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Dear Friends:

New economic realities—more sophisticated supply chains, co-production practices and shifting trade patterns—have replaced the paradigm of trade in goods to trade in tasks. Unfortunately, the benefits are not always revealed in conventional trade statistics. What is captured distorts trade, generates poor policies and creates tensions (p1-2).

The American Jobs and Closing Tax Loopholes Act will hurt American workers, reduce American exports, and make American companies less competitive in the international marketplace (p3-4).

Mergers and acquisitions have been a quick and easy way for multinationals to enter the Chinese market—until now. Such deals are declining for Western firms as Chinese companies grow more competitive in the M&A arena (p5-7).

I hope you find this issue informative and, as always, we welcome your comments.

Sincerely,

Tim J. Nowak
Executive Director
World Trade Center Saint Louis

Conventional Statistics and Assumptions No Longer Reflect Today's Global Realities

Bad data distorts trade and generates poor policies and tensions

By John Manzella

International trade theory has its roots in the 18th-century writings of Adam Smith. He argued that nations could increase their combined output if each specializes in producing goods at which it is most efficient, and then each engages in trade. Every country will be better off, he astutely claimed, in terms of the quantity of goods available for consumption, resources expended and additional output obtained through specialization.

According to David Ricardo, a prominent classical economist, even if a nation does not possess an absolute advantage in the production of a commodity, it still will benefit by producing and exporting those products in which it has a comparative advantage. Put another way, the less efficient nation should specialize in and export the goods and services in which it has the least disadvantage. This personal contemporary example explains the

point: if you can type letters faster than your assistant, who is paid considerably less than you, should you put aside your more sophisticated and profitable projects so you can type? No. You are better off delegating the typing to your assistant even though you are more proficient at it.

Although this 18th century trade theory still holds true, conventional trade metrics used to measure global activity do not.

From Trade in Goods to Trade in Tasks

New economic realities—including more sophisticated supply chains, complicated co-production practices, and shifting trade patterns—have replaced the paradigm of trade in goods to trade in tasks. Not surprisingly, this is not well understood. One reason: the value generated is not accurately captured or reflected in conventional trade statistics. As a re-



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sult, what's not revealed—factors that often benefit the United States—have instead led to misinformation, trade distortions, bad policy recommendations, and trade friction.

The Value of Value-Added Data

Today, instead of flowing directly to America, much of Asia's exports first go to China for assembly, processing and manufacturing, and then to the U.S., inflating the U.S.-China trade deficit. Unfortunately, conventional trade statistics don't capture this changing trade pattern or the benefits it derives. To grasp a more accurate picture of what's occurring, it's important to identify how much value is added when a country manufactures, processes or assembles goods.

According to the U.S. International Trade Commission (ITC), Chinese value-added, as a component of Chinese exports, is about 50 percent. Stanford Professor Lawrence Lau puts this figure at 37 percent. And based on additional ITC analysis, this figure drops to 35 percent of the value of goods produced in Chinese export zones. As a result, one-half to two-thirds of the value of Chinese exports are of non-Chinese origin.

China is not unique. According to the World Trade Organization, the domestic values of exports from South Korea and Malaysia are 56 percent and 50 percent, respectively.

The Apple iPod manufacturing process is very telling. On the back of each iPod is the statement, "Designed by Apple in California and assembled in China." However, conventional trade statistics don't disclose this. What's more, the U.S. import cost from China of an iPod, according to the University of California, is \$150. Yet, only about \$4 of this is Chinese value-added derived from Chinese labor and components; the remaining \$146 represents the value of components produced in the United States, Japan, Singapore, Taiwan, and Korea.

In addition, the U.S. retail price, at \$299, handsomely compensates U.S. retailers, distributors, logistic compa-

nies, marketers, researchers and Apple shareholders. Yet, based on conventional metrics, the \$150 iPod import figure is applied to the U.S.-China trade deficit and perceived as having a negative effect on the U.S. economy.

