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Full speed ahead
Chinese NOCs continue M&A trend

Energy & Resources

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Introduction

China has invested heavily in the outbound oil & gas business since the early 1990s, with Chinese national oil companies (NOCs) China National Petroleum Corporation (CNPC), China Petroleum & Chemical Corporation (Sinopec), China National Offshore Oil Corporation (CNOOC), and Sinochem International Corporation (Sinochem) leading the way. These state-owned companies have participated in over 70 exploration and production (E&P) projects in more than 30 countries.[1] The financial crisis of 2008 and slump in oil prices have provided a good buying opportunity for cash-rich Chinese NOCs to expand their overseas resource acquisitions but also for international oil & gas companies with strategic assets.

For those Chinese NOCs that have cash, today's economic environment offers an opportunity to acquire assets at favorable valuations. Some Chinese NOCs are looking to use this opportunity to grow their businesses by improving their reserve positions through mergers & acquisitions (M&A) activities. Alternatively, companies who have cash flow issues and/or heavily leveraged may be looking to divest some assets. In both cases, these companies should consider concentrating on deal execution and then follow up with appropriate steps to maximize long-term strategic value of their transaction.

Chinese NOCs' outbound M&A: Challenges and risks

Oil & gas are indispensable strategic resources for developing economies. In particular, they are a lifeline for China, which is experiencing rapid development, and are significant to the national livelihood. China has become the second largest oil consuming country after the US since 1992[2], with increased dependence on foreign oil. According to the International Energy Agency, it is expected that China will have to import crude oil of 100 million barrels every day, with foreign oil dependence reaching 74% by 2030, so "going overseas" has become a basic strategy for the Chinese oil & gas industry.[3]

Figure 1. World primary oil demand to 2030

	1980	2000	2007	2015	2030	2007-2030**
OECD	**41.7**	**46.0**	**46.5**	**45.7**	**43.9**	**-0.2%**
North America	20.9	23.3	24.6	23.9	23.9	-0.1%
United States	*17.4*	*19.3*	*20.2*	*19.3*	*19.0*	*-0.3%*
Europe	14.6	14.3	14.0	13.9	13.1	-0.3%
Pacific	6.1	8.4	7.9	7.8	7.0	-0.5%
Japan	*4.9*	*5.4*	*4.8*	*4.4*	*3.5*	*-1.4%*
Non-OECD	**20.9**	**27.3**	**34.9**	**44.6**	**57.7**	**2.2%**
E. Europe/Eurasia	9.5	4.4	4.8	5.7	5.9	0.9%
Russia	*n.a.*	*2.7*	*2.8*	*3.3*	*3.4*	*0.7%*
Asia	4.5	11.5	15.8	21.4	30.8	3.0%
China	*2.0*	*4.7*	*7.5*	*11.3*	*16.6*	*3.5%*
India	*0.7*	*2.3*	*2.9*	*4.1*	*7.1*	*3.9%*
Middle East	2.0	4.6	6.2	8.4	10.5	2.3%
Africa	1.3	2.3	2.9	3.2	3.7	1.0%
Latin America	3.5	4.5	5.2	5.9	6.8	1.2%
Brazil	*1.3*	*1.9*	*2.0*	*2.4*	*2.8*	*1.5%*
International marine bunkers	**2.3**	**3.0**	**3.8**	**4.1**	**4.7**	**1.0%**
World	**64.8**	**76.3**	**85.2**	**94.4**	**106.4**	**1.0%**
European Union	*n.a.*	*13.6*	*13.4*	*13.2*	*12.4*	*-0.3%*

* Excludes biofuels demand, which after adjusting for energy content, is projected to rise from just over 0.8 mb/d in 2007 to 2 mb/d in 2015 and 3.2 mb/d in 2030 in the Reference scenario (see chapter 7).

** Average annual rate of growth.

Source: Word Energy Outlook 2008, International Energy Agency

The widespread liquidity shortage resulting from the deepening financial crisis and slump in oil prices in mid-2008, have exerted great pressure on some highly-leveraged oil companies and severely affected the finances of oil-producing countries with a single industrial structure. The financial crisis and recession in some parts of the world have also created a great buying opportunity for Chinese oil & gas companies seeking high quality assets at lower than average prices. These companies are now embracing the opportunity for making acquisitions at low prices. The next one or two years will see a new round of integration in the global oil industry.

