CHAPTER 15

M&A and Post-Merger Integration Considerations for China and Japan

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PART 1: CHINA

PART 1 LEARNING OBJECTIVES—IN THIS PART, YOU WILL LEARN:

- ➤ Current trends of cross-border M&A in China
- ➤ Common pitfalls when entering the Chinese market
- ➤ Critical issues and approaches that could make or break an M&A deal
- ➤ China outbound M&A trends and issues

PART 1 SUMMARY

Part 1 elaborates on trends and issues involving both inbound investment into China by foreign companies and China outbound investment. It describes the motivations behind the inbound and outbound investments, and points out the critical issues that have a significant impact on the success or failure of an M&A project. It also provides some approaches to deal with the issues.

OVERVIEW OF M&A TRENDS IN CHINA

Since the market reform was initiated to shift from a centrally planned to a market-based economy in 1978, China has experienced rapid economic and social development. Joining the World Trade Organization in December

2001, China has shown accelerated growth and progress. With a 1.3 billion population, China had become the world's second largest economy, a title Japan had held for more than 40 years. It has become a major player in global trade and a key factor in the world economy. Over 90 percent of Fortune 500 companies have entered the Chinese market, although the successes of such investments seem to be mixed.

Globalization, industry consolidation, and maturing domestic markets drive companies to become global in scope and scale to effectively compete and thrive. Factors such as low-cost manufacturing, research and development (R&D) resources, and a large consumer market have attracted ever-increasing amounts of foreign direct investment in China. Cross-border mergers & acquisitions (M&A) have become a global expansion strategy for multinational companies (MNCs) and one of the most prevalent forms of foreign direct investment (FDI) in China. As labor costs continue to rise in China, many manufacturing-based FDI have shifted to southeast Asian countries, and this has somewhat slowed the growth of China's inbound FDI investment. However, as China's economic reform deepens, name-brand consumer products will be in high demand, and new investment will likely to continue to flow into China to capitalize on this growing trend.

In the meantime, an increasing number of Chinese companies are not only very active participants in domestic M&A deals but also have gone overseas to seek investment opportunities. This trend is evidenced by data from the published reports of the Chinese Ministry of Commerce and the National Bureau of Statistics as shown in Figure 15.1 and Figure 15.2. Figure 15.1 shows FDI inflows from 2000 to 2014, while Figure 15.2 illustrates outbound investment volume by Chinese companies from 2005 to 2014. According to this Chinese government report, outbound M&A values typically exceed half of all outbound investment overseas.

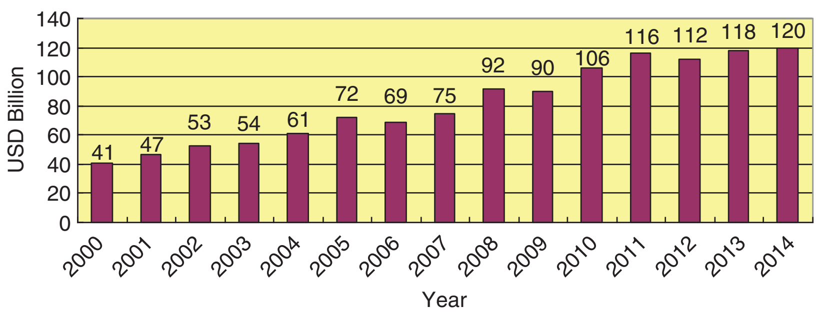

FIGURE 15.1 Foreign Direct Investment in China (2000–2014)

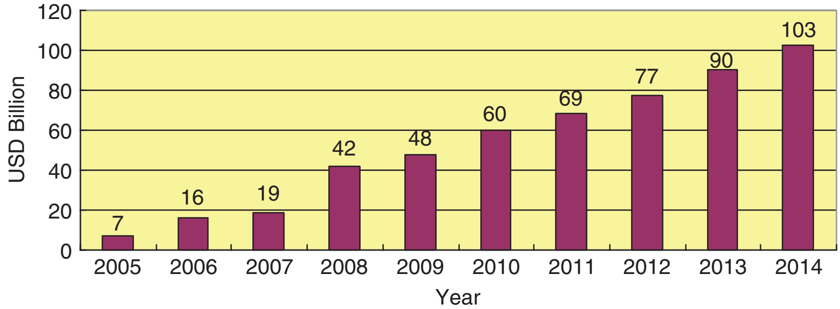

FIGURE 15.2 Outbound Investment (Nonfinancial) from China (2005–2014)

The data in Figure 15.1 show that inbound foreign direct investment to China continues to rise and reached an all-time high of $119b in 2014, although the rate of growth has been nearly flat since 2011.

From Figure 15.2, we can see that outbound investments made by Chinese companies have grown sharply since 2008.

To better understand this M&A trend, we need to look at the driving factors in China's economy.

Structural Shifting in China's Economy

Even with the double-digit growth seen in the first 30 years after the market reforms, China remains a developing country (measured by per capita income). Growth is still important for China; however, healthy and sustained growth has become the top priority. Heavy foreign direct investment and rapid economic ascendance have resulted in many challenges such as overly export-dependent industries, labor-intensive and less energy efficient manufacturers, significant rise in the cost of labor, imbalanced urbanization, and environmental pollution. China also faces demographic pressures related to an aging population and a shortage of skilled labor.

As such, the Chinese government has initiated a major shift in economic structure in its 12th Five-Year Plan (2011–2015). The plan encourages state-owned enterprises (SOEs) to deepen reforms and shift to more innovative, greener, and energy-efficient businesses. It encourages the development of services, energy-efficient, and high-tech industries and takes measures to address environmental and social imbalances and to reduce pollution with a reduced annual growth target of 7%. With various policy measures, the Chinese government is in the process of steering its economy from a world factory ("Made in China") and export-dependent economy to a more innovative ("Created in China"), more domestic consumption and service-oriented economy. This will stimulate more sustained economic development and provide plenty of room for both local Chinese companies as well as foreign multinationals with excellent brand and advanced technologies to thrive in China.