The bottom line: since increasing numbers of products are co-produced across borders, origin labels—and the distorted trade pictures they perpetuate—mask what's really happening. Even the Airbus 380 European label could be contested, says WTO Deputy Director-General Alejandro Jara. The engines are from the United States and Airbus Industrie has more than 1,500 suppliers in 27 countries.

Currency Assumptions are Outdated

The value of the renminbi (RMB), also known as the yuan, is undervalued by 25 percent on a trade weighted basis (JPMorgan says 10 percent),

and 40 percent against the dollar, says Fred Bergsten of the Washington, D.C.-based Peterson Institute of International Economics. The assumption goes: if China raises the value of the RMB—which it began to slowly do on June 21—Chinese exports to the U.S. will become more expensive. In turn, fewer Chinese products will be purchased by Americans—bringing down the U.S. trade deficit. But due to today's complex variables, including pass-through rates, the availability of domestically produced substitutes, and the change in cost of imported inputs, assumptions based on old textbook theories don't always hold true.

For example, if an importer's national currency falls by 10 percent and the cost of imports rises by 10 percent, the pass-through rate would be 100 percent. In turn, the weaker currency would reduce import

demand. But today, many types of imports, especially consumer goods, have not become more expensive as the value of the dollar has come down. Why? Exporters to the U.S. often reduce their prices and accept smaller profit margins in order to maintain U.S. marketshare. As a result, real pass-through rates are significantly less than 100 percent.

A deeper look reveals this fact: between July 2005-July 2008, the RMB appreciated 21 percent against the dollar. Yet, the U.S. trade deficit with China rose by 33 percent. Likewise, from 2002-2005, despite considerable dollar appreciation against the Canadian dollar, euro, Japanese yen, Korean won, and Brazilian real, the U.S. trade deficit with each country rose. Thus, surprising to many policymakers, although the Chinese RMB is undervalued causing various

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problems, boosting its value is unlikely to have a significant impact on the U.S. deficit, noted former Federal Reserve Chairman Alan Greenspan.

Even if the pass-through rate were 100 percent and the price of Chinese goods rose enough to discourage imports, U.S. buyers would still seek lower-cost imports from other developing countries. Instead of focusing on the RMB—which is anticipated to gradually rise—policymakers would be wise to concentrate on other factors to correct U.S.-China and other global imbalances. ■

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Hobbling Exports and Destroying Jobs

An ill-considered bill will make American companies less competitive

By Gary Clyde Hufbauer and Theodore H. Moran

The U.S. House of Representatives recently passed the American Jobs and Closing Tax Loopholes Act (HR 4213). This bill will hurt American workers, reduce American exports, and make American companies less competitive in the international marketplace. Since the U.S. Senate has already passed companion legislation, the American Workers, State, and Business Relief Act (S 3336), these ill-considered bills could soon be reconciled in conference and become the law of the land. If so, American firms and workers will pay the price.

The two bills contain a veritable shopping list of benefits and taxes, with a price tag of \$110 billion over 10 years. We concentrate on just one aspect: tax measures costing \$14 billion over 10 years that affect foreign operations of U.S.-based multinational corporations (MNCs). As the numbers suggest, this is not the biggest aspect of the legislation. However, the foreign tax measures at issue illustrate an unfortunate direction of U.S. tax policy under the Obama administration and its congressional allies: the eagerness to tax the foreign income of U.S.-based MNCs as if they competed only with firms that are subject to U.S. tax rules. That conceptual foundation completely ignores the real world of intense competition between MNCs based in diverse countries.

While the technical details of the foreign tax measures in HR 4213 are mind-numbing, over a period of 10 years, what are being called "loophole closers" would, as mentioned, supposedly raise about \$14 billion from U.S. firms doing business abroad. The \$14 billion figure is the score assigned by the Joint Commit-



tee on Taxation and counts in budgetary "pay for" arithmetic. But the revenue gains will prove elusive because of collateral damage to U.S. exports and jobs, as we discuss in a moment.