1 Jonathan Green, "The Rise of National Oil Companies and Their Challenge to International Oil and Gas Companies." IPLOCA Annual Convention, Sheraton on the Park, Sydney, Australia, October 1-5, 2007. HIS Consulting. http://www.iploca.com/platform/content/element/311/Green.pdf

2 Energy Security Leadership Council, "Recommendations to the Nation on Reducing U.S. Oil Dependence." December 2006, pg. 17.9, 2009

3 Ibid pg 28

Obtaining overseas oil & gas resources: from green field investment to cross-border M&A

Green field investment

Green field investment involves directly investing in building new overseas oil facilities including exploration and production, transportation and refining. Such a method of investment can not only provide Chinese companies with oil & gas resources, but also promote product exports and labor export. There are increasingly small probabilities of finding large oil & gas fields, so the focus on E&P operations shifts to remote areas, deeper layers of oil, and unconventional production areas with complicated structures. The investment cycle has become increasingly longer. These challenges have led to greater risks in green field investment. Chinese NOCs have therefore increasingly adopted another method: cross-border M&A.

Cross-border M&A

By implementing a cross-border M&A strategy, Chinese NOCs can greatly reduce the time it takes to develop oil & gas assets and take full advantage of senior management experience and marketing channels of acquired companies which tend to be relatively more mature. This method of investment is not only useful in saving limited capital but is also helpful in making up for the disadvantages of the acquiring companies which are inexperienced in cross-border M&A and operate in the host country by leveraging experiences and reputation of partners. Cross-border M&A is an important method for large NOCs around the world to develop global oil resources, obtain advanced technology, and implement global strategy.

M&A in the global oil & gas industry

A historical review of supermajor oil companies has been full of M&A activities. In the West, cross-border M&A has been in full swing since 1998 with BP acquiring US companies Amoco and then Arco, followed by merger of Exxon with Mobil Oil. This consolidation period ended with the Chevron's purchase of Texaco and the merger between Conoco and Phillips.[4]

In 2007, the number of global oil & gas M&A transactions reached 893 and deal value reached $291.1 billion; the number of deals over US$1 billion reached 57 (Figure 2).

Figure 2. 2007 M&A deals in the global oil & gas industry

	Deal number	Deal value (US$ billion)
Upstream	576	133
Midstream	74	30
Downstream	94	62
Oilfield service	149	67

Source: John S. Herold

However, as oil & gas exploration and production becomes increasingly complex, there are fewer opportunities for undertaking M&A in the upstream business which will also see reduced deal value of a single M&A deal (Figure 3).

Figure 3. Average value of a single M&A deal

	2006	2007
M&A deal number	588	576
M&A deal value (US$ billion)	185	133
Average value of a single M&A deal (US$ million)	315	231

Source: John S. Herold

Chinese outbound M&A: High speed growth

Chinese companies' outbound investment has been on the rise since the early 1990s and the amount of overseas investment has been growing rapidly particularly after 2000. In 2007, Chinese outbound investment amounted to about US$26.5 billion, higher than inbound investment for the first time.[5] Chinese outbound investment mainly centers in Asia, Africa, and South American areas and is expected to hit US$60 billion in 2010.[6]

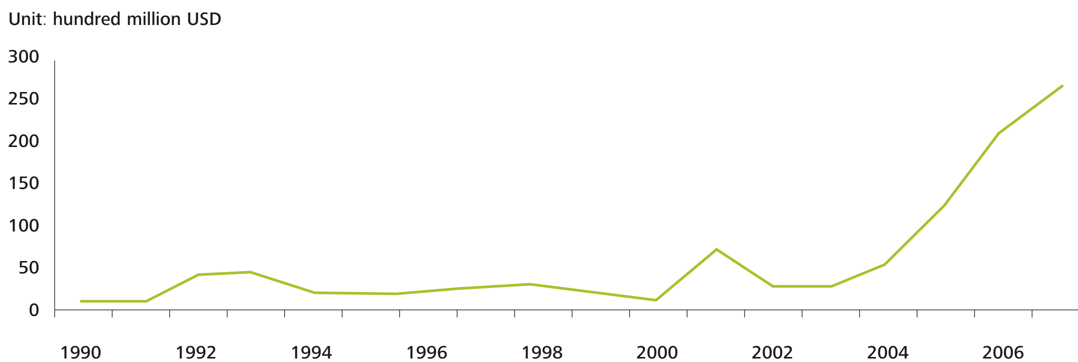
4 James Brock "Merger Mania and its Discontents." Multinational Monitor July/August 2005 pg 10-14

