New wave of acquisitions rolls out of China and India – Impact and counterstrategies

> Risk or opportunity?

Their cultures and their economic development paths may be completely different. To German companies, however, China and India have one thing in common: the menacing rate at which they are conducting mergers and acquisitions in Europe. This expansion is going far beyond the already rapid increase in the two countries' shares of global production and exports. **Dr. Carsten Herbes** and **Peter Schneidewind** talked to the managers of companies affected and analyzed what strategies the investors are pursuing, what these acquisitions mean – in negative or positive terms – for the companies affected, and what counterstrategies can be adopted.

At many German production firms, management teams have long been considering direct investments in India or China. Too long, perhaps, because the Asians have now turned the tables. Chinese conglomerates are beginning to take over these companies' European rivals. So, instead of making their own inroads into China, German companies are now faced with the prospect of fighting off Chinese competition on their own doorstep.

Economic indicators pointing sharply up

The population figures alone are impressive. China's 1.3 billion inhabitants and India's 1.1 billion together account for more than one-third of the world's population. While vast reserves of economic potential remain to be tapped, both countries are advancing at a frantic pace. China is expected to have become Germany's third-largest trading partner (for imports) in 2006.

Key figures for the Chinese and Indian economies

	China	India	Germany
GDP in 2005 [USD bn]	2,224	775	2,797
Average economic growth p.a., 2001-2005	10%	7%	1.7%
GDP/capita in 2005 [USD]	1,709	705	33,854
Global GDP/capita ranking in 2005	110	135	19
Share of global exports in 2004	7%	1%	10%
Average export growth p.a., 2001-2005	21%	19%	6%

In terms of Gross National Product (GNP), China already ranks fourth and India twelfth in the global league table. And both countries are still moving up through the field. Once the two Titans have decided on a policy of outbound M&As, they can free up tremendous financial resources in order to implement this strategy. They will succeed in doing so, although neither country yet makes it into the top hundred in terms of per-capita income. Here too they are catching up, however, as the figures clearly show. Per-capita GDP rose by more than 50% in China and more than 70% in India between 2000 and 2005.

The economic differences begin with the driving forces behind this growth: big government in China, entrepreneurs in India. For M&A transactions, this means that China's industry focus will be guided more by central planning.

Outbound M&A activities increasing fast

Until a few years ago, German companies regarded China and India almost exclusively as promising export targets or venues for their own foreign investments. Direct investment has recently stopped being a one-way street, however. As early as 2005, Chinese outbound M&As totaled USD 6.5 billion. Moreover, the rate of acceleration is such that it took only five months (January through May 2006) to exceed the figure for the whole of the previous year. The key strategic motive for Indian and Chinese M&A activities is the desire to access markets, brands, technologies and raw materials. Another driver of M&A activity comes indirectly from the old continent itself, as more and more European-based companies commit to joint ventures in China and India. These joint ventures place higher technological and quality expectations on local suppliers. In order to satisfy these expectations, the larger suppliers thus enter into partnerships with European companies – or buy them outright, thereby closing the loop.

It is noticeable that the two countries are focusing on different industries in their commitments to Germany. While Chinese firms are strongly represented in the machine tool industry, India concentrates more on pharmaceuticals, automotive engineering and software. Broadly speaking, there is evidently a tendency to effect smaller transactions to buy into still relatively fragmented markets. Insolvent or underfinanced companies are often the preferred targets. Exceptions such as Arcelor only confirm this rule. Usually, the predators are large conglomerates that are many times larger than their prey. Those of Chinese origin are mostly state-owned companies. Incidentally, the case of Arcelor points to another emerging player that is turning its M&A attention westward: Russia. In this instance, Severstal stepped in as the white knight that saved Arcelor from the clutches of Mittal. Via the agency of the foreign trade bank, the Russians have even acquired a 5% stake in EADS. Deutsche Telekom too is currently fending off the unwanted attentions of Russian conglomerate Sistema.

