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World Maritime University

Shanghai, China

**THE STUDY ON M&A IN TODAY'S CHINA
SHIPPING INDUSTRY**

By

CAO YICHUN

China

A research paper submitted to the World Maritime University in partial
Fulfillment of the requirements for the award of the degree of

MASTER OF SCIENCE

2006

DECLARATION

I certify that all the material in this research paper that is not my own work has been identified, and that no material is included for which a degree has previously been conferred on me.

The contents of this research paper reflect my own personal view, and are not necessarily endorsed by the University.

(Signature):

(Date):

Supervised by

Professor Zhao Gang
Shanghai Maritime University

Assessor

Professor Gerhardt Muller
U.S. Merchant Marine Academy

Co-Assessor

Professor Shi Xin
Shanghai Maritime University

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I would like to dedicate also this paper to my nearest and dearest who have made my loneliness during this long way easier to stand. They have created a stable environment which has favored my creativeness and my courage to carry out such a project. Mom and Dad, I am grateful to you for your sympathy and help.

I hope that the reader will finally take as much interest as I have had along my thinking and writing, and that my thesis will at least partly improve his knowledge and arouse his curiosity about merger and acquisition in China shipping industry.

ABSTRACT

In 2005, although there came along another wave of M&A activities in global shipping industry, we haven't seen any sign of the emergence of large-scale M&As in China shipping industry so far. It's quite unfavorable to the future development of whole China shipping sector. Besides, most Chinese shipping companies show no interest in, and even resist carrying out such economic event.

However, the reasons behind the problem are various and intricate. The unique China macroenvironment and different kinds of deficiencies in Chinese shipping enterprises really hinder the appearance of mass M&A activities in China shipping industry. Here the macroenvironment includes the paradigm formed in Chinese culture, unfledged China financial market, and inappropriate conduct by China government as well as imperfect China M&A laws. They are just main categories. Each influential element that makes up the macroenvironment further encompasses several sub-items. For example, the imperfections of China direct, indirect financing channels and investment banks all constitute the inefficiency of China financial market.

In order to solve such weird M&A matter in China shipping industry, some viable measures should be taken as soon as possible. Within a series of future possible reforms, the reconstructions of China financial market and relevant financial institutions would be on the top of the list. Moreover, a fair and impartial M&A law system is necessary to encourage more M&A activities happened in China shipping industry in the future, which includes Antitrust Law, M&A Law and other complementary laws. Financing innovation and capital market improvement are

another important issues to resolve. Modern corporate system should be popularized among Chinese shipping enterprises so as to be compatible with new external macroenvironment. Finally, appropriate government support can guarantee that M&A activities would be carried out in an efficient and effective way, which in turn stimulate more M&As in China shipping sector.

KEYWORDS: M&A, China Shipping Industry, Macroenvironment, Reform

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LIST OF ABBREVIATIONS

M&A	Merge and Acquisition
FDI	Foreign Direct Investment
UNCTAD	United Nations Conference on Trade and Development
EPS	Earnings per share
PE	Price-earnings
BCG	Boston Consultant Group
3PL	Third Party Logistics
CEO	Chief executive officer
IPO	Initial public offering
IMF	International Monetary Fund
HR	Human resource
OTC trading	Over-the-counter trading

1 Introduction

1.1 Background

Mergers and acquisitions (M&A) count among the growth of scale of a company. The respect of pursuit of economic scale and bigger market share are catalysts to make for mergers and acquisitions in global shipping industry.

Globalization is a key feature of the new competitive landscape within which the mergers and acquisitions frenzy is taking place. Today we observe the rapidly growing trend of cross-border mergers and acquisitions. It is associated with a growing convergence in economic systems, culture and management practices (Child J. et al, 2001, pp. 9-10).

Globalization has seen an increase in mergers and acquisitions in recent years. It's a happy year for mergers and acquisitions as 2005 closed out as the best year for M&A since 2000. By the end of 2005, global M&A volume is pegged at about \$2.86 trillion, according to M&A tracking firm Dealogic, that's up 37 percent globally from 2004 level. The process of mergers and acquisitions supports the conquest of new markets and maintain customer's stronghold.