5 Bloomberg newswire. "2007 Outbound Investment Climbs 25 Percent." The Standard Newspaper, September 17, 2008

6 YANG Mu and TENG Siow Song. "China's Overseas Direct Investment." EAI Background Brief No. 340 July 12, 2007 http://www.eai.nus.edu.sg/BB340.pdf

Figure 4. Cumulative amount of Chinese outbound investment from 1990 to 2007

Unit: hundred million USD



Sources: MOFCOM National Bureau of Statistics of China

History of outbound M&A development

Compared with cross-border M&A by foreign NOCs, Chinese counterparts started later, but developed relatively fast under the influence of global M&A. After the periods of start-up and development, Chinese NOCs have managed over 70 oilfield investment projects in more than 30 countries around the world since 1992.[7]

Start-up period: 1992 – 2001

Priority in this period was given to oil & gas production in mature oil fields, with regions of overseas investment expanding continuously. The form of cooperation also changed from cooperating with resource countries by exploring together and sharing production to acquiring offshore oil resources in the manner of share participation or M&A. Most oil fields obtained in the start-up period were small in scale and complicated in structure, producing small amounts of crude oil. Throughout the investment deals in this period, Chinese NOCs familiarized themselves with the overseas operating environment, accumulated experiences in international investment, developed talents able to manage their businesses globally, and explored methods for managing overseas projects and subsidiaries so as to be prepared for more cross-border M&A. These oil & gas investment projects in the early period did not greatly improve the supply of oil & gas in China, but they facilitated the ability of Chinese companies to go to international oil markets and initiated overseas oil & gas investments.

Development period: 2002 – present

During this period, Chinese NOCs succeeded in listing shares and carried out large scale M&A of oil & gas resources and companies, entering a further period of internationalization. Investment focused on large and medium-sized projects with low risk, while setting foot in some exploration projects with higher risks; the focus expanded from E&P as well as downstream projects, and development expanded from onshore field to shallow sea. Chinese NOCs realized the transition from oil-producing companies to cross-border capital operating companies. In the period of the Tenth Five Year Plan, China realized its goal of exploring and producing overseas oil & gas in four major strategic areas: Russia, the Middle East, North Africa, and South America. The country also consolidated and expanded its oil & gas exploration business, increased its share output and reserves owned, and built a stable offshore oil production base. Chinese companies took a more aggressive attitude in competing for global oil & gas resources and acquired overseas resources through share participation. Overseas M&A became an increasingly important method for Chinese NOCs to participate in global competition. Chinese companies have improved the quantity and revenues of crude oil exploration by acquiring overseas oil & gas assets and expanding overseas business scale continuously.

7 Jonathan Green, "The Rise of National Oil Companies and Their Challenge to International Oil and Gas Companies." IPLOCA Annual Convention, Sheraton on the Park, Sydney, Australia, October 1-5, 2007. IHS Consulting

Most of the overseas oil resources being acquired by China are located in politically high-risk areas. From a geopolitical point of view, the oil supplies from Russia and Central Asia are for the moment, relatively safe, in sharp contrast with foreign oil companies that reduce risks usually by acquiring oil resources from major oil producing regions around the world.

Identifying the challenges

Oil consumption in China continues to increase, while domestic oil production can't meet the demand of domestic oil consumption. Overseas oil investment can not only fill the gap between domestic oil production and demand, but also diversify Chinese oil supply, giving China greater control over dealing with oil supply from outside and preventing China from being adversely affected by the fluctuation of international oil prices.