Whatever the revenue, the philosophy underlying these and other foreign tax proposals floated by

payment to Uncle Sam. Some of the avenues require extensive tax planning. But the end result gives U.S.-based MNCs approximate tax parity with their MNC competitors based in Europe, Asia and Latin America. Like the tax laws of nearly all countries, current U.S. tax law amounts to

The American Jobs and Closing Tax Loopholes Act will hurt American workers, reduce American exports, and make American companies less competitive in the international marketplace.

President Obama is that, no matter where in the world they do business, U.S.-based MNCs should pay the U.S. corporate tax rate. This approach is intended to prompt MNCs to export goods and services from the United States rather than expand overseas and "ship jobs abroad." While the political rhetoric may resonate on the campaign trail and in the halls of Congress, the economics falls flat.

Under current law, U.S.-based MNCs are allowed many avenues to conduct business abroad and pay the foreign tax rate on their foreign earnings, with only a small additional

a de facto territorial system: income earned outside the United States essentially pays the foreign tax rate in the host country and only pays a small "top-up" tax (usually under 5 percent) when repatriated to the United States. In the view of President Obama and his congressional allies, this system amounts to a vast network of "loopholes." Unless and until U.S.-based MNCs pay the U.S. corporate tax rate on their entire worldwide income, they are, in this populist view, evading their "fair share" of the tax burden and, at the same time, "shipping jobs abroad."

But President Obama's tax philosophy and the legislation now coming out of Congress ignore two important facts: first, that the U.S. corporate tax rate, when federal and state taxes are combined, is one of the highest in the world (around 39 percent); and second that competing MNCs based in Europe, China, India, or Brazil pay far less than the U.S. tax rate when they compete head-to-head with U.S. firms in world markets. If the purpose of U.S. tax policy is to weaken U.S.-based firms in the global economy, to move headquarters' jobs to friendly locales like Toronto, Hong Kong and London, to undermine President Obama's goal of doubling U.S. exports, and to shift manufacturing jobs to China and service jobs to India, then HR 4213 and S 3336 make good sense. Otherwise they make no sense.

Careful studies compare U.S. firms that engage in outward investment with similar firms that stay at home. The studies show that outward-bound firms consistently export more from the United States than the homebodies. If U.S. tax policy is changed so as to hinder outward investment by U.S. firms, the result will be fewer U.S. exports, and fewer exports will spell fewer U.S. jobs. Since export-related jobs pay wages around 10 percent higher than the average for homebody jobs requiring similar skills, "good jobs" will be lost to the American economy.

Revamping U.S. tax policy to retard outward investment by U.S. multinationals will not lead to more investment at home either. Mihir Desai, Fritz Foley, and James Hines show that the years in which American MNCs make greater capital expenditures abroad coincide with years of greater capital spending at home by the same firms. They find that 10 percent greater foreign investment by the multinational triggers 2.2 percent additional domestic investment.

The plants of U.S. multinationals are the most productive in the United States, in terms of both total factor productivity and labor productivity;



they are the most technology-intensive and pay the highest wages. MNCs show labor productivity 16.6 percent higher than large homebody firms and 44.6 percent higher than small U.S. firms and pay wages that are 7 to 15 percent more than wages at comparable domestic plants. The U.S. parents of MNC groups accounted for 29 percent of all U.S. private-sector investment in 2007 and 74 percent of all U.S. private-sector R&D. A handful of U.S. multination-

unionized workers, just as it does for US workers overall.

We recognize that, under "pay for" rules, the authors of HR 4213 and S 3336 had to find revenue—even if illusory—to finance the multiple benefits and tax breaks that are the main object of their legislation. But it makes no sense to take the first step down a long path of tax policy that would weaken U.S. firms in the global economy, destroy American jobs, and hamper U.S. exports along

The best bottom line for American workers—and the American economy as a whole—is to make the United States a more favorable location for American multinationals to do business.

als account for more than half of U.S. exports. It defies common sense to embark on a course of taxation that would undermine these crown jewels of the American economy.