State-Owned Enterprise Reforms to Accelerate

With renewed emphasis on improving efficiency China's State Council has issued guidelines and plans for state-owned enterprise reform. It will allow SOEs to have mixed ownership such as employees and it also encourages SOEs to become publicly traded companies. As a pilot program, the plan identified six large SOEs to open up for private investment and to improve corporate governance. Another pilot aimed at improving management efficiency will allow the SOE boards of directors to appoint senior management teams and set performance measures. With more reforms coming, more market-based competitors can be expected and the environment will be more attractive to foreign investors.

Over-Capacity in Many Industries and Others Going through Consolidation

Due to the global economic slowdown, and the lack of demand after the 2008 global financial crisis, many industries received investments from the government's economy stimulus measures that resulted in high inventories and over-capacity. In addition, declining exports, the rise in domestic competition, and industry consolidation are becoming the new norm. This leads to more companies starting to "go overseas" in order to expand distribution networks and access the global market. Going overseas also helps bring back better technologies and management skills to enhance competency at home. This kind of activity along with industry consolidation has been driving a sharp increase in domestic M&A as well as outbound M&A deals. This trend is expected to continue for at least another decade, especially in outbound investment by Chinese companies, both SOEs and private companies. How to execute their global strategies and maximize the return on such investments and lower risk is a top concern for many Chinese companies looking to expand overseas.

SOE restructuring, industry consolidation, and the government policy to increase domestic consumption will drive more M&A activities and deal flows both inbound to and outbound from China.

In this chapter, we identify some of the critical M&A issues in China related to inbound and outbound activities. We will also share our perspectives and practical approaches to tackle these issues based on our extensive cross-border M&A and post-merger integration (PMI) project experience.

ISSUES AND APPROACHES FOR INBOUND M&A IN CHINA

In this section, we will discuss some of issues encountered by foreign companies when investing in China.

Although there could be many strategic or operational reasons for inbound M&A into China, typical objectives of a foreign company coming to China and acquiring or entering into a joint venture with a Chinese company can be categorized as follows:

- **Outsourcing or cost reduction:** This could be in the form of establishing a joint venture or a directly owned manufacturing base or an R&D center. It is largely driven by supply chain cost reduction or accessing a larger human resource pool in China.
- **Market access or market expansion:** The main objective is to seek growth internationally by entering the Chinese market, the largest or one of the largest markets in the world, depending on the specific industry. This is typically accomplished via an acquisition or a joint venture with existing distribution networks in China.
- **Acquiring strategic assets and setting up joint ventures with local strategic partners:** Many deals are motivated by the need to comply with foreign ownership control policies and the desire to get more favorable treatment as a "local player" due to China's increased regulations on antimonopoly and national security.

No matter what the strategic rationale is, cross-border M&A remains more complex than domestic transactions and the success rate is considerably lower. For example, a research report found that only 17% of cross-border acquisitions created shareholder value, while 53% destroyed it. There are common issues that are critical to determine the fate of an M&A deal in China.

Key issues and challenges:

- The common problems of M&A such as uncertainties in valuation and control of target companies are complicated by a lack of local knowledge, relationships, and the changing regulations in China.
- Significant differences in culture, management styles, market environment, competitive landscape, legal systems, accounting, and tax policies.
- Strategy disconnect, intentions "lost in translation," or policies not localized.

Although there have been successful and profitable entries into the Chinese market for companies such as Starbucks, Yum!, Coca-Cola, Carrefour, Apple, and others, there are many high-profile failures by some well-respected Fortune 500 companies. For example, Mattel, Best Buy, and Home

Depot all closed their China stores in 2011. eBay was basically pushed out by local competitors. Google, although political factors may have played a role, never had a comparable market share as they had elsewhere before they exited China.

In hindsight, we have seen many analyses and commentaries as to what went wrong with those market entry ventures. Some suggest wrong strategies, some found culture misfits, and others point to the market timing as a factor. However, very few analyses discussed how those companies executed their strategy after entering the Chinese market. From many published news reports and interviews, we have seen that commonly known problems of government protectionism, corruption, or Chinese customer characteristics were not the key reasons for failure. In reality, a lack of localized strategies, inappropriate headquarters control, and misunderstanding of local competitions are some of the crucial causes of failures.

Understanding the issues and proactively mitigating the risks will greatly increase the chance of success of companies investing in China. Some of the key approaches include effectively handling the management style and cultural differences, installing the right local management team, balancing the priorities of growth versus process, and maintaining flexibility and making timely adjustments when necessary. We will address the key issues in the following sections.

Issue No. 1: Understand the Difference in Behavior, Culture, and Environment

As we learned in Chapter 7 of this book, culture is the number one issue for cross-border M&A. Since there are distinct differences between the culture in China and most of the countries in the Western world, this issue becomes more pronounced and is the most crucial of all. There are many aspects and layers of culture such as national, regional, generational, social, and corporate. We will primarily discuss business and corporate culture.

Cultural differences are also the root of conflicts and disagreements between overseas and local Chinese companies. This is reflected in both business negotiations before the deal and integration execution after the deal.

Guanxi The way the Chinese conduct their business tends to differ from foreigners. Chinese are very particular about having a good relationship or "Guanxi" with each other, especially in business. There is an old saying in China: "Guanxi first and business later." They invest significant effort in socializing and in building relationships with others, as they believe that Guanxi is the foundation of a successful business. The relationship building over time allows them to develop trust with each other and minimize commercial and legal risks while doing business. This factor affects the working relationships with Chinese teams in all phases of the M&A process.

Originally, Guanxi signified the personal connection between two people in which one is able to receive a favor or service from the other as reciprocity for favors or services given before. It describes the basic dynamic in personalized networks of influence in Chinese society and has been expanded to describe a network of contacts that an individual can call upon when something needs to be done, and through which he or she can exert influence on behalf of another. Reciprocal favors are the key factor to maintaining one's Guanxi web. Giving a favor could simply start with saying something that makes the other person feel good or it could be a free service that saves the other person trouble or makes that person looks good ("save face": boost or maintain someone's prestige and/or social status). There are many forms of Guanxi building, but one needs to be careful of falling into the trap of corruption, on which many countries have specific rules and laws, which will not be discussed here.