2005 is a special year for the global shipping industry as well, in which the world's

largest shipping line was born as AP Moller acquired P&O Nedlloyd¹. The merged Maersk Sealand-P&O Nedlloyd will be more than twice the size of its nearest rival, Mediterranean Shipping Co., and three to four times the size of many of its peers. That is a gap in scale the market will simply not allow to remain unbridged.

However, it is not a single M&A case in the shipping sector in 2005, TUI, the parent of Hapag-Lloyd, bought CP Ships located in Canada for \$2.3 billion. And another event took place in September, CMA CGM² successfully gained DELMAS from BOLLORE Group. Coincidentally, they have all achieved remarkable feat after mergers and acquisitions. Take P&O Nedlloyd for example; by the end of 2005 it announced the best annual financial report with the unprecedented profit income. As for CP Ships, it had been frustrated by poor asset play for quite long time before its acquisition. Last year, this company came back to life and had strong performance in the stock market. The shareholders of BOLLORE Group never expected that their stock price would pick up significantly just before the selling of DELMAS. But it is not the total, unexpected profit gain from OTAL which served in West Africa also added to the higher charge for the bidders.

It's really a good and profitable fiscal year for foreign M&A buyers and sellers, but it didn't happen to Chinese shipping companies despite they tried their best. In July, 2005, China Shipping Group offered \$1.69 billion for CP Ships. At that time, medium throughout the world all reckoned that China Shipping Group would most likely get CP Ships. Things don't always go the way you have planned it. Ultimately, China Shipping lost its overseas gambling under the spotlight. Whereas, it's a good try for Chinese shipping companies.

Although the number of registered Chinese shipping companies has already topped

¹ Before the acquisition, AP Moller and P&O Nedlloyd were the world's No.1 and No.3 container shipping services provider respectively.

² CMA CGM: A leading worldwide container shipping company and number one in France.

the world, most enterprises are not strong in core competence. Amongst plenty of domestic shipping service providers, small and medium-size private shipping firms account for the majority. If we look into the entire China shipping industry, we will find that the whole Chinese shipping companies take on a pyramid shape in terms of their scale. There are quite a lot of Chinese shipping firms running their vessels domestically and they can't enjoy the advantage of economy of scale. Except for top three China shipping companies (COSCO, China Shipping Group and SINOTRANS, see table 1), the rest are rather vulnerable to global market risk.

Table 1 – The ranking of liner operators 2006 (As of January, 2006)

Rank	Company	Share (%)	Existing TEU	Existing Ships	On Order
1	Maersk	18.2	1,665,272	586	133
2	Mediterranean	8.6	784,248	276	37
3	CMA-CGM Group	5.6	507,954	242	74
4	Evergreen Group	5.2	477,911	155	38
5	Hapag-Lloyd	4.5	412,344	131	15
6	CSCL	3.8	346,493	123	19
7	APL	3.6	331,437	104	30
8	Hanjin / Senator	3.6	328,794	84	14
9	COSCO Container Lines	3.5	322,326	126	21
10	NYK	3.3	302,213	118	30
32	Sinotrans	Less than 0.4	28,243	34	3

Source: BRS-Alphaliner (2006). TOP 100 of Liner operators at 01 January 2006 (2006, February 1). ALPHALINER. Retrieved March 2, 2006 from the World Wide Web:

<http://www.alphaliner.com/brs-alpha/search.htm>

Of all Chinese shipping companies, only 15 firms exceed 100,000 deadweight tons. The number of medium and small-sized shipping companies comes to about 5000. They possess roughly 170,000 ships, and each ship is around 118 deadweight tons on average. Middle and small shipping companies constitute 65% of total ships and 26% of total tonnage respectively³. However, those shipping firms do not concentrate on one market, while they often offer a full range of shipping service. Once a certain kind of market went better, they would rush for it with a result of over-competition. In the last decade, growth through acquisition has been a critical part of the success of many companies operating in the shipping industry. M&A activities have been one of the most important segments in building their global market. Before 2005, the previous M&A wave in global shipping industry came along during the period from 1998 to 2000. Table 2 shows some events took place from 1998 to 2003.

