Don't Let the Name Fool You

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For the past several months now, I have been on an extended research trip for the express purpose of taking a close look into China's domestic A-share market. While many investment professionals typically rely on screening functions to select potential portfolio holdings in specific sectors, when it comes to mainland China's domestic-listed, A-share companies, you will want to proceed with caution.

In recent years, many Chinese companies, and especially A-share listed firms, have been using their capital—either with cash or with shares—to make acquisitions. Some firms are expanding their operations within specific value chains (either upstream or downstream), some are adding more products or service offerings and some are even entering entirely different sectors from where they began. In a few extreme cases, firms have transformed themselves by divesting their original businesses and re-emerged in a new industry. In the interim, they may even continue to maintain their old firm name before revisions reflect their new business models.

I've recently met with several firms that have made acquisitions within the past two years. Through my discussions with management teams, I gained insight into the motivations that have driven recent acquisitions. Due to the economic slowdown, firms that have been operating in traditional industries, such as the property and manufacturing sectors, are facing some difficulty. So expanding into more value-added areas in related industries is an attractive move. Alternatively, major shareholders or management teams may decide to strategically pivot and enter new areas in order to tap other growth drivers or convert the company entirely. Due to the lack of relevant talent and the time it takes to develop expertise organically in new areas, a firm in this situation may also opt to purchase a strong existing player in the new sector.

This kind of diversification and business transformation makes sense. As in many cases, firms can either leverage current resources to create synergy with the new businesses, or if they venture into an area they are not familiar with, they can pay a reasonable price for a leader with a good track record and then allow the acquired management team to retain a partial stake. If these firms don't change, they may not survive by merely adhering to their old business strategies. In other words, they have little choice but to adapt.

On the other hand, there are also firms that make acquisitions in "hot" areas such as information technology, health care and media. Acquisitions are sometimes made simply for the sake of having exposure to such industries despite a lack of any concrete plans for development in the sector. A company may also make so many acquisitions in a single year that integration becomes problematic. In nearly all cases, there are profit guarantee clauses embedded in the acquisitions, and if the acquired firms are unable to meet targets, there are penalties imposed.

Though many firms have thus far delivered on profit guarantee clauses, there is still no guarantee that all profit targets will be met at the end of the contract term. Meanwhile, in cases where profit targets are not met, the acquirer must then write down assets.

As long-term investors, our job is to identify those firms with solid management teams who have clear objectives for acquisitions to provide new growth areas for themselves and to avoid those that pursue "hot" concepts to support their stock prices in the short term. As Chinese investors become more mature, they will eventually reward only firms that achieve long-term earnings growth from such acquisitions.

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