China gets a foot in the engineering door

The Chinese government has formulated a general "go abroad" strategy that encourages foreign expansion by easing the restrictions on outbound M&As, for example. The aim is for M&A transactions to secure access to the sales resources, brands (see IBM-Lenovo) and technology needed to expand global sales. Other equally important motivating factors are competition between domestic companies, which has become extremely fierce, and the consolidation that is sweeping many industries. These developments are forcing Chinese firms to go looking for new markets abroad. Furthermore, analysis of the most recent Chinese acquisitions reveals an additional motivation: the need to safeguard energy resources. In two spectacular one-off deals in 2005, for example, Chinese market players snapped up oil and gas fields and energy companies worth USD 2.3 billion and USD 4.2 billion respectively. In Germany, as we have seen, China has so far played a very active role in the engineering sector. Waldrich Coburg, Zimmermann, Kelch and Heinkel were all taken over in 2005 alone. A year earlier, Schiess and Dürkopp-Adler likewise came under Chinese ownership. The buyers were large-scale conglomerates. When it acquired Schiess, Shenyang Machine Tool Co., for example, was already posting annual sales of around EUR 350 million with a work force of some 10,000 people. Harbin Measuring & Cutting Tool Group (Kelch) had more than 3,000 employees.

This focus in Germany is only one aspect of China's moves to ramp up its already strong worldwide mechanical engineering industry in line with the government's new five-year plan. Another part of the strategy is to collaborate with Japanese machinery firms (Japan is the world leader in machine tools). Beijing No. 1 Machine Tool and Japanese manufacturer Okuma, for example, have been working together since 2002.

India penetrates the pharmaceuticals/medical systems, software and automotive industries

Mittal Steel's bid for Arcelor dominated the headlines in 2006. However, analysis of Indian corporate acquisitions in Europe since 2000 reveals a different medium-term focus. In this period, 18 deals have gone through in the pharmaceuticals and medical systems industries, while 17 European software companies have been purchased. 12 acquisitions took place in the automotive industry, 10 in other capital goods sectors and 7 in textiles. Indian acquisitions in Germany too clearly concentrate on the drug and automotive industries. Like their Chinese counterparts, Indian buyers too see access to markets and technologies as their primary strategic objective. In the pharmaceuticals industry, the market access motive was obvious in Indian investments in Heumann and Espharma. In both deals, production activities were explicitly excluded from the acquisition. The acquisition of Flanschenwerke Bebitz improved the Indian buyer's access to global customers, thanks to the company's large number of end customer licenses. Peiner Umformtechnik is another target where access to customers – in this case to automotive OEMs in Europe – was the main attraction. In other cases, such as that of Trevira, access to technology was probably the primary consideration.

Buyers apparently reckless about approaching candidates, but careful about integration

Chinese general trading companies monitor the German market via their offices in Germany and supply China with information about potential acquisition candidates. In some cases, both Asian countries are already familiar with these partners from experience of existing collaboration. To German eyes, buyers often seem rather reckless in the way they approach acquisitions. Potential risks – such as special termination rights for contracts in the event of a change of ownership, which can lead to substantial sales losses – tend to be overlooked to begin with. Restructuring expenses too are seldom estimated in advance. During the integration phase, however, a far more cautious procedure is adopted. Integration in the parent company usually takes place relatively slowly and is very selective. In most cases, one or two of the buyer's managers are seconded to positions of leadership in the acquired company, although they seldom assume operational duties. Many effectively commute from China or India from time

to time, for example. In the interviews we conducted, German managers unanimously welcomed the tremendous operating freedoms that such arrangements leave them. Integration in reporting systems too, which are often a major issue for US-based investors, for example, tends to be kept on a very low level.