Table 2 – M&A activities from 1998 to 2003 in global shipping industry

Year	Events
August, 1998	Evergreen acquired Lloyd Triestino ⁴
April, 1999	MOL merged with Navix Line
July, 1999	Wallenius merged with Wilhelmsen ⁵
Nov, 1999	AP Moller acquired Sealand
June, 2000	CSAV Group bought out NORASIA
April, 2003	World-Wide Shipping took the control of Bergesen

Source: Establishing virtual shipping alliance, and seeking for today's ark (2005, April 5). *Shanghai Port Administration*. Retrieved March 2, 2006 from the World Wide Web:

<http://www.shanghaiport.gov.cn/text.asp?id=2555>

³ Dong Ping (2004): Private shipping enterprises and international transportation

⁴ Lloyd Triestino: An Italian famous shipping companies. Since Jan. 5, 2006, it changed its name to Italia Marittima Spa.

⁵ Wallenius and Wilhelmsen: The global No.1 and No.2 ro-ro shipping service providers.

1.2 The problem

After all what on earth is problem? As I mentioned above, foreign shipping firms began merging and acquiring other peer companies about a couple of decades ago. They think of this sort of stuff as business routine. On the contrary, for Chinese shipping service providers, it becomes a big deal, because they virtually had no hands-on experience on not only domestic M&A but cross-border M&A. Despite there are a few ones taking place across the country at times, but it can not change the entire macroscopic environment in which Chinese shipping carries are reluctant to carry out an M&A that may bring potential benefits to them.

The reason I picked up this topic, *The Study on M&A in Today's China Shipping Industry*, is to find out the reasons behind this problem, and identify the potential obstacles and concerns that have maintained this kind of weird phenomenon for quite long time. As my study goes on, I found some elements in Chinese culture, imperfect China financing market, incomplete laws and regulation relative to M&A, and something else are to blame for that. I'll talk about the details in late chapters.

According to my knowledge, the case that China Shipping Group attempted to acquire CP Ships in 2005, it's the first time that Chinese shipping enterprise in that scale went beyond the border to buy an overseas shipping operator. So, there wasn't a successful example for him to follow and learn from. Furthermore, doing preparatory work insufficiently also added to the possibility of its subsequent failure.

I hope I could do something meaningful to put forward some inspiring ideas that are likely to be adopted by Chinese government, market and shipping enterprises to change the current domestic M&A situation. After all, whatever an M&A happens in nation-wide scope or in a global way, it will eventually improve the conditions of Chinese shipping firms. In this way, Chinese shipping companies will really have the capability to maintain and grab a fair market share.

1.3 Approaches and reader's guide

Here I'll present some scientific perspectives on which a student must focus when investigating a determined problem area. In fact in order to write a thesis, a method that allows the student to reach the objective of the study, must be designed and explained. Such an explanation is important for the student in order to be clear on what method to select as well as for the readers, so as to give them an understanding of the research process and how the result has been attained.

First, I give some explanation on some basic ideas about M&A so that readers can have a general idea about what I'm going to talk about and will not be confused in my late chapters.

Secondly, I collected all kinds of correlative material from various sources, so as to induce the rationales behind the phenomenon. The information is from a wide variety of media, which including newspapers, trade magazines, books and internet. In Chapter 4 and 5, I divided the content into sub-items to reflect that I take different angles into consideration.

Thirdly, my research in this study is in the middle of an objective and analytical perspective and a subjective and personal perspective. The analytical perspective describes and explains the objective reality. The typical demonstration is in Chapter 4, The Hurdles Blocking the Way of M&A, except for the first sub-item, namely, Chinese Culture Factor. In this chapter, all conclusions and analyses is based on the real facts and official statistics. Whereas, the Chapter 5 which mainly focused on the suggestions or recommends to the improvement of M&A condition in China shipping sector is primarily around my personal thoughts. It's the same case to the first sub-item of Chapter 4. In fact, since this thesis deals with phenomenon, the solutions to the issue is not absolute. Besides, the comprehension on Chinese culture is influenced to a large extent by my own interpretation and presentation. So, they are

easily perceived as subjectivity.