Prior to the 1970s, international oil companies controlled the production, transportation, distribution, and sales of oil with the aim of building market share in the world oil market. This made it difficult for oil consumption states and production states to compete with them.

Progressive overseas expansion

The early form of overseas oil cooperation mainly included cooperative exploration and sharing production. Small-sized projects were focused on enhanced oil production in mature oilfields, share purchases, and drilling rights to target regions. Later, share participation and acquisition was increasingly adopted to acquire overseas oil resources, leading to significant rise in the quantity and earnings of crude oil exploration. Overseas M&A became a major strategy for Chinese NOCs to join international competition.

In the course of overseas expansion, Chinese NOCs usually chose progressive expansion. Initially, they lacked sufficient knowledge about overseas oil resource markets, especially the situation of overseas competition. They were also limited by the shortage in funds and human resources. The strategy of phased development included the following: investment scale enhanced from small to large; core projects introduced one after another; and the regions of overseas investment continuously expanded.

State-owned companies are major investors

Currently, the large state-owned oil & gas companies are the major players in Chinese outbound investment initiative. There are various types of oil companies in the US, of which there are many large domestic and foreign oil companies, and also some medium-sized oil companies, as well as a large portion of small ones. These diversified types of companies can complement each other in business because of their different positions in the market.

Insufficient high-quality oil resources to satisfy domestic demands

Large publicly-traded oil companies in Europe and US currently control the resource production in the world's oil-rich regions. Large state-owned oil companies ranked in the top 50 in the world own more than 80% of the proved high-quality oil reserves in the world.[8] In recent years, Chinese NOCs have made tremendous investments in overseas oil exploration and production. But many of the projects are located in regions with decreasing reserves or "non-essential oil fields" with such a low rate of return that large western oil companies are unwilling to invest.

Acquisition targets are generally located in high-risk areas

Most of the overseas oil resources being acquired by China are located in politically high-risk areas. From a geopolitical point of view, the oil supplies from Russia and Central Asia are for the moment, relatively safe, in sharp contrast with foreign oil companies that reduce risks usually by acquiring oil resources from major oil producing regions around the world.

8 Petroleum Intelligence Weekly. PIW Ranks the World's Top 50 Oil Companies. Special Supplement December 1, 2008

Outbound investment made by Chinese NOCs is centralized in neighboring countries in Asia and have gradually expanded to the Middle East and Africa and further into countries and areas which maintain good bilateral relationships with China and have rich oil resources and great potential for the long-term development of Chinese NOCs. The three main strategic development areas are: Middle East-North Africa, Central Asia-Russia, and South America.

M&A deals are mainly paid in cash instead of equity swap

Previous M&A deals conducted by Chinese NOCs were mainly settled in cash. On the surface, this kind of payment is more competitive than equity swap and may enjoy preferential prices. However, the fact is that Chinese companies can't take full advantage of overseas M&A under the circumstance of economic globalization. On one hand, Chinese NOCs are unwilling to give part of their equity to foreign NOCs in view of the control over the companies which have strategic significance to the national security. Alternatively, the vendors are not likely to accept equity swaps offered by Chinese NOCs because holding the equity of Chinese companies apparently means to accept China's political risks which foreign companies are most concerned about and unwilling to encounter.

M&A projects are relatively small in scale and constrained by capital shortfall

International oil E&P comprises high inputs and high risks. Large oil production projects often require tens of billions of capital, bearing a risk that the investment may not be recoverable. China's overseas oil M&A started relatively late and Chinese NOCs have had to face relatively high thresholds and make relatively high inputs because the opportunities have been taken by large multinational oil companies in Europe and the US.

Compared with large western multinational oil companies, Chinese oil companies are severely restricted in their investment scale due to a shortage of capital. From the beginning of the 1990s when Chinese NOCs started outbound investment, they started from small projects and developed an overseas oil production base and room for development at low prices and low profits, using comparative advantage.

Due to capital restriction and being short of experience in overseas exploration and production, initial overseas investments focused on small projects in order to minimize risk, such as enhancement of oil production in mature oilfields, share purchase and operation over target blocks. In addition, large international oil companies usually gain relatively low profits through investment in medium and small projects due to huge administrative expenses, and at the same time foreign independent oil companies would not like to operate these projects due to limited capital, which provide room for development of Chinese NOCs' outbound investment.

Investment cost is relatively high

As China's outbound oil & gas investment started relatively late, most of the low-cost and high-profit overseas oil & gas resources with low risk have been occupied by large international oil companies. Under this condition, China made investments in unstable areas where European and US oil companies are unwilling to invest in order to explore for and develop oil. As for high-quality oil & gas resources, Chinese oil companies have to buy a portion of equity from international oil companies at relatively high prices, which undoubtedly means paying extra cost of entry and increased overseas investment cost of Chinese oil companies. In addition, since most of China's overseas oil projects were won through international bids under severe competition, the cost is relatively high. In order to win the bid for overseas oil projects, quotations are generally high and the projects won through severe price competition usually produce much less profit.

Strategy analysis of overseas M&A Collaboration and alliance

Choose the best strategy for overseas M&A game

For the purpose of enhancing the advantage of Chinese outbound oil & gas resources for sustainable competition, China should develop a clear overall strategy for outbound oil & gas investment and development and establish a coordinated mechanism overseas. Previously, most Chinese NOCs struggled alone without unified strength and overall coordination. Therefore, Chinese NOCs should cooperate with and support each other, coordinate their overseas development strategy, manage internal conflict, improve efficiency, and enhance overall competition capability.

Consequently, in expanding overseas, Chinese NOCs should regard collaboration and alliance as the long term strategy for sharing overseas oil & gas resources in order to better cope with the severe competition for overseas oil & gas resources and secure an advantageous position in the marketplace.

At the same time, Chinese NOCs should make full use of their geopolitical relationships, employ oil diplomacy, develop and maintain friendly partnerships with oil resource countries and oil companies around the world. This will create a favorable condition and environment for gaining the initiative in oil competition and for the success in overseas investment M&A. As part of their host country strategy, Chinese NOCs should take their interests and strategies into full consideration, choose appropriate competitive strategy, give up or grant benefits properly, attempt to change the balance of power in the competition, and seek opportunities for collaboration and alliance. Each party's advantages should be given full play in the collaboration and alliance so as to realize an overall optimal strategy and win-win result. Methods like overseas oil equity participation can be adopted to strengthen cooperation with the host country or other NOCs and establish overseas oil production and supply base so as to complement each other's advantage and share benefits with the partners appropriately.

M&A opportunities within the financial crisis

Many oil & gas asset acquisitions have been delayed or postponed following the sharp fall in oil prices during mid-2008. This has had a direct impact on the acquisition price. Some foreign NOCs have started to raise funds and appear to be waiting for the right time to buy overseas oil & gas assets; the Russian government has promised to provide nearly tens of billions of dollars in loans to its four largest NOCs to buy overseas oil & gas assets. Under such circumstances, Chinese NOCs are also faced with the good opportunity to buy assets at low prices.

Under current circumstances, Chinese NOCs should use caution in implementing their strategy for acquiring overseas resources and assets. The current M&A opportunity does not lie in "price" – because for China, M&A price of energy assets is not the only factor – but having the strength in cash compared with potential opponents. A number of energy buyers are no longer aggressive in their M&A activities because of the global recession.

Nevertheless, there are a limited number of "big bargains" for Chinese NOCs. Most premium oil & gas resources in the world are controlled by NOCs in the Middle East that are generally independent from foreign capital. Although the market value of some international companies such as BP and Shell has been affected by the financial crises and has fallen to some extent, it is still in accordance with the economic trend, and so far none of them is threatened with bankruptcy and liquidation. Therefore, there is little likelihood that Chinese NOCs will conduct massive M&A against all expectations.

The Deloitte member firm in China has pointed out that the companies really impacted the most by the global recession and oil price slump are small-and-medium-size independent oil companies that are registered or listed in the U.S. and Europe and have oil exploration and mining rights in Middle Asia, Africa or Middle East. CNPC, SINOPEC, and CNOOC have little interest in small independent oil & gas companies as their resources are usually distributed all over the world. During the Houston Energy Financial Forum in November 2008, Xu Yongfa, the dean of CNPC Research Institute of Economics and Technology, said that although it is the right time for Chinese oil companies to acquire overseas assets, they should be prudent in implementing the strategy and know clearly about whether the acquisition could bring either resources, capital, technology or advanced management concepts.

