

Due Diligence

Reading The Tealeaves On China Business Partners Requires Independent Research and Investigation

By Peter Humphrey

There has never been greater pressure on corporations than there is today to read the "tealeaves" correctly on the companies and people they are getting into business with. After the latest dramatic downfalls of several new-era Chinese tycoons amidst fraud allegations, that is especially true of the China region.

Since the collapse of the global accounting firm Andersen and the energy giant Enron, companies have been under greater pressure to exercise the highest standards of corporate governance, to conduct thorough due diligence on business deals, take steps against fraud, carry out checks for compliance with anti-bribery laws and anti money-laundering laws, and to face the wrath of their shareholders if they get it wrong.

This pressure on businesses has been reinforced by a string of Enron-like scandals around the world involving fraudulent accounting and by fiascoes embroiling the world's top investment banks who are alleged to have egged on share prices and misled punters by distorting research and analysis on IPOs and listed companies. As a result, there has been a surge in demand for independent research, research that is independent of big audit firms, independent of investment banks, independent of brokers and the like.

Against this backdrop, multinationals and their stakeholders have become much more sensitive from a regulatory standpoint about investments in China, a place unfortunately known at least as much for corruption, white collar crime, share ramping, opacity, and theft of intellectual property, as it is for high standards of corporate governance.

More and more firms are therefore seeing the need to conduct pre-deal health checks on prospective joint-venture partners or acquisitions in China, and even against suppliers and distributors, in order to assess their suitability as business partners from the perspective of corporate governance and compliance with anti-bribery laws such as the American Foreign Corrupt Practices Act (FCPA) or the OECD Anti-Bribery Convention. As China becomes a strategic link in the global supply chain, with western multinationals shifting sourcing and manufacturing operations to this country, nothing could be more crucial.

There have been plenty of earlier lessons in Asia's business history pointing to the need for solid investigative due diligence before transactions are done in this region, prone as it is to under the table deals done on a handshake, and hidden liabilities. The Asian crash of 1997-1998 exposed widespread cases of fraud. And the bursting of the dotcom bubble in Asia a few years ago showed how many of the wizards of the new economy were in fact dot comen. But it was, later, the regulatory impact of the Andersen-Enron debacle that hammered home the due diligence message. As we witness the investment stampede into a booming China spurred by WTO-related liberalization as well as by the downturn in the rest of the world, the need for independent professional due diligence in the China region has grown more acute.

A recent case story that underlines this necessity involved an overseas investment consortium that had invested heavily in a joint venture with a PRC equipment maker. After several years the venture was increasingly unprofitable, the investors took a closer look and discovered their

partner had been siphoning money out of the business into phantom suppliers, namely companies that he owned, and by paying huge bills for fictitious "PR work". Had they bothered to investigate him before they entered into the deal in the first place, they would have discovered that he had already defrauded previous partners in a similar way and that some of his companies had been shut down for tax evasion.

In another case, a multinational was surprised one day to be raided for smuggling. It then investigated and discovered that its Chinese import-export agent was owned by one of its own local managers and that he had been falsifying customs paperwork and pocketing supposedly paid duties for several years. It turned out his previous employer had quietly fired him because of similar antics. Had the multinational investigated his background when they hired him, and conducted due diligence against the import-export company, they would have discovered serious grounds not to employ the man and not to use the agent. They could have avoided being raided and punished for customs duty evasion.

On a more positive note, though, a multinational that did conduct investigative due diligence recently versus a prospective partner in the Northeast found out that the local firm had falsified financial records, grossly exaggerated its capitalization, and provided misleading information about its ownership of a prime property. The due diligence revealed that the local entrepreneur had orchestrated a series of bankruptcies and was under investigation by authorities in several Chinese provinces.

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It was clearly positive that this discovery helped the multinational avoid an investment disaster. It was negative, of course, that the multinational no longer had a deal or a partner to negotiate with. But not every such exercise has to be a deal killer. In fact, sometimes, negative discoveries can help companies adjust their negotiating stance and obtain a better deal with reduced risks.

However, there are very few who can lift the lid of secrecy from Chinese companies and uncover their true state of being. Many local firms are opaque, patriarchal organizations that keep multiple sets of financial accounts and conceal their real P&L. At the same time there are many impediments to the discovery of high-quality information about China's companies. Unlike in an advanced country like the U.S., or say Singapore, there is no national centralized database channel for the general researcher or the investing multinational to obtain corporate registration data in China. The same is true of real estate records, and other registries and databases that we take for granted in an industrialized country as a routine tool of corporate and personal research.

Despite what you might expect in an authoritarian state, the records are still decentralized and often chaotically managed. Access is restricted to local lawyers and a handful of other privileged people. The access that an investing foreign multinational might have is at best indirect and secondhand. Even when you can find a way to access this data, its quality leaves much to be desired and requires careful verification through discreet field inquiries that only a professional investigator with extensive contacts can carry out unnoticed. That raw business intelligence needs then to be combed and synthesized by a professional analyst to make sense out of it.

There are a number of D&B-style Chinese credit reporting agencies that obtain registry data and sometimes make approaches to the target firms to obtain additional information. But the reports that they sell are based on questionable officially filed figures from the companies concerned, in a country where tax evasion and the keeping of multiple sets of books are widespread practices. The only way to get beyond this and gain comprehensive insight into a company is to supplement the data with additional intelligence acquired through discreet on-the-ground inquiries with walking, talking human sources.

However, the investigation business in China is still in its infancy. This year China is issuing its first Commercial Investigation Licenses, but only to domestic firms. Until now Chinese detective agencies operated under consumer polling licenses, law licenses and patent and trademark agencies. Most of China's detectives lack a business education, and do not know what questions to ask in a due diligence inquiry. What often happens is that they simply repackage corporate registry data as a product of their "investigation". To avoid trouble, multinationals investing in China clearly need an overarching approach to due diligence that combines high-quality human source data and reputational assessments with balance sheet analysis and asset verification, and culminates in a thorough, integrated appraisal, with the seal of a reputable firm signing off on it. Accounting firms can provide balance sheet due diligence but not investigative intelligence; most investigation firms cannot provide the financial appraisals, and the intelligence that most provide is often merely dressed-up corporate records.

Whoever can provide all the requirements in one package and read the tealeaves accurately on Chinese companies will have no shortage of clients at their door. But

there are very few who can do it, and finding such service remains a bit of a challenge.

To maximize the reduction of risk and to support high standards of corporate governance, independent due diligence must satisfactorily address these key issues:

- Genesis, evolution, and background of target company
- Real structure of company
- Any hidden shareholders, any power behind the throne?
- Reputation with business associates (e.g. suppliers, distributors)
- Industry reputation (e.g. impressions of competitors, trade bodies)
- Fate of past tie-ups (e.g. international JVs, distributorships)
- Professional managers' background and credentials
- Reputation, integrity level, character of principals
- History of bankruptcy or company closures
- Any record of negative litigation
- Political ties: genuine, appropriate, useful?
- Undesirable relationships and encumbrances
- Corruption issues, any FCPA liabilities?
- Stability of workforce
- Potential regulatory problems
- Compliance (social, labor, tax, customs, ecology, etc.)
- Any other non-balance-sheet risks?