In regard to Guanxi, there are also many stakeholders that need to be managed appropriately in addition to the shareholders of the M&A target company itself. Some are apparent, such as industry players, industry regulators, the State Development and Reform Commission, the Foreign Exchange Commission, the Ministry of Commerce, and the State-Owned Assets Supervision and Administration Commission of the State Council. Some are less visible, such as local governments at the city or provincial level. Building a good Guanxi, for example, could mean that your M&A project brings benefits to the society in the city of your project's location.

In order to make M&A projects more successful, acquiring companies need to leverage the personal relationships developed by the local executives over time and avoid demanding immediate favors or reciprocity.

In addition, Chinese companies tend to be more hierarchical. They pay more attention to social status and involvement of senior executives from the acquiring companies. It is highly advisable that they handle negotiations at the appropriate time. Subsequent change management initiatives are considered to be a form of Guanxi building and therefore need to be handled with the utmost care.

Management Style When it comes to M&A success, one of top concerns for the acquiring foreign companies is how to manage the people to implement the business strategy and make changes when necessary. Understanding style differences and recognizing the mentality and the motivation of Chinese management enables more effective partnerships and execution.

In Western companies, typical top management sets the vision and strategy for the business and empowers the teams to execute. They encourage two-way communication with employees and encourage bottom-up input in decision making. In China, management tends to be autocratic and top-down. They manage teams at a micro level. This can be very efficient for critical missions. With the direction set at the top, employees simply follow the orders and execute. However, this discourages ownership at the lower level and makes accountability ineffective.

Not only are there apparent differences in management styles between China and the West, but there are internal differences between Chinese companies. From this perspective, business organizations in China can be categorized in two groups:

1. SOEs or formal SOEs
2. Nonstate or privately owned businesses (could be publicly traded companies as well)

Although it might be difficult to accurately portray and generalize the management styles and culture differences between the two groups, a few distinctions can be made from the perspective of M&A projects.

A typical SOE management team consists of both a general manager and a party secretary general. The general manager is typically in charge of business operations, while the party leader controls the overall strategy and human resources. Although many decisions are subjective and made ad hoc, some are decided by committees. The SOEs are typically vertically organized and managed through autocratic authority and seniority. Accomplishments and rewards are managed as a group versus individuals; accountability can be very unclear and is often difficult to track. Since competitions for SOEs are relatively few and far between, their operating efficiency becomes an area for improvement. One of the main concerns for their management teams is to meet the requirements set out by the government (the most important stakeholder) while making no mistakes. The management teams at both the top and middle level are therefore very sensitive to risks and are more resistant to change initiatives—even when market conditions would require them to do so. Therefore, when negotiating deals or initiating post-deal strategy and operational changes, identifying common ground and aligning interest is key. Carefully articulated and less risky benefits that can satisfy the management team as well as the key stakeholders tend to be more acceptable and are implemented with less resistance.

A typical private business, on the other hand, is dominated by a single entrepreneurial but equally autocratic leader. These leaders will be very aggressive in pursuing changes for market gain since they often operate in a very competitive market environment. Final decisions are usually made by the dominating leader, despite the presence of board members and various company committees. Middle managers at key positions tend not to have sophisticated management skills, but are proactive and open-minded about changes and improvements. They are very open to new market opportunities and actively seek advanced technologies to boost the competitiveness of their core products or services. Emphasizing upside potential and benefits in negotiations would be desirable and welcomed.

In addition to what we described previously, there are also generational differences. Even Chinese managers sometimes struggle to cope with the so called "post-90" younger generation as they adopt Western influences and values. Recognizing those issues and learning to deal with them requires patience and experimenting.

Other Factors Most Western acquirers come from an environment where business operations are highly transparent, with standard and mature processes supported by reliable financial data and a well-developed legal system. In China, however, things are much less transparent, business practice is changing, and the legal system is evolving. There are multiple parallel and inconsistent financial data and companies can be heavily affected by government bureaucracy. As a result, there are many uncertainties and ambiguities during an M&A project. Managers need to be ready and mentally prepared.

To add to the complexity, communication barriers present challenges for everyone. Lack of clear communication and the different language interpretation issues will cause employee anxiety, mistrust, and uncertainty about their future, and some managers or talents may leave. In the absence of official "news," rumors often travel faster than email announcements.

It is a good practice to publish weekly or monthly newsletters in local languages, with news from the Chinese human resources (HR) department as well as from the acquiring company's management team, and to clarify the integration roadmap and initiatives. Identifying key talent and developing retention plans and early incentive announcements (before deal close) would be another way to manage the risk.

Understanding those differences and risks and being prepared to handle them with the right team would greatly enhance the effectiveness and chance of success of M&A projects in China.

Issue No. 2: What Is the Right Profile for the Integration Management Team?

The high-profile failures of some well-respected Fortune 500 companies when entering China have sparked many discussions. There seems to be a consensus that a foreign company needs to find local talent to help it adapt to the local environment and to better manage the deep cultural gap, the language barrier, and differing management styles.

Language Is Not the Issue Language barrier issues seem to be apparent since most of the locals in China are unable to communicate well in English, especially in the second- or third-tier cities, and many foreigners only know a few words of Chinese. One might argue that with the help of interpreters the issue can be resolved easily. However, being able to speak the language does not mean that the parties will be able to converse effectively. Some expatriate managers have hired bilingual executive assistants to help with the communications, and other companies hired local managers to deal with the language issue.

However, as those companies found out, an effective manager would not only be able to understand the language but must also be familiar with both the Chinese culture and that of the foreign company. Therefore, some companies, especially the larger multinationals, were lucky enough to find a native Chinese-speaking manager from the home office (where the company headquarters are located) and send them to the battlefield (China) hoping that this would be that silver bullet. Those managers have typically come out of China and worked in the foreign companies for a few years and have shown promising ability in a functional area such as marketing/sales or product development or have done well in project management and earned a level of trust from business unit leaders. A few of them were able to hit the ground running but many cannot deliver the expected results in the first few critical months or even years after the close of an M&A deal. There could be many reasons, but the main challenge is that the "rising stars" had very little work experience, if any, in China before they left China to study abroad and later on joined a foreign company. Some of them become successful in certain functional areas in the Western business environment but they rarely have the necessary experience to deal with the social, market, and legal complexities in such an emerging market as in China. It would be challenging enough for them to lead a single functional area of an acquired Chinese company, not to mention the cross-functional and cross-border teams. A better option would be to look for those who have been working for multinational companies in China for many years with multiple roles after returning from abroad, those who have a better understanding of both the Western corporate culture and what it takes to navigate the waters in a local Chinese company.