Many oil & gas asset acquisitions have been delayed or postponed following the sharp fall in oil prices during mid-2008. This has had a direct impact on the acquisition price.

Risks in outbound M&A and responses

Political risks

As oil & gas resources are strategic resources, some governments are politically sensitive to oil & gas M&A. Host country governments usually pay close attention to outbound M&A, and even intervene directly or indirectly. Moreover, as all the large oil & gas companies in China are state-owned, their outbound M&A activities are usually deemed to be supported by the State and the Government, which increases political risks. Currently, Chinese NOCs usually choose the oil & gas resource countries which have good relationship with China.

Even so, restrictions or changes in the politics and laws of host countries still bring about tremendous risks to companies conducting M&A. When the operations of acquiring companies are not consistent with the interests of host countries, they will employ policies including economic protectionism and even modify laws and regulations so as to limit the operation of acquiring companies. Such unforeseeable economic changes will lead to much higher risks.

European and US countries have in the past, opposed Chinese oil & gas companies efforts to conduct overseas M&A projects under the pretext of "economic threats" or "national security." The failed bid made by CNOOC in 2005 to acquire US-based Unocal is an example. In this case, the US Congress required the Committee on Foreign Investment to review the role that the Chinese government played in this acquisition case. As a result, the Chinese oil & gas enterprise was forced to quit although its quoted price was US$1.4 billion, higher than that of competitors.

Political and legal risks may significantly impair M&A projects, thus the expert panel with NOCs should propose a continuous monitoring and analysis of M&A so as to find solutions to avoid risks, as well as provide necessary assistance with the M&A process in virtue of the professional resources and experience of intermediate institutions.

Overcoming political risks

It is generally less risky to set up joint ventures with host countries than operate as a sole proprietorship enterprise, and the former is more welcomed by host countries. By leveraging the counterpartys' advantages in personnel, information technology, culture and people relationships and giving full play to their technical and capital strengths as well as experience, Chinese companies can not only win more bids, but also know more about the oil resource of the host country and local political condition, economic situation and cultural traditions, further obtain trust from the host government and local companies, which is beneficial to market development. Other solutions include the following:

- Cooperate with a third country to conduct M&A and build up strategic alliance. Due to the variety of partnerships with many different nations, the host country is unlikely to offend multinational governments in order to intervene in a certain company, which can reduce the political and legal risks.

- Transfer the political and legal risks faced by NOCs to insurers by purchasing insurance so as to reduce potential risks. Currently some international organizations, governments and private insurers are able to deliver insurance services related to political and legal risks.

- Enhance public relations of governments and media, which can contribute a great deal to lower political risk besides playing a great role in the marketing.

When NOCs conduct outbound investments, Chinese tax law also has great influence on their investment structure and operation mode

Tax risk

Tax risk refers to risk in the host country and tax planning issues after the targeted company was acquired, as opposed to tax risks arising from past operations of the acquired company. In the early period of M&A deals, Chinese companies generally focused more on the target company's scale, deal value and investment pay-back period rather than the specific operational mode, personnel arrangement, profit remittance restrictions and exit strategies. Since the above issues often involve China corporate laws, the host country's tax laws and international laws, companies should have comprehensive tax planning both for individuals and the company itself.

Prior to making an acquisition, Chinese NOCs should consider conducting a comprehensive feasibility analysis, have a deep understanding of the target company's financial status and tax status, and carry out relevant tax due diligence as well as tax planning to avoid additional tax cost incurred after the deal. In the period of actual operation after the M&A deal, companies should employ third-party professionals who are familiar with local tax laws to assist in dealing with regular tax declaration, while the parent company should consider implementing proper regulation and management on the taxation status of its overseas subsidiaries, and consult relevant advisors on newly arising problems so as to minimize tax risks.