The following guide is created to provide the reader with a structural overview of the thesis.

Chapter 2 is dedicated to the explanation and definition of mergers and acquisitions. It lays the foundation for the presentation in next chapter.

In Chapter 3, I will discuss the motivations or driving forces of M&A. In the same time, it also implied the benefits for concerned parties once they conducted an M&A. Different kinds of synergies and creating extra value are main advantages M&A can give to the participated entities. But for China shipping companies, they will care more about the possession of new market shares and strengthen its core competence.

In Chapter 4, I am going to investigate the rationales behind mist of long-standing 'custom', by which most domestic shipping companies have abode to 'resist' against mergers and acquisitions. And then we'll find that the unique 'custom' will involve several principal aspects: Chinese culture, imperfection of China financial market (including financial institutions), and unsystematic law framework.

In Chapter 5, the core of my thesis will go deeper to the solution level on how to improve Chinese macroscopic environment in which mergers and acquisitions can be readily conducted. In this section, I'll set forth my own proposals to the problem. The reconstruction of current China investment banks and amelioration of China capital market will be the main focus of this chapter. In addition, a sound law system and proper government intervention will be taken into account.

Chapter 6 concludes what was discussed and presented in analysis of previous chapters and provides an holistic view on recent achievements, especially within the first year of 2006, in improving M&A macro-environment of China shipping sector.

2 Literatures review

The terms M&A (mergers and acquisitions) is not a new word for us. Since it came into being, there have developed quite a lot theories and cases about it, which covers all kinds of concepts [37][41][56], synergies [30][39][44][47][51], and even detailed implementation procedures [9]. If you can google it, you will find that about 3000 books and more than 20000 articles discussing M&A are out there right now. It's astonishing number. It means the studies and researches on M&A activities have reached a mature level as yet.

When it comes to M&A in shipping industry, the studies in that field become very fewer. Besides, those studies only focused on specific cases or shipping enterprises, and some modified M&A concepts specific to shipping industry. For example, an article speaks of the growth process of COSCO in brief [5]. Another one touches on the M&A cases related to Maersk, CMA and Hapag-Lloyd [59]. In the former one, it mainly talks about the progress of COSCO by way of M&A. The latter one just gives us a clear picture on the rationales behind these recent outstanding M&A activities. So, it's very hard for people to look for an article or thesis that is in relation to a special problem in shipping industry, just like what I will do in this thesis. Even if there existed a few of such literatures, they, unfortunately, are too narrowly-focused [20][62]. However, my thesis will deal with a complicated and across-the-board M&A problem in China shipping industry.

Since my topic is an intricate issue to discuss, so, it, by all means, involves more

sectors and areas than shipping dimension, such as the government, financial market, and law system. In order to find out the in-depth reasons of this problem, I referred to a great deal of correlative literatures. They include the discussion on the government influence in M&A activities (here the government refers to China government) [19][31], the study on China financial market [32], and Corporate Law of People's Republic of China [8], etc. Sometimes I need some classic theories, for example, 'economic man' [34] to explain certain 'wired and commonplace' phenomena.

For the purpose of presentation of workable and effective solutions to the problem, I have to refer to practices and mechanism already adopted by developed countries. To learn and adapt those useful experiences is critical part to solve the issue. For instance, the mature foreign investment banks and reasonable taxation polices for their shipping industry are good references among literatures [40][33]. After all the issue I will study is characterized by noticeable Chinese features. So, the literatures reflecting China current situation will be preferable. The typical example is The Study on Laws Relative to China Corporate Financing written by Fan Hongyi & Jiang Nan [16]. This book lists some law deficiencies and gives out suggestions relative to China corporate financing. But a couple of law matters have been resolved within recent one or two years, and even the first year of 2006. The weakness of such literatures is obvious that they can't keep tight pace with the latest development of China. In my thesis such problems will be solved effectively by avenue of referring to the latest information posted or published on newspapers and internet [27][49].