With a larger budget and bigger resources, some of the serial acquirers have been able to find and train this type of manager and were able to develop strong in-house capabilities over a period of 10 to 20 years. Many other companies, however, don't have the luxury to maintain a dedicated team of PMI specialists and have to "borrow" part-time resources who typically have line-management roles in sales, marketing, finance, HR, or even legal in an acquiring company's business unit. There are even companies that put a generic project manager in charge of the entire M&A and PMI program.

A Project Manager Is Not Enough As we all have seen, during a full M&A project cycle, there could be many obstacles that require an experienced PMI leader or a PMI team to proactively manage the many conflicts between the acquirer and the target in China. Not only should the PMI leader have the skills as a super project manager to identify and coordinate the many interdependencies across the various integration work streams, he or she also needs to possess the leadership ability and the political sensitivity to deal with a broad range of cross-functional teams, from the steering committee and CEO at the top to work stream project members at the bottom, over whom the PMI leader very often doesn't have direct authority but still needs to lead and exert influence.

Having realized the significant challenges and importance of the local management role during the transformation period after the deal is closed, some companies have done well by bringing in senior executives who previously have successfully managed integration projects in China. Others find hiring highly experienced and specialized consultants as interim general managers very effective during the critical transition period. They typically are bilingual and have a deep understanding of Chinese culture and the ways business is conducted in China. They have also managed many operational teams both in China and abroad, and can handle the uncertainty and the changing environments very well. Not only are such external resources sensitive to critical issues, they can also effectively move the integration team forward with the ability to resolve the challenging matters at the appropriate management level. Sometimes, they are set up as the interim CEO of the acquired company before a permanent candidate can be identified and brought onboard.

To ensure a successful return on acquisitions in China, companies need to be mindful of this crucial issue at an early stage and be prepared to bring in the right team to handle the complexities often not seen in their home countries. The fast-paced emerging market in China is quite different from that of a well-developed and mature economy.

Issue No. 3: What Is the Appropriate Governance and the Level of Control?

A crucial aspect in M&A projects is to identify and establish the required level of management structure and control. In a cross-border situation, key decision makers often lack the information on the ground and the necessary experience to properly assess a program prior to making key decisions. This could lead to inadequate planning, poor execution, or insufficient monitoring and control. The following section addresses some of the common issues and provides recommendations based on the experience we have accumulated over the years.

Reporting Line and Decision Making To ensure control and compliance, many companies have sent expatriates to China only to learn that they need to adapt to the local environment. Thereafter they hired local resources on the Chinese management team, or found seasoned executives with international experience in running businesses. However, reporting lines are such that a China country manager or integration director often needs to go through layers of management before reaching the top management at headquarters. Examples of such layers are the manager of the APAC division, or a senior executive from the international business division. More often than not, those managers outside China typically don't have a daily view of situations on the ground. Even though they may have visited China a few times, they don't have the comprehensive knowledge of the local cultures (which sometimes can be quite different in different cities in China. For example, people born in the north part of China are typically more straightforward than those from the south), but have the responsibilities to make key decisions that impact the local situation and integration result.

Due to the information imbalance and lack of understanding of the dynamic and fluid business environment in China, they tend to take longer to move forward with making decisions. To complicate things, headquarters processes may dictate lengthy discussions and consensus building, greatly affecting the speed of executions at a time when swift adjustments to integration plans or ad hoc decisions are required. This may partially explain why smaller foreign companies often do better in adapting to the environment in China than some of the larger Fortune 500 companies.

Integration Management Office We have seen more successful approaches where companies gave their local integration management office (IMO) team more authority and flexibility in making the necessary decisions, allowing them to be more independent and report directly to both the headquarters and the local company CEO or country manager. This helped the PMI to maintain a balance between process compliance and progress effectiveness, between strategic control and operational flexibility. However, the steering committee would also need to set reasonable boundaries on "go/no-go" decisions, so that key decisions with great risks can be managed. Other alternatives include setting shorter deadlines for decision feedback from the headquarters or the steering committee, having more frequent steering committee meetings even if not every member can be present at those meetings so that key decisions get made quicker.

Set the Right Priority As companies enter into emerging markets such as China, growth and market share often override the significance of synergy and profitability. Management is more focused on controlling key functions such as financial reporting, HR, and audit and aligning key persons than on an acquisition strategy to drive change and move forward. Senior executives need to be visible, especially the local CEO, and be up front in breaking down the resistance to change by applauding small and early achievements. Such actions motivate alignment to changes. The IMO needs to leverage the existing management team, but establish key control points within the acquired company.

Issue No. 4: M&A Strategy Execution and Localization

Generally, there are two types of pitfalls in executing the M&A strategy. The most common one is the strategy disconnect between the deal team and the PMI team. As the deal closes, the deal team typically moves on to other projects and rarely has the opportunity or interest to constantly reengage the PMI team on strategic and due diligence issues. Additionally, during the course of PMI, work stream leaders may go through changes or replacements, and the strategy message is often lost in transition. In other cases, due to communication issues, the real contents of M&A strategy are not translated correctly to the team on the ground.

Strategy Clarity It is the responsibility of the project steering committee to set and enforce the expectation of strategy clarity and consistency throughout the entire M&A project life cycle. It is the responsibility of the integration management office to ensure the strategy messages get interpreted and transferred, and the actual sources of value can be understood by the entire team and every member of the PMI team as well as the employees of the target company. Ideally, IMO managers would join deal teams early on, in order to identify key issues and risks in the due diligence process, assist the culture assessment and fitness evaluation, and validate synergy estimates with business unit leaders.

Localization The second pitfall, which is often more fatal than the first, is that the M&A strategy was not adjusted or localized to fit into the fast-changing business and social environment as well as the competitive landscape in China. Traditionally, some people may say, “We only change tactics but not the strategy.”

