Update China Desk

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How China is investing in Germany - an opportunity for international corporations and medium-sized companies alike

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China has come a long way since it first opened its economy to foreign direct investments (FDIs) in the late 1980s and up until recently outbound direct investments (ODIs) by Chinese companies were rare, mostly restricted to state owned enterprises (SOEs)[1] and went into developing countries rich in natural resources. Only by 2008 ODIs slowly started to increase and flowing into developed markets.

As China wishes to move from a low-cost manufacturing economy to an innovation driven one, Germany has become one of the most attractive destinations for Chinese ODIs in Europe due to its strong reputation for high-end engineering. German firms are looking for fresh capital, entry to the Chinese market, purchaser in the context of private equity exit transactions or – in case of family businesses – a successor because the next generation doesn´t want to take over.

Large acquisitions and acquisitions in the German Mittelstand

Besides the large acquisitions, e.g. EEW, KraussMaffei, Kuka, there are numerous acquisitions of medium-sized companies – Chinese companies are looking for targets in the German Mittelstand, e.g. the fork-lift truck manufacturer Kion.

While in many cases Chinese companies buy 100 % of the German target, there are several examples where the Chinese investor first acquired a minority or majority share, which was subsequently increased, as in the case of Kuka, for example.

Regulatory framework for ODIs

The Chinese regulatory framework for ODIs is still cumbersome, however it has been greatly simplified in the last years and it is estimated that cross-border capital flow will be com-

[1] The Economist Intelligence Unit Ltd., Chinese Investment in Developed Markets (2015), p 2.

pletely relaxed in the near future along with a "managed" capital account convertibility of the RMB.[2]

Record filing primary administrative measure

Prior to these recent reforms investors had to attain a verification from different authorities. Verification is now only required for outbound investments exceeding USD 1 billion - a threshold only few investments breach - or involving sensitive countries or industries. Record filing has thus become the primary administrative measure for Chinese ODI projects.

Challenges

While the new regulatory framework has encouraged Chinese investors to venture abroad, other challenges to a successful ODI remain – finding a suitable target company or handling differences between Germany and China with regard to economy, legal system and culture being the major ones.

Acquisition process

In addition the acquisition process itself can present a challenge: Acquisitions follow a certain process in Germany that usually is presupposed by the parties and ensures an efficient and professional transaction process. Chinese purchasers often lack experience with this process during their first acquisition in Germany. It is helpful to choose an internationally experienced transaction team to avoid this pitfall.

In a first step of the acquisition process a suitable target company has to be identified and closely analyzed in line with the strategy and goal of the acquisition. Then the acquirer will typically engage the target company and preliminary talks commence, followed by the signing of a confidentiality agreement, letter of intent and a thorough due diligence.

Concerns and cultural differences

Concerns and cultural differences have to be taken into account during this process and in particular during the next steps – the negotiation of the Share Purchase Agreement and the post-merger integration (PMI), e.g.

- German companies are often reluctant to disclose know-how in fear of corporate espionage.
- Negotiations are influenced by different "negotiation cultures".
- German employees fear the relocation of jobs to China.

[2] IMF Report: http://www.imf.org/External/spring/2015/imfc/ statement/eng/chn.pdf

- The management culture of the Chinese purchaser often is more hierarchical than the management culture of the German target.
- Chinese people communicate in a more indirect form than German people.[3]

The success of Sino-German transactions hinges upon tackling these concerns and cultural differences.

Mastering these challenges

The major issues are to be aware of these challenges, to consider them while planning the transaction and especially while communicating with the other party and the German employees and hereby create an atmosphere of mutual trust.

From a legal perspective a two phase due diligence, where sensitive information is only disclosed at a later stage when the likelihood of the transaction taking place is high, can allay concerns of corporate espionage.

When Beijing No. 1 Machine Tool Plant acquired the German machine tool manufacturer Waldrich Coburg in 2005 – one of the pioneer oversees acquisitions – it decided to disrupt the target firm as little as possible by keeping it almost as a completely separate organization with the original management and brand name. This approach ensured a successful PMI.

Conclusion

As Chinese ODIs in Germany are becoming more common, success stories are starting to emerge. This recent “Go West” drive poses a great opportunity for both Chinese and German companies, for international corporations as well as for medium-sized companies.

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[3] Bayer, Sonja, Chinesisch/deutsche Transaktionen - Unkalkulierbares Wagnis oder wichtige Chance für den deutschen Mittelstand? in: Kuckertz, Middelberg „Post-Merger-Integration im Mittelstand – Kompendium für Unternehmer“ (2016), p.23-36.

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