3 The hurdles blocking the way of M&A

In China domestic shipping sector, just a few mergers and acquisitions have been witnessed so far. In sharp contrast to what happened in global shipping industry, China lags far behind in M&A game? Several causes are given out as follows.

3.1 Chinese culture factor

3.1.1 Loser mentality

Culture plays a significant role in this strange phenomenon – the whole China shipping industry is short of incentives and passion to conduct M&A activities. According to Hofstede (1980, pp. 67-91), culture is a “collective programming of the mind” (or of minds) which is difficult to modify. In particular, national culture, which contributes to shaping the culture of the country’s companies and behavior of individuals, is too deeply ingrained from childhood for it to disappear easily.

Currently, in the country with the world No.1 number of shipping firms, private enterprises account for the majority in that shipping industry. They offered services covering marine businesses from ocean transportation and costal shipping to inland water transport. On the whole, although they are great in number, they are not strong in competitiveness at all. The only way ahead for those shipping firms is to merge with or acquire other shipping companies. Surprisingly, the CEOs and owners of

those firms are reluctant to do this. Because nearly all of them started shipping businesses from scratch, they cherish their enterprises like the way parents attend to their own children, even if those companies are not good in performance and competitiveness. In the sense of Chinese culture, the sale of their private-owned company means they don't have the capability to maintain its daily ordinary operation any more; they will thus become a loser in the eyes of the peers. Most likely this kind of viewpoint of others will affect their future business.

3.1.2 Conservatism

It's just part of Chinese culture element which is influencing the entire China shipping industry. Another facet I will show you immediately is about the fact that Chinese private owners, actually, are more conservative than westerners. Now Chinese private-owned shipping firms could enjoy some exclusive advantages as follows:

- 1) Owners have undisputable ownership of the enterprises, which allows them to adopt flexible structure or system to organize their enterprises. In addition, the combination of manager and owner (the owner of a private-owned shipping company is a manager as well) is quite favorable to avoid agency risk.
- 2) Thanks to relatively smaller scale of private-owned shipping firms, they can change their marketing and operational tactics easily in parallel with the progress of the shipping market. The reason why a quick decision can be made in this kind of organization structure is they have fewer hierarchies than those big ones.
- 3) Less social and economic burden is another benefit for private-owned shipping firms. Compared to those state-owned shipping enterprises, they don't have legacy problems, such as redundant workforce, labor contracts and debt problem. Therefore, the owners of private-owned shipping firms can run their companies

at a low cost.

It's just because these benefits that Chinese private-owned shipping firms are not willing to take part in any M&A activity to become a bigger shipping company or be merged/acquired by a national shipping enterprise. The owners of private-owned shipping firms fear they will lose what they had once their companies merge with or are acquired by some other shipping companies. This sort of worry didn't belong to owners of private shipping companies in particular; the executives of those national shipping enterprises also shared it. They are anxious about their present positions and welfares. Any kind of external turbulence including M&A activities will add a piece of worry to them. Therefore, the worry held M&As back in China shipping sector. The two kinds of mindset mentioned above are both roots in Chinese culture.

3.2 Imperfection of China financial market

The M&A activities need a platform that can provide enough funds for involved firms to conduct a merger or acquisition. Thus, that platform should function as a capital source for M&A activities. Such a platform is known as financial market. To which extent do financial market develop has much to do with the quantity and quality of M&As.

For medium and small-size shipping companies in China, problems like limited capital source (few financing options or channels), and imperfection of China financial market both retarded their M&A development.

The history of China financial market is very young, so, a lot of problems are out there waiting for being solved.

In theory, financial market can be divided into two categories: capital market and monetary market. Capital market is a main component part of financial market. The purpose of this market is to help enterprises to obtain long-term funds (more than one

year). The capital market is comprised of two sections: stock market and bond market. Monetary market is a short-term financing market (funds in this market often are less than one year). The financial service of the market includes short-term loan, commercial credit and short-term bond. Figure 1 shows the subdivision of a financial market.