Well, this may work in a well-developed market and system in the West. However, in an emerging market such as China, many uncertainties exist. The legal system is less than perfect, new government regulations come out every year, and competition is often fierce and cutthroat. Top management needs to adjust their perspective and to adopt an emerging market mind-set. They also need to be flexible and be prepared for the shortened cycle of many business operations to meet the changing market needs in China. A leading practice is for top management to set boundaries, but to not dwell on stringent processes and rules. If progress falls short of expectations during the first-100-day review, there should be a serious review of the initial strategy by functional area, to assess the impact of the actual local conditions on the ground. One cannot stick his or her head in the sand to tough it out. Additionally, a well-constructed governance structure and localized management team would also be important to ensure timely monitoring and practical decision making. Failure to adopt a localized strategy has been one of the crucial mistakes for some of the well-known brands that entered China but failed, and this lesson learned is invaluable to other future corporate investors.

CASE STUDY

How Starbucks maintains its global brand image, but still manages to localize its operations and product offerings.

Unlike many other foreign brands that sometimes use price cuts to fight for market share with the local competitors, Starbucks maintained its brand integrity by maintaining its global standard services to create the same exceptional experience as elsewhere in the world. One of its successful practices is to bring their best baristas from established markets to China to train new employees. Not only do they teach superior skills of coffee making, but more important they bring Starbucks culture and global standard of service to each local store in China.

In contrast to Home Depot or Mattel, Starbucks did not fall into the trap of "global products," or "global platform"; they offered a highly localized menu of beverages that is particularly tailored to Chinese consumers' tastes from their extensive research and analysis. It even gives each store the flexibility to choose from a wide variety of its beverage portfolio that fits the particular local customers, as taste may differ across different regions in China. It is critical for global brands to adapt their businesses to local markets in order to succeed in China, and Starbucks did just that.

ISSUES AND APPROACHES FOR OUTBOUND M&A FROM CHINA

As mentioned earlier in this chapter, China's outbound foreign direct investment (OFDI) expanded significantly from 2005 to 2014. A lot of investments initially targeted the developing world but the focus has been shifting to North America and Europe. Since 2009, Chinese direct investment in America and Europe has increased significantly. For example, Chinese investment in the United States grew from less than $1b annually before 2008 to $2b in 2009 and $5b in 2010. The deal flows are poised to grow more beyond 2014 through the next decade, according to many economic estimates.

Overall, as shown in Figure 15.3, outbound M&A has grown sharply since 2008 and has reached $56.9b in 2014. In comparison, just two months into 2016, Chinese companies have already made roughly $55b in outbound M&As according to data reported by *China Daily*.

With such increased activity in outbound M&A, some companies have achieved their initial goal of "going global." However, they encountered many social, legal, and operational issues that needed to be resolved. To understand the challenges, we need to look at the types of investments and the motivation behind them. Outbound investments for Chinese companies can be grouped into the following three categories:

- Acquiring natural resources
- Acquiring distribution channels
- Acquiring advanced technology and well-known brands

In the past, since the double-digit growth rate in China outweighed the potential offered by overseas opportunities, OFDI from China in the early years was focused on developing countries, investment in developed economies, such as Australia and Canada, was limited to securing natural resources and building

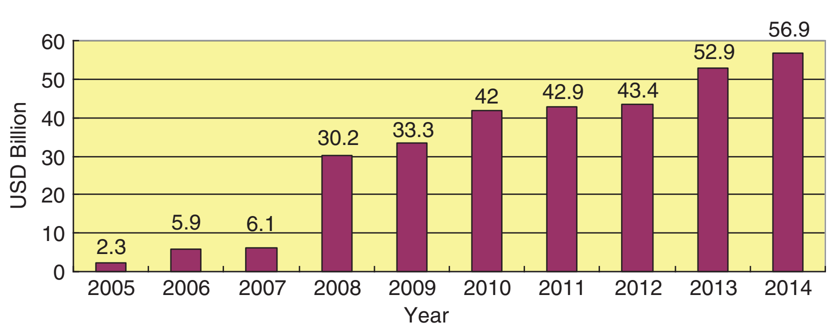

FIGURE 15.3 Outbound M&A from China (2005–2014)

the infrastructure necessary for cross-border trade. Maintaining control at board level to implement strategy is achievable and relatively less complex.

This began to change in 2008 when investment flows to Europe and North America grew sharply. The emerging trend behind Chinese investments in developed economies was driven by business and government policy that pushes Chinese companies to look abroad. As export trade slowed down after the global financial crisis in 2008, access to improved distribution networks became more important to Chinese companies. They sought to build and improve control of their export distribution channels.

In addition, as capacity over-builds and domestic competition heated up, more Chinese companies started to look overseas for ways to resolve overcapacity or low value added price competition issues. Publicly traded companies tried to leverage the size of the global market as additional growth potential when their domestic market space became more saturated and the overall Chinese market slowed down during 2010–2015, mainly due to a reduction in industrial output, sluggish property investment, and a contraction in exports. However, a key motivator for many Chinese companies doing overseas M&A deals is the need to acquire advanced technology or well-known global consumer brands to upgrade their product offerings, to move up in the value chain in areas previously conceded to companies from the developed countries, and to augment managerial skills and staffing to remain globally competitive.

The North American market is important to Chinese firms for its market size in terms of export trade from China, availability of abundant innovations and global brands, advanced technology, and management practices. The European market also became attractive due to the fact that the European Union is an integrated market, has a single currency, a good regulatory environment, and availability of acquisition targets at more attractive prices in recent years after the financial crisis.

Several large-scale acquisitions have been made, such as Sinopec Shanghai Petrochemical Co.'s (Sinopec) $2.5b investment in five shale oil and gas fields owned by Oklahoma-based Devon Energy Corp.; the $2.6b acquisition of the movie theater operator AMC Entertainment Holdings by China's Dalian Wanda Group Co.; the $1.8b successful bid of Zhejiang Geely Holding Group to carve out Volvo from Ford; and the record-breaking $43b cash buyout of Swiss pesticide and seeds giant Syngenta by the Chinese state-owned chemical company ChemChina announced on February 3, 2016.