Acquisitions can help a company survive – or threaten its existence

It is fair to say that acquisitions by the Chinese have kept many German engineering firms alive. Many were insolvent or had been bleeding red ink for years. Injections of fresh capital from their new owners have given them equity ratios that are in some cases far superior to those of their rivals. This gives them financial stability and the chance to invest in production capacity or product development, say. In other cases, however, a small initial cash boost was all that the acquired companies ever saw. After that, they were left to themselves and had to stump up their own money for investment purposes.

Acquisitive Indian and Chinese conglomerates give their German targets the chance to grow, above all in their booming domestic markets, via the buyers' existing sales channels. The prospects for the cross-selling of Chinese machines in Germany, say, likewise look good – at least at first glance. In practice, however, extra resources often have to built up first. This is because sales operations in Germany are frequently focused on selling expensive special-purpose machinery, for example, and are thus unable to sell lower-cost standard machines from their new partner at low prices. New networks of dealers have to be set up to do so. Conversely, since Chinese partners are often not used to handling major project business, the German sales organization also has to provide a lot of support in China. In the cases we analyzed in the capital goods industry, this kind of problem cropped up again and again. Above and beyond cross-selling opportunities, the next step is (in some cases) to have certain basic machines or intermediate products manufactured by the foreign partner and then finished in Germany. In this way, the acquired German company benefits from the partner's low production costs even if it may have been reluctant to built its own production plant abroad. This ultimately makes it more competitive on its home (European) market as well. As in the case of sales, however, there is a fly in the ointment in this constellation too. German experts often have a lot of work to do on site in China or India to ensure that intermediate products meet the required quality standards.

If collaboration is to prove fruitful for the acquisition target too, roles must be split very clearly – along the lines of machinery sizes and price classes, for example. If the German side possesses technological knowledge and skills that are difficult to transfer, close cooperation can be very profitable indeed. Conversely, if the German company's core business overlaps significantly with that of the investor, and if the latter has comparable skills and knowledge, the value chain links hitherto based in Germany may be at risk. However great the opportunities may be, management should therefore never overlook the negative examples. Only a year after being snapped up by the Chinese D'Long Group, Fairchild Dornier went out of business. Chinese buyer TCL quickly shut down production at Schneider Electronics too.

Nor should one underestimate the harsh and, in some cases, almost panic-stricken reactions from German competitors. To defend their turf, some will do anything from advertising their own goods as the "only true German" products through terminating licensing agreements to trying to have their now-Sino-German rivals ejected from German industry associations. In the weeks and months following a change of ownership, it is thus vital for the acquired company to communicate quickly and comprehensively in order to preserve its customers' trust. Business partners are not the only group that exhibits a hefty response, however. Without exception, the managers we talked to all reported a sudden huge spike in media interest. As a result, some of the companies concerned have now employed their own media advisers to professionally turn this coverage to their own advantage.

German executives repeatedly stress the same point: When dealing with their buyers, voluntarily ensuring transparency and openly addressing their own problem areas nurtures trust and leads to relatively considerable entrepreneurial freedoms. Actively creating win-win situations is part of this trust-building exercise. This may involve relinquishing the Germany-based production of certain product segments and transferring the corresponding knowledge to the buyer. In some cases, this makes obvious sense because German production is likely to be unable to compete on cost in the foreseeable future.

Counterstrategies focus on competitive advantages, product portfolios and proactive moves to ward off acquisitions

Before drafting a counterstrategy as a knee-jerk response, companies should first answer one question in all honesty: Might partnership with a foreign buyer not possibly be the best alternative? The need to find the right counterstrategy should come into play only when a conscious decision to remain independent has been based on a solid, objective foundation.