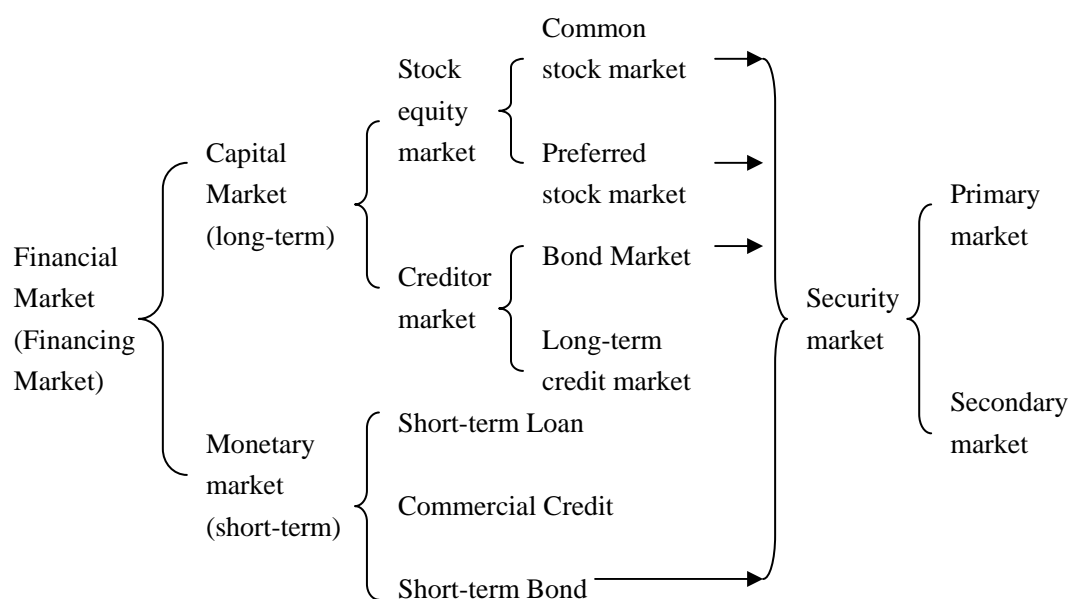


Figure 1 - Subdivision of financial market

Source: Liu Hongmei & Wang Keqiang. (2002). *The study on China financing market*. Peking: China Price Press.

3.2.1 Stock market

According to China Business Post published in December, 2005, China stock market was ranked the worst on the list of global emerging markets by overseas commentary. During the period from 2000 to 2005, China stock market indices was once below 1000 points, 51.7% down from the peak ever reached in 2001. Meantime, the total value of the market shrank to 3.159 trillion Yuan⁶ from 5.3631 trillion Yuan.

The basic function of stock market is financing. Because of the reform about the

⁶ Chinese currency unit, the exchange rate between Yuan and US dollar is 8.025 to 1.

separation of stock rights⁷, all IPO and refinancing activities have been stalled since the start of the reform.

Theoretically, the position of stock market is determined by the proportion of direct financing to indirect financing. Direct financing is defined that enterprises get their needed funds by means of issuing corporate stock or corporate bond. Indirect financing refers to that funds are raised by way of bank loan.

Based on the economic data of developed countries, direct financing in a usual way accounts for roughly 60% of total financing value. In China, the maximum of this figure appeared in 1998, only 15%. Since 2001, this rate has gone down all the way without rebound.

In the year of 2002, direct financing in China made up 4% of the whole financing value. Financing through stock market was around 90 billion Yuan out of 2 trillion Yuan, the total value of financing that year. It didn't show any sign of bettering off in 2003 and 2004, the rate of direct financing to the total financing value slipped to 3%. During the same period, of total amount of 3 trillion Yuan of financing, stock financing lingered between the range from 80 to 100 billion Yuan.

Wholly speaking, the real reason behind that 'astonishing performance' of China stock market is that a few corporations raised too much money on this market, which resulted in weak financing capability of the entire stock market.

Observed from the perspective of total volume, China stock market has only raised 1 trillion Yuan ever since the set-up of it. At the same time, the bank loans have increased from 1.5 trillion Yuan in 1990 to 19 trillion Yuan in the end of 2004. So, we can clear see that direct financing through stock market is trivial for indirect financing by comparison⁸.