The Challenges

Key impediments for Chinese firms when setting up shop overseas are their inexperience and lack of capabilities rather than political or social issues. This puts the Chinese firms at a disadvantage on pre-deal target sourcing, due diligence, and negotiations. On top of that, as the Chinese companies rush out to secure deals (many of the deals were such that Chinese firms became the largest shareholder but not necessarily have the majority of shares of the foreign companies they had invested in), they may not consider PMI as important as the M&A deal itself, or they simply don't have the power to initiate an integration agenda due to the lack of majority shares or negotiation compromise when signing a deal to leave the current management team and many of its practices unchanged. This would make the outbound investment even more challenging and risky.

Some of the key challenges for Chinese companies going overseas are:

- Lack of management capability and control in foreign countries, especially in the West
- Huge differences in culture and management styles
- Lack of understanding of local legal, financial, labor, environmental compliance systems, and foreign market risks
- Poor brand recognition and general concerns over product quality toward Chinese brands by foreign consumers
- Lack of unique technical or product competitive advantages other than price

In addition to the typical issues in cross-border projects that we discussed earlier, some unique challenges that may derail the efforts of the global strategy for many Chinese companies remain.

People Management

People management can be very tricky for Chinese managers because of differing management styles. A top-down micromanaging style can put a lot of stress on Western employees who are not used to it and may feel they are not being fully trusted to manage their own work. This can lead to employees being less motivated, depressed, or simply leaving the company, especially in Western countries. What motivates Chinese employees is not always the same as what motivates foreign employees. This is one of the key culture issues that makes it very challenging for Chinese managers on the ground to control local employees and execute planned strategies.

Management Issues

Due to different governance structures in foreign companies, especially the larger ones, simply becoming a major shareholder and controlling the board doesn't guarantee complete control of the company's daily operations. Sooner or later, companies will need a strategy and a solid plan to transform and integrate the acquired business based on the acquiring company's business strategy and deal rationale in order to realize its expected deal value. After all, many of the large M&A deals made by the Chinese companies were secured through bidding and a relatively high premium was paid for the targets. Even though plenty of due diligence has been performed to identify risks and issues, there is no substitute for a well-planned and well-executed post-merger or post-investment integration. Just as foreign companies need excellent PMI teams when entering into the Chinese market, Chinese companies also need a sophisticated PMI team to implement the M&A strategy and capture the value when investing overseas. There are no shortcuts.

Local Experts Needed

When dealing with M&A projects in foreign countries, a comprehensive and pragmatic approach needs to be taken to study and understand the local cultural, social, legal, and regulatory environment. Engaging local experts to assist with these tasks would be very helpful. Most important, the issues of corporate control and governance need to be understood and well prepared for with realistic post-deal measures. Optimistic assumptions can come back and bite the returns out of the investment. Thus we strongly recommend that Chinese firms going abroad equip themselves with highly experienced deal and integration teams, ideally including hired local experts as well as seasoned executives with international experience. This would greatly increase their chance of success in their overseas ventures.

CHAPTER CHECKLIST FOR PART 1: CHINA

- Inbound case to China
  - Understand culture differences down to the regional level
  - Manage Guanxi (relationship) proactively and build trust first
  - Recognize the motivation of the Chinese management team
  - Understand the motivation of Chinese employees and generational differences
  - Keep clear and frequent communications with the employees of the target company
  - Secure talent with international experience
  - A project manager is not enough; a seasoned PMI team is needed
  - Set up an appropriate reporting structure between headquarters and the local PMI team
  - Set the right priority between growth and profit
  - Maintain a clear and consistent integration strategy
  - Adjust the M&A and PMI strategies based on the local situation

- Outbound case from China
  - Understand the management styles in Western cultures
  - Leverage local resources to minimize uncertainty in foreign legal, financial, and labor issues
  - Create a dedicated and well-qualified local PMI team
  - Establish a structured governance system
  - Go beyond controlling the board and motivate the middle managers

PART 2: JAPAN

PART 2 LEARNING OBJECTIVES—IN THIS PART, YOU WILL LEARN:

- ➤ Current trends of cross-border M&A and PMI in Japan
- ➤ Critical issues and approaches in outbound and inbound M&A
- ➤ Practical approaches for problems we will face

PART 2 SUMMARY:

Part 2 describes key issues and practical approaches to solve the problems Japanese companies face when they purchase foreign companies and when a non-Japanese company purchases Japanese companies. The issues are categorized for outbound from Japan and inbound to Japan. We have to carefully treat organizational issues peculiar to Japanese companies. On the other hand, simultaneously, we have to quickly install and utilize standardized PMI methodologies in integrations. Moreover, we need to have some knowledge to avoid pitfalls that occur when working with Japanese companies. Otherwise we will lose the expected outcomes from the integrations.

OVERVIEW OF M&A AND POST-MERGER INTEGRATION IN JAPAN

Japanese companies think of M&A as one of the major corporate strategies in addition to traditional organic growth. The number of mergers and acquisitions conducted by Japanese companies has grown since 2011 in both "In-In" and outbound deals. In-In denotes Japanese companies buying other Japanese companies.

Additionally, acquirers have started to pursue bigger deals than before. There are lots of cases. Tokyo Marine Holdings, a leading Japanese insurance company, purchased HCC Holdings for $7.5b. Meiji Yasuda Life insurance bought StanCorp Financial Group for $4.9b. And Nihon Keizai Shimbun, a major economic press, bought the Financial Times group for 844 million pounds. In order to understand these mega-deals, we need to learn a bit of background about the Japanese economy.

Matured Economy

The Japanese domestic market is saturated in most industries. Some economic data show that Japan's gross domestic product has been saturated since around 2000. This is due to the declining population and workforce. Therefore the market is required to be reconstructed and domestic companies are forced to be merged for more economic efficiency. To name a few, retail banking service, retail store chains, and petroleum industries are good examples of domestic M&A in Japan. This trend will continue for a while as it is difficult to write scenarios for growth in the domestic market.

Growth Strategy

As we cannot expect more growth in most of the Japanese market, many companies try to expand their business into the global market. Some companies are getting better with the help of the government-led economic stimulus package. They are pursuing the next growth strategy and they have two options. One is to start a new business, and the other is to expand their current business from local to global. As a result, many Japanese companies conduct M&A against foreign companies to expand their activities.

In this Part 2 of this chapter, we can identify post-merger integration (PMI) issues following both inbound M&A and outbound M&A conducted by Japanese companies. And we can try to propose practical approaches to solve the PMI issues.

ISSUES AND APPROACHES FOR OUTBOUND M&A AND POST-MERGER INTEGRATION FROM JAPAN

Many Japanese companies invest a lot of money and assets for M&A deals. But most of them do not regard the post-merger process as important. In many cases, the operations in the acquired foreign companies are kept as completely the same as before. Although they buy a new technology or add a new business, they seem to believe it is better to keep the operation the same as before. They literally put in practice "When in Rome, do as the Romans do." However, this laissez-faire policy sometimes brings little or no governance to control the acquired company and cannot take appropriate actions once the new organization worsens financially. Parent Japanese companies, in some cases, even fail to notice the fact that the acquired company is in a crisis situation.

There are several reasons for their reluctance to control acquired companies. We have to clarify the critical factors coming from Japanese culture and its characteristics.

Issue No. 1: English Conversation Capability

A majority of Japanese business persons, in general, are not good at English conversation compared to other major developed countries. The score of the Test of English for International Communication (TOEIC) shows that Japan was ranked fortieth out of 48 countries in 2013. English itself is a communication infrastructure in global business. Therefore poor English capability causes misunderstanding and troubles in global business scenes. And it often occurs when Japanese companies purchase foreign companies.

Issue No. 2: High-Context Culture

Even if your Japanese counterpart can speak English proficiently, his or her communication may depend on an "A-Un" style, a form of traditional nonverbal communication, which is not saying any words or expressing any thoughts among insider members. Japan is an island country and historically developed in isolation from other countries. Therefore the Japanese have developed a monocultural identity and don't need special efforts to understand each other. It might be a generalized idea, but it is still true.

Issue No. 3: Slow Decision Making

Japanese decision making is often based on mutual consensus without discussions. The reason is that the Japanese community originated from a village community. The role and responsibility of each member is very vague and naturally occurring. In the village community, even important issues are not discussed and critical decisions are suspended. Slow decision making is still very comfortable for many Japanese businesspeople.

Issue No. 4: Bottom-Up Problem Solving

In general, each employee is very capable and highly committed to his or her job. So they are very good at kaizen, or continuous improvement, based on bottom-up problem solving. However, depending on kaizen too much is a double-edged sword. They can improve the situation gradually but are not accustomed to the revolutionary change that is required, especially after mergers and acquisitions.

Issue No. 5: Inclination to Avoid Changes

Traditional Japanese businesspeople prefer stable organizational systems. Japanese companies were operated under a lifetime employment system for a long time. So the workers have little or no resilience to downsizing or layoffs. The current government-led employment safety-net system is not sufficient to cover the drastic changes that Japanese companies have not experienced before. They try to avoid restructuring themselves even after integrations.

Due to the previous five factors, when Japanese companies try to merge with foreign ones, their integration is implemented very slowly and they hold insufficient traditional structures and processes. Therefore there is lots of room to improve. We can maximize the outcome of integration by focusing on post-merger phases as follows.

Crystallize Goals and Strategies

As the first step, the strategy of the new organization should be clearly defined and shared with all members, including purchased companies. The corporate strategy in some Japanese companies is sometimes vague and not shared with employees. Their employees have to work without fully understanding vision and strategy. What is required at Japanese companies is that they get away from their traditional comfort area where mutual nonverbal understanding exists. And then crystallize and declare their goals and strategies to new foreign participants who have different cultural backgrounds and perspectives.

Document Operational Process

Japanese operational knowledge should be defined and shared with related members. The operational process is often generated empirically from task-dedicated blue-collar workers. They have often developed the accumulated knowledge, but they rarely share this with others in their workplace. In order to introduce efficient operation in a new organization, it is necessary to put the accumulated knowledge down in writing.

Define Key Performance Indicators

Key performance indicators, or KPI, should be also defined and assigned to each role in new organizations. It is still not easy to share the same directions even though the management members try their best to deliver their strategy to the new organization, due to the difference between Japanese and other cultures. We need not only strategy sharing but also more practical guidelines to move forward after cross-border integrations. Our experience shows that well-defined appropriate KPI setting is critical to manage new organizations with multicultured members.

Use Standardized Process for Post-Merger Integration

The PMI process, which is standardized and accepted for globally successful companies, should be used as an inevitable element for integrations. Japanese companies sometimes make light of the PMI process and omit it. And they try to keep the same operation in acquired companies as before. However, it generates various types of problems after integrations. The standardized PMI process is an efficient and productive way to share mutual understanding among culturally different companies at the early stage of integrations.

Communicate More

More communication should be actively conducted. Culture and language barriers generate bad communication and, as a result, many concerns remain unsolved in the integration processes and may cause serious problems as the integration proceeds. The concerns should be identified at an early stage and shared to find solutions for them. If your company was purchased by a Japanese company and the company has not announced their managerial concerns, then you should point out your concerns proactively from the purchased side's perspective. Otherwise chaotic situations may be generated later. Proactive communication from both sides is also a key to success.

ISSUES AND APPROACHES FOR INBOUND M&A AND POST-MERGER INTEGRATION IN JAPAN

Now we move to inbound M&A and PMI instead of outbound. Our experiences show that major purposes for purchasing a Japanese company can be categorized as follows:

- To enter the Japanese domestic market
- To acquire Japanese technological advantages
- To incorporate Japanese-trusted brand names

Some pharmaceutical and retail multinational blue chips had purchased Japanese companies for the purpose of entering the Japanese market during the last two or three decades. As Japanese GDP is used to being ranked second in the world and Japan still has over 126 million people, some market segments are still attractive for some industries.

On the other hand, the trend has shifted to the pursuance of technological advantage and brand names for market entry purpose. Some industries, like medical devices and electrical appliances, are interested in incorporating Japanese technological advantages into their research and development (R&D) and manufacturing departments. And Japanese brand names are also valuable for emerging new powers, including well-funded Chinese apparel and food companies.

Although their purposes are different among purchasing parent companies, our experience shows that there are common and critical issues for success when integrating Japanese companies. The key idea is the well-balanced approach between global standardization for outcomes and cultural adaptation for processes.

Issue No. 1: Necessity to Install Reporting Systems Quickly

Most companies that purchased Japanese companies and are performing well, have well-established reporting systems that include budget-planning and performance-tracking systems, by which top management can grasp and control real business by each department separately. Generally speaking, we have to consider cultural differences. However, as to reporting systems, in most cases there is little need to re-tune your original systems. You might not have to translate the original language in the original system.

Japanese employees may initially complain about it, but they can make full use of it soon if you provide appropriate supports. You can install reporting systems immediately after integration.

However, in many cases, it is the first experience for Japanese employees that the company for which they work is purchased by a foreign company. Therefore, explanations are needed for why new reporting systems are important to the new parent company and how to fill the reporting formats with appropriate guidelines and templates. In other words, Japanese employees may be averse to change if they do not understand the reasons and procedures, but once they understand them, they become very dedicated and cooperative.

Issue No. 2: Lack of Clear Definition of Expected Result

Even if a purchased Japanese company is a well-known major player in the industry, it is not common to have well-organized job descriptions or roles and responsibilities defined clearly for each position. We can adapt the same approach as the reporting systems to this issue. We can translate and adopt the parent company's job descriptions directly as in the first step.

The point is that we have to consider definitions of expected results and expected processes "separately." The definition of expected results is required for each position because most Japanese companies lack it. But some cases might not have to be changed, because the current processes are often optimized for their local business environment.

Japanese nonmanagerial staff and workers are generally more capable and committed to their tasks than those of non-Japanese parent companies, especially in the operation and manufacturing departments. Coerced introduction of the parent company's standardized process might bring unproductive confusion. We need to clarify expected results for each position, make employees commit to the result, and then delegate how to achieve it.

Issue No. 3: Loss of Respect for Employees' Dignity

Japanese employees are sometimes very far from "homo economicus." They do not necessarily prioritize monetary benefit when confronting personal decisions. We wouldn't say that an attractive retirement package does not work for targeted low-performing employees at the downsizing stage after integrations. But in cases where Japanese employees feel their past contribution was denied or they were strongly insulted by a new foreign employer, they will pretend to obey but secretly betray new bosses, and sometimes attack them with their labor union.

A certain global pharmaceutical giant integrated some midsized competitors and tried to optimize the size of its sales force in Japan. Following their standard downsizing process, they designed early retirement packages, which were very attractive, identified the targeted employees to be fired, and then announced them in the very short term. It was common and reasonable for the parent company's culture.

But many Japanese employees felt insulted by this downsizing action, even if the retirement package was appealing from a monetary perspective. They were supported by the labor union and leaked internal information to a major economic press. In the end, the parent company had to retract the original downsizing plan and make a promise to sustain full employment.

From another standpoint, we can take advantage of employees' mentality. If employees wish to be treated with full respect for their dignity, the retained employees will show their strong commitment to new bosses and new organizations, and nonretained people will accept mediocre packages if asked to leave the company. We have to utilize effectively the peculiar sensitivity of Japanese employees.

Issues No. 4: Too Much Dependency on Fluent English-Speaking Members

The management members coming to Japan are apt to trust and depend too much on fluent English-speaking Japanese. However, unfortunately, English-speaking capability does not accord with functional or managerial capability in most Japanese companies, partly due to the excessive emphasis on reading and grammar capability in the past education system for English in Japan.

It is understandable that expats from parent companies depend on them, but this tendency can devastate their integration effort. We observed lots of cases where expat members made wrong decisions by depending on biased and incorrect information from Japanese with very limited English-speaking capability.

Moreover, these employees will be easily promoted to managerial positions only due to their English capability with recommendations from expat members even if their functional performance is mediocre. A certain Japanese automobile manufacturer was bought by a German automobile giant. In this case, many skillful procurement staff members were fired or left voluntarily. The remaining and newly hired staff were surely able to communicate well in English, but most were amateurs and mediocre performers in function.

Our recommendation is that foreign expats must not hesitate to use more than one translator in order to communicate with and get information from functionally capable employees who cannot speak English well. It is true that there are some risks in using translators because a translator might manipulate and control sensitive nuances of the conversation for his or her own benefit. Sometimes a translator might behave like "fox that borrows the authority of a tiger," which means a person who swaggers about under borrowed authority. Despite the possibility of the risks, it is better to use two or three translators.

Issue No. 5: Malfunction of Integration Management Office

We have also observed that some experienced parent companies struggle against unexpected obstacles in the integration process of Japanese companies. A certain European electronics company purchased a medical device division from an American company. Its highly vaunted integration management office teams were sent to each office in order to facilitate local integrations. Like their past records, the integration team succeeded in every country except Japan. The two sales teams that originated from each company still have deep antagonism for each other even five years after the initial integration.

These frictions are often caused by ignoring the previous five issues that are not necessarily the same as those in Asian developing countries or in developed Western counties. We have to care about these issues described earlier.

It may be necessary to put additional local Japanese-native IMO support members in order to bridge the dispatched headquarters IMO team and the local employees. The IMO support members should be familiar with the cultural and organizational issues and should be able to handle the obstacles they face.

The IMO support members can be internal or external. If the parent company has a plan to purchase more Japanese companies in the near future, it is reasonable for it to have its own IMO team especially for Japan, otherwise it could be useful to hire external inbound IMO specialists.

Don't underestimate the obstacles you will face when purchasing Japanese companies. And remember that you will face many more difficulties to incorporate their capability than you expect. You have to prepare and adopt appropriate approaches to tackle these obstacles.

CHAPTER CHECKLIST FOR PART 2: JAPAN

- Outbound case from Japan
  - Crystallize goals and strategies
  - Document operational process
  - Define key performance indicators
  - Use standardized process for PMI
  - Communicate more
- Inbound case to Japan
  - Install reporting system quickly
  - Define expected result clearly
  - Respect employee dignity
  - Don't depend too much on members who are fluent in English
  - Utilize an IMO