Counterstrategies can consist of one or more of the following three key approaches:

1. Consciously acquire for yourself the specific competitive advantages of your Indian and/or Chinese competitors
2. Adopt a proactive product portfolio strategy that redraws the lines of competition and averts the threat of a takeover
3. Watch the market closely and collaborate with European rivals to prevent the possibility of attempted acquisitions from Asia at an early stage

Lower costs compared to operations based in Germany are one of the main competitive advantages that Indian and Chinese companies often contribute to acquisitions. Logically, therefore, adopting an active footprint strategy can be one useful long-term counterstrategy. This strategy identifies the region in which each link in the value chain can be located to maximize efficiency. The company's entire location portfolio is then mapped out in light of these insights. In early 2005, Agie Charmilles, for example, expanded its production capacity in China by 40% to more than 1,000 machines. It now even develops and manufactures special-purpose electric discharge machines for the Asian markets in Beijing. Another closely related approach is known as low-cost-country sourcing – an area in which small and midsized enterprises too can tap significant potential.

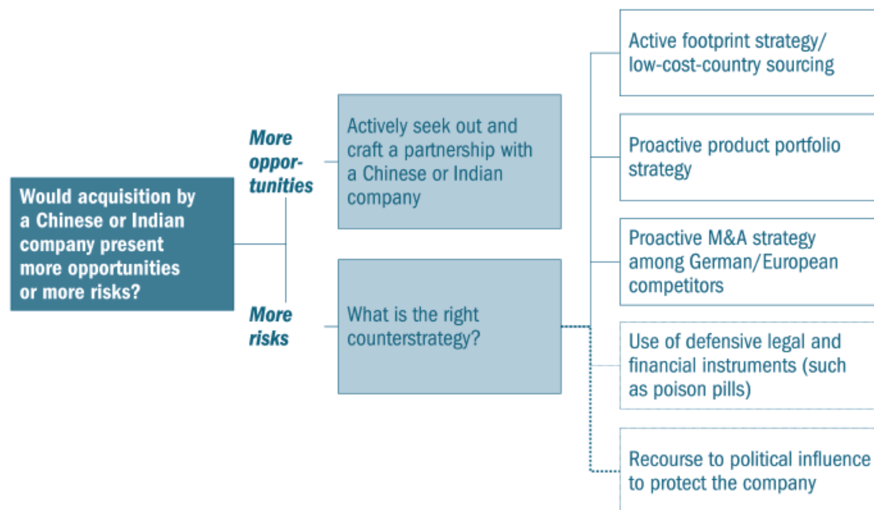
The second counterstrategy is for a company to develop its own product portfolio so fast that it avoids having to compete (and lose) on cost, which would inevitably make it a candidate for acquisition. Technological innovation is not the only option on this score. Within the framework of a proactive product portfolio strategy, it may be expedient to voluntarily dispose of certain business areas (such as lower-priced machinery) where the company no longer enjoys a competitive advantage. Such a move frees up resources that can better be deployed elsewhere.

The third potential strategy is to actively partner (or engage in mergers and acquisitions) with German or European rivals. This can help all the parties to such collaboration to nip acquisitive Asian ambitions in the bud. In the past, target companies in Germany often filed for insolvency or prepared to do so when a takeover bid was launched. Since most players in the industry usually know when a company has this kind of difficulties some time in advance, this information lead can be leveraged to drive industry consolidation. However, one problem with this approach can be that most potential buyers are themselves SMEs that do not have sufficient resources to fund such transactions.

Publicly traded companies also have another defense known as the "poison pill". One such "pill" would, for instance, grant special rights to shareholders, thereby making the company unattractive to potential buyers.

In the USA, Unocoal and Maytag, when respectively threatened by CNOOC and Haier, showed that companies can also draw on political influence to successfully protect home-grown industry. Ultimately, however, such an approach merely delays the point at which an entrepreneurial decision must be taken. In Germany, this alternative has never been commonplace up to now.

Decision tree for German managers



When board members and executives think about China and India – and not only then – they would therefore do well to consider that they themselves or their competitors could be on the takeover hit list too. This being the case, an early decision to actively seek out partners, collaborate with potential buyers or deploy carefully planned counterstrategies keeps all their options open.