For tax planning considerations, Chinese companies should consider imposing applicable withholding tax on dividends and interest paid by the local enterprise to Chinese shareholders as well as the issue of how to impose tax on capital gains obtained by Chinese companies through transferring the local companies (i.e. exiting mechanism). If the withholding tax on interest, dividends and capital gains are relatively high, Chinese NOCs can consider setting up a Special Purpose Company (SPC) abroad.

They can also make tax planning on remittance of investment income and exit of venture capital through appropriate use of the favorable terms in the tax treaty between the residential country of the SPC and that of the target company in order to reduce the overall taxation.

When making outbound investment, Chinese NOCs need to understand the tax system of the host country, for example, the way in which tax is levied on operating profit obtained from local investment projects, and pay special attention to the risks of changes in tax laws and policies of the host country. Since tax rates of oil & gas products are relatively high in most nations, and while tax rates applicable to oil & gas companies are likely to be volatile in the international market, it is crucial for investors to analyze and anticipate the development trends of the host country's tax policy. When conducting the feasibility study, Chinese NOCs have to take into account the potential tax increase and the possible incremental proportion so as to make reasonable investment decision.

When NOCs conduct outbound investments, Chinese tax law also has great influence on their investment structure and operation mode, e.g., according to China's new *Enterprise Income Tax Law* about "Permanent Establishment" and "system of controlled foreign corporation." Profits gained by Chinese companies from investing overseas shelf companies may be subject to China corporate income tax as well. During tax planning, companies should also consider whether they could be subject to the General Anti-Avoidance Rule. Furthermore, whether the foreign-sourced income tax on dividends gained by Chinese companies from indirect investment can be fully deductible within China tax law (i.e. "foreign tax credit system") or not has significant impact on the overall taxation of overseas investment.

In the process of outbound investment, the transfer pricing system in relevant countries is another important consideration in international tax planning. Companies should analyze the transaction mode and transfer price, arrange the sharing of risks and functions and profit distribution etc. in advance so as to lower the corresponding tax risks.

NOCs carrying out outbound M&A also need to choose appropriate forms of investment in accordance with related local laws and regulations:

- Whether to set up a local subsidiary company or a branch company.

- If a subsidiary company is to be established, whether to set up it by direct investment or indirect investment through an intermediate holding company.

- Whether to invest through entire equity investment or loans from shareholders.

- If international operation is concerned, whether Chinese companies or another overseas affiliate companies in countries or regions with lower tax rate should participate in the operation.

The above issues will affect the tax payment made by Chinese companies, invested companies and other affiliate companies during the operation of projects, thus eventually affecting the project performance. Therefore, they should consider the gains and loss from the perspective of tax in a comprehensive way. Only when companies take the overall tax factors into account and carry out international tax planning on overseas investment in a systematic and comprehensive way, can they reduce the overall taxation and increase returns from overseas investment.

Risks in oil & gas reserves and financial information

This risk mainly refers to losses the company may suffer from wrongly estimating the value of the target company because of information asymmetry in the target company's oil & gas reserves and its financial position between the acquiring company and the target company. Oil & gas reserves are the essential information in evaluating the price of an M&A deal. However, the acquired company tends to overstate the reserves for the sake of its own interest so as to raise the purchasing price. An expert panel within the acquiring company should make an independent analysis of and investigation into the reserves or employ advisors to do so in order to lower risks.

In the aspect of financial information, the target company may deliberately select the favorable accounting policies and the way in which they are applied, which may substantially affect the key indicators in an M&A deal such as evaluation result and the cash flow forecast. Taking advantage of analysis of the target company's historical financial status and evaluation-related matters made by independent advisors with professional expertise and considerable experience, investors can better understand the target company, evaluate its financial risk, determine the transaction structure and identify the factors affecting close of the deal as soon as possible. An expert panel and advisory team on the part of the purchaser may investigate the target company in terms of the following aspects:

- Trends reflected in historical financial data.

- Analysis of key sensitive indicators in evaluation modeling.

- Analysis of provisions.

- Accounting policy.

- Key terms and conditions in the current loan agreement with banks.

- Production cost structure.

- Analysis of working capital.

- Non-core business proposed to be divested.