Do U.S. multinationals deserve tax punishment because they "ship jobs overseas"? The evidence indicates that U.S. export performance would be weaker, not stronger, as a consequence. Somewhat surprisingly, the positive relationship between outward investment and exports holds for U.S. lowtech (low R&D) industries just as for U.S. high-tech industries and heavily unionized U.S. industries just as for non-unionized U.S. industries. Outward investment creates more export-related jobs in the U.S. economy for low-tech workers and

the way.

The best bottom line for American workers—and the American economy as a whole—is to make the United States a more favorable location for American multinationals to do business. Instead of raising taxes on the foreign income of US-based MNCs, Congress should be lowering the U.S. corporate rate to 20 percent. Other countries understand the competitive realities well enough, but Congress seems determined to turn the United States into a loser. ■

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New Challenges Are Emerging with Chinese M&As

How to close the deal

By Barry Chen

China's booming economic growth continues to attract huge flows of foreign investment. And the World Expo in Shanghai is drawing still more attention. As a result of this and other factors, the economy grew a robust 11.9 percent in the first quarter of 2010, on top of 8.7 percent growth in 2009. During this same period, the United States and Europe were still struggling.

Growing numbers of multinationals, both those in China for lengthy periods and newcomers, are keen to expand their China stake. For some time, mergers and acquisitions (M&As) have been a quick, easy and favorable means to achieve this. However, such deals are actually declining for Western firms as local Chinese companies grow stronger and more competitive in the M&A arena.

Western M&As Are Down

Foreign company M&As only accounted for 27 percent of total M&As in 2009, down from 55 percent in 2008. Chinese company M&As accounted for the remaining 73 percent in 2009, up from 45 percent.

This trend, which continued in the first quarter of 2010 and resulted in only 23 percent of M&As involving foreign companies, is due to a number of factors. These include a changing market environment, a failure by foreign companies to adopt suitable strategies for identifying good targets and concluding negotiations in a timely manner, and government encouragement of local mergers and takeovers to help consolidate weak and fragmented industries.

"The failure rate of M&A deals closure is very high... more than 70 percent, even after letters of intent are signed," an M&A specialist said. I concur.



Question Assumptions

Even though the domestic M&A market is getting very competitive, foreign companies can succeed if they have clear cut strategies, realistic expectations about target companies, and flexibility in their approach. And they should act decisively and be prepared to pay a premium to win over targets. It's important to understand

With sound advice from an M&A consultant, the European company shifted its strategy and began looking for a small, regional player with different product lines. The result: it found several suitable targets and is currently negotiating an M&A deal.

For the F&B market, my firm, InterChina Consulting, strongly recommends seeking small, regional

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that Chinese market realities are in constant flux and basic assumptions need to be questioned. As a result, a predetermined strategy usually does not satisfy this situation.

For example, one European food and beverage (F&B) company with several billion euro in annual sales had been in China for more than a decade when it decided to search for an M&A target: a large Chinese company making the same product. The European firm spent 1.5 years hunting for a partner, but found most large Chinese F&B makers unwilling to sell, since their profits were significantly up in the fast-growing market. Other targets identified did not make the same product line, and therefore, were not seen as a good fit.

targets that—unlike the failed Coca-Cola-Huiyuan deal—will not exceed the threshold for an anti-monopoly law investigation.

Understand What Works

Deals fail for many reasons: unrealistic expectations on both sides, little flexibility of potential acquisition forms, lack of Chinese experience dealing with international companies, unreasonably high acquisition prices due to the extremely fast Chinese market growth, and a failure to comprehend the intentions of Chinese sellers. Why? Local executives often communicate in a vague manner to "save face." Plus, an experienced deal professional required to read the situation and determine the sellers'

motivations and concerns is often overlooked.