⁷ The issue about the separation of stock rights is an exclusive feature of China stock market. It means stock holders exert unequal rights over tradable stock and non-tradable stock.

⁸ Jiao Qiang (2006). China stock market reform is in trouble

In accordance with the standard stated in the recently released World Economic Outlook by IMF, if the drop range of stock market indices is beyond 37%, we can judge that the stock market is on the way of slump. China stock market has gone through 4 year's bear market and the maximum of drop range ever reached 57%. Therefore, we can safely assume that it is on the verge of collapse.

3.2.2 Direct financing

In a general way, the efficiency of direct financing is far more than that of indirect financing, and it can drive some industry to develop in a rapid way. But it's not the case in China.

Bank loan has become the main capital source for those poor-performed listed shipping companies to pay back their cost of direct financing. In this case, the risk of direct financing would be spread to the field of indirect financing. In consequence, it pushed up the risk level of whole financing market.

Currently, the imperfection of China direct financing market lies in the fact that the market is full of investment risk and short-term speculation, and lack of complete regulatory and law system. The Chinese thus prefer to deposit their money in banks rather than invest into the direct financing market. The imbalance of financial input between the direct financing market and the indirect financing market resulted in stagnation or even regression of the direct financing market.

Within the direct financing market itself, there also exists development gap which is between stock market and corporate bond market. A couple of reasons brought on this problem. First, the government overcontrolled corporate bond issue. There are too many constraints on corporate bond issue, such as the concerns about issuer of corporate bond, bond quota, fixed number of years of bond, and fixed interest rate of corporate bond. As for the real practice of corporate bond, the government often

interferes with the process of corporate bond issue. This kind of planned economy severely hobbles corporate bond development. Secondly, the corporate bond quota varied from year to year, the executives of enterprises are therefore at a loss to make a decision on bond financing. Thirdly, nowadays, corporate bond interest rate is very close to that of bank deposit for the same fixed number of years. Besides, 20% individual income tax is levied on interest rate income of corporate bond. Both of two points have greatly impaired confidence and incentive of investors.

Under current circumstances, if a company wanted to issue corporate bond, it must be examined and approved by National Development and Reform Commission, and State Council. In addition, the corporation should get bank guarantee otherwise its application will be rejected. Typically, only those big-scale firms can pass so rigid examinations. Most of them are national enterprises and big companies with government support. For private-owned companies, it's really a mission impossible.

3.2.3 Indirect financing

For most Chinese medium and small-sized shipping companies, direct financing is too difficult to get it not only because of its cumbersome procedures but poor-performance of capital market in past a couple of year. Moreover, the cost of direct financing is much higher than they can afford. Therefore, the only way they can go right now is indirect financing. Bank loan thus becomes the primary capital resource of those Chinese medium and small-sized shipping companies. In this way, they can get funds at a comparatively lower cost, and procedures are more simple by comparison with that of direct financing. Since bank loan requires less accounting information about bank loan applicants, it is more preferable for those shipping companies in small-scale. However, in effect, bank loan is also a thorny path for Chinese medium and small-sized private shipping companies to go through.

(1) Bad assets and policies of commercial banks

As the critical medium of indirect financing market, banks bear a great deal of accumulated operational risk because Chinese shipping enterprises in whatever scale depend on bank loans in varying degree. Moreover, an abundance of bad assets have been affecting the ordinary financial function of Chinese banks over a past decade. As a consequence, the feeling about crisis was deepened.

As of the end of 2003, the non-performing loan of national banks had jumped to 1.92 trillion Yuan, which constitutes 20.36% of total loan in that year⁹. In the end of 2005, the accumulated bad assets of Chinese banks dropped to less than 10%. As a matter of fact, if we think of policy-based stripping factor and dilution effect of new loan, the accumulated bad assets of Chinese banks had risen to a yet higher level.

The main body of Chinese banking industry is national banks. For quite long time, the basic rule national banks have being abided by is to support state-owned economy. Although national banks have already started to grant loans to private shipping companies on a basis of firm's status, they didn't change their original focus at all. To support state-owned economy is still their main task. Under the same condition, