companies have evolved, many of them inevitably have historical baggage.

Immediate majority: Insisting on a majority holding from the start, instead of being flexible enough to first acquire a minority stake and then gradually increase it.

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The law firm perspective

1. Inadequately managing due diligence

Some Chinese sellers are less experienced with cross-border M&A and thus less familiar with Western-style due diligence. Taking time to educate them on the needs, purpose and steps involved in the due diligence process can prevent surprises and unrealistic expectations. Otherwise, a lack of understanding may impede the sellers' responsiveness, resulting in delays to the collection of necessary information and the overall transaction.

Even when a Chinese seller appears to be familiar with the process, many tend to avoid confrontation or red flags at the early stage of a transaction, by checking the right boxes or providing partial records to move a transaction forward without revealing underlying issues so as to paint a positive image of the target company's operations. The purpose of the omissions may not be to hide a deal breaker, but the cultural preference for avoiding confrontation may be construed as ill-willed and intentional misrepresentation.

The acquirer should take an active role in managing the due diligence process in China, where it may otherwise rely on a paper trail of questions and answers to reveal issues. For example, an acquirer can verify the information received by confirming with public records, using online searches or records of local authorities. A foreign acquirer should also consider employing ancillary methods such as management interviews and onsite due diligence reviews. A more active approach can also help the acquirer to better understand the business practices and core values of the target company, in preparation for the transition.

2. Underestimating the complexity of labour issues

Underestimating China's complex labour regulations can result in unforeseen liabilities, jeopardise the integration of the companies and undermine the synergies the buyer aims to capitalise on from the acquisition.

Government approval is generally required if a workforce reduction is expected, and regulatory concerns around social unrest can complicate this approval process. If a key business value from the acquisition involved a workforce reduction, governmental consideration of social implications cannot be underestimated.

Many foreign acquirers attempt to avoid labour-related liabilities through asset deals, in which the target's employees have the option to be transferred with the assets or not. The foreign acquirer must plan to ensure the retention of key personnel. To ensure a smooth transition, it also needs to take a firm stance on which transaction party will be responsible for severance pay, and whether the purchaser will pay for additional severance if the transferred employees are allowed to accumulate prior years of service in the calculation of future severance.

In the event that the employer remains unchanged in an equity acquisition, unexpected labour opposition from Chinese employees could lead to unwanted publicity or regulatory scrutiny. In several reported transactions involving the sale of interests in China operating entities, Chinese workers went on strike when they anticipated a cultural clash with their company's new shareholders and management. Therefore, communication with Chinese employees is also critical to closing Chinese acquisitions successfully and ensuring smooth transitions.

3. Ignoring competition risks

Restricting the seller's ability to compete with the target company in the same market after closing – especially when the deal marks a foreign acquirer's first entry into the Chinese market – may define the acquirer's ability to succeed in China. However, unlike many common law jurisdictions where the interpretation and enforcement of non-competition and non-solicitation clauses are supported by a wealth of cases and precedents, Chinese law does not always provide clear guidance on these issues. Documentation of the agreed terms around these clauses is critical to increasing their enforceability in the event of a dispute.

Effective clauses should include well-defined underlying rationale of any restrictions. To enhance the enforceability of the terms, the language should clearly address how such restrictions on the sellers are necessary and proportional to the transaction. The scope of restrictions and prohibitions also needs to be reviewed in the context of business reality in China, preventing abuse of any loopholes and creating clearly-identifiable triggers of a breach. Pre-agreed damages are also important to the clauses' enforceability given the difficulty of determining the damages in the event of a default.

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