In one case, an American industrial manufacturer was looking to take over a Chinese distributor. Negotiations were lengthy and constantly delayed by the Chinese firm. After six months of discussions over an ownership issue, it became clear that the seller wanted to retain a stake in the company to maintain his legacy and local social position. In the end, the American company came to understand this desire and allowed the owner keep a small percentage.

In another example, a European equipment maker spent little time building the relationship with its a Chinese equipment maker. Instead, it focused on collecting company information and financial data, which the seller often withheld. Eventually, the foreign company realized the Chinese firm had no intention of selling, but instead, was trying to determine the value of the company.

Consider Non-Financial Factors

In the western context, an acquisition often is viewed simply as a business transaction. In China, there are many concerns, such as the type of relationship, as well as legacy and face issues.

As such, it is important to put non-financial issues on the table and accurately address Chinese concerns. For a typical Chinese company considering an M&A, the motivation to sell often is driven by a succession issue, a desire for some liquidity or equity funding for additional growth, or to cash out to invest in other more attractive industries. Keep in mind that most first-generation entrepreneurs are not actively seeking to sell their companies. Therefore, it is crucial to determine early on why the target company wants to sell.

The China Premium

Multinationals often believe Chinese targets are too expensive. The valuation benchmark typically employed is based on methods



used to calculate corporate values in home countries. The problem: many Western firms fail to grasp the growth disparity between companies in China and overseas. For example, a company in Europe will grow 2-3 percent per year, compared to 20-30 percent for a similar firm in China. On a growth adjusted basis, the valuation on a forward basis should be comparable.

For instance, in a North American pharmaceutical company negotiation with a Chinese target, the seller's

point negotiations were halted while the European company sought other candidates. In the end, the European firm decided the best target was the original Chinese firm. But due to the elapsed time, the purchase price more than doubled and required new terms.

the market. They also need to clearly understand potential synergies to be gained from a deal. A seller will rarely budge on price when a company is growing quickly. And in this scenario, prolonged negotiations will not only jeopardize the deal, but could result in higher price expectations. In this example, a European F&B company found a Chinese F&B firm to be a perfect fit—all the right synergies and a complementary distribution network. However, the two could not agree on price. At one

When buying a Chinese firm, the wrong valuation benchmark is typically employed. Many Western firms fail to grasp the growth disparity between companies in China and overseas.

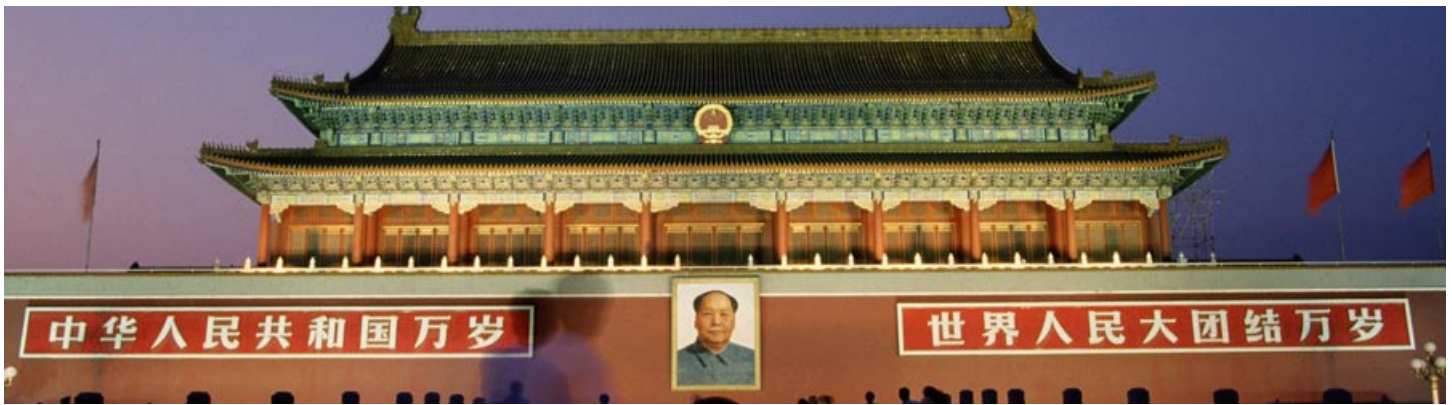
expectation was 13x EBITDA (earnings before interest, taxes, depreciation and amortization). However, the buyer was only willing to pay 9x EBITDA. Consequently, the negotiation took two years. During that period, the Chinese target experienced 35 percent annual growth, resulting in the doubling of the acquisition price. The target eventually became aware of a greater potential and chose not to sell, even though the acquirer was willing to pay more than twice the original valuation. Disagreements over price are frequent deal killers.

In an environment where sellers are not motivated and their growth prospects are bright, acquisition firms have to decide early on if they are willing to pay premiums to get in

point negotiations were halted while the European company sought other candidates. In the end, the European firm decided the best target was the original Chinese firm. But due to the elapsed time, the purchase price more than doubled and required new terms.

Speed and Clarity of Objectives

In Chinese M&A deals, time is key. Unfortunately, many foreign companies fail to understand that prolonged negotiations tend to destroy deals. And common misunderstandings, due to differences in working styles, cultures and perspectives, lengthen the process. And poorly defined objectives certainly don't help.



In one example a European retail company identified two M&A targets. But due to its own mixed priorities, it could only meet with each target every three months. The discussions were generally noncommittal and lacked specifics. As a result, after a year the Chinese targets lost interest and pulled out.

Western companies tend to view the M&A process as a “cookie cutter” standardized process, and often complicate matters by withholding decision-making power or interfering in the process. The result: 80 percent of negotiating time is spent on internal decisions, while 20 percent is spent negotiating with the target.

Chinese entrepreneurs are very effective, practical and nimble. And private companies typically have one or few owners. Consequently, decisions can be made quickly. In turn, Chinese owners expect decisions to be made by Western firms in a similar fashion.

One year in China equals five to 10 years in Europe, according to a Chinese proverb. And it can be difficult for foreign companies to realize just how quickly and dramatically market conditions can change there. As a result of this, as well as cultural norms and behaviors, Chinese targets prefer to deal with Chinese acquisition firms. To overcome this and get the deal done, it is important for American firms to be decisive and utilize sound intuitive judgment to recognize the right moment.

Different Approaches

Another important factor in closing a Chinese M&A deal is the ability to identify, assess and allocate risks correctly. For example, Western buyers tend to be data driven and information oriented. They typically do not make decisions until all vital information—which is deemed to reduce risk—has been gathered and analyzed.

Information gathering in China

In many cases, Chinese and Western views are diametrically opposed. As a result, it is burdensome to achieve a “meeting of the minds” and relatively easy to sow the seeds for future disagreements.

can take an exceptionally long time to complete. And the process is difficult since Chinese firms typically do not keep information in centralized locations or store it in a systematic way.

When making decisions, Chinese entrepreneurs do not appear to rely on data to the same extent. Instead, they tend to make decisions based on gut instinct and intuition. Additionally, from a cultural perspective, when a foreign buyer meets a successful Chinese target, the foreign buyer often sees risks, whereas the Chinese target identifies possibilities.

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to achieve a “meeting of the minds” and relatively easy to sow the seeds for future disagreements. Thus, once equal weights are assigned to important but solvable issues, such as compliance and historical/legacy issues of the target, a deal can become even more difficult to close.

Assistance Is Available

The M&A advisory community in China can help corporate investors

bring deals to successful closure. In the long run, professionals also influence how the M&A game is played in terms of educating Chinese targets about the proper process for deals.

As noted above, advisors to Western acquisition firms are not effective if they recommend the same process and employ the same metrics used in the home country. ■

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