Funding risks

Funding involved in M&A deals in the oil & gas industry are huge, with the average value of a single M&A deal exceeding US$300 million in 2006 and 2007 (Figure 5). Additionally, the funding involved in the significant oil & gas M&A in the past were even larger, with BP acquiring Amoco Oil Company at in 1998[9] and Exxon, the biggest oil company in the US, acquiring Mobil Oil at record high price of US$75.3 billion in the same year.[10] Payments of such large amounts may pump out the cash flow of the purchaser, leading to high debt ratio and increasing the funding risks. If profits fail to be obtained from M&A in time, it is likely to cause disruption in the cash flow.

9 Bhushan Bahree, "Bigger Oil: BP to Acquire Amoco in Huge Deal Spurred by Low Energy Prices." Wall Street Journal August 12, 1998 pg A1

10 Christopher Cooper and Steve Liesman, "Exxon Agrees to Buy Mobil for $75.3 Billion – Historic Deal, Precipitated By Plunging Oil Prices, Signals Shift in Industry." Wall Street Journal December 2, 1998 pg A3

Operation and management risks

After completing M&A successfully, Chinese NOCs are still faced with great management risks. They will be faced with the problem of how to reduce cost after the acquisition. Labor cost is relatively high in European and American companies, so headcount reduction is undoubtedly a practical measure. However, according to legislation of many countries, employees cannot be dismissed at will and huge amounts are likely to be compensated even if they are dismissed. Thus Chinese companies going for cross-border M&A should be familiar with local labor laws and regulations in order to avoid legal disputes incurred from staff matters and beware of getting trapped into "human cost." If companies don't know much about local conditions and labor laws, it is likely to incur strikes and production shutdown.

On the other hand, Chinese NOCs are short in managing talents with international experience. They not only possess general knowledge and skills concerning products, techniques and management, but they also need to have an international vision and thorough understanding of foreign political, economic, legal and cultural environment, familiar with foreign markets and capable of negotiating and communicating in a cross-cultural environment, as well as mastering the methods and skills of leadership, decision-making and incentives.

Integration risk

Outbound M&A is involved with integrating two or more companies which are totally different in industry structures, management levels, status of assets, and especially corporate cultures. Cultural integration after the M&A deal is the most difficult part throughout the whole process. Compared with domestic M&A, cultural conflict under cross border M&A is more serious as cultural differences not only exist between the acquiring and target companies but also between two countries where those two companies reside. Domestic companies succeeding in China usually have a strong corporate culture; while overseas companies that are acquired or merged feel their culture may be superior to Chinese corporate culture, thereby making cultural integration extremely harsh after Chinese companies finished cross border M&A.

Conclusions drawn from the experiences of some successful M&A cases are that buyers should have fully considered the integration before the M&A deal, develop a clear-cut and feasible integration plan for M&A program based on the actual situation of the target company, sufficiently communicate the integration plan with management of the target company, and integrate the acquired companies as planned step by step after completing M&A deal.

Conclusion

Through cross border M&A, NOCs can greatly increase their scale, reserve, output and profit within a short period of time as well as achieving significant synergy effects, market position, international operation and relatively stable international energy and resources. At present, China has an increasingly growing demand for oil as well as rising dependence on overseas resources; therefore, for Chinese NOCs that still lack overseas experience, the success of outbound M&A is not only related with their own development but also with China's oil safety.

In recent years, China's outbound investment management system and domestic oil & gas pricing system has improved. The overseas oil exploration and production fund and Oil Stabilization Fund are under negotiation and planning, all of which has facilitated the gradual enhancement of outbound M&A policies. Chinese NOCs will have greater discourse power in international negotiations with growth of China's national strength. Under the global economic downturn, the next wave of integration in the oil & gas industry will definitely be a challenge for Chinese oil & gas companies to join the global energy competition.

Chinese NOCs should grasp M&A opportunities brought by financial crisis and oil price slump, adhere to the M&A strategy of cultivating and strengthening core competitiveness of companies, analyze various kinds of risks in an all-round way, scientifically select M&A target companies, and facilitate integration of acquired companies by properly leveraging the means so as to increase the chance of success in cross border M&A undertaken. Chinese NOCs' outbound M&A will definitely become the most concerned topic among investors in the oil & gas industry in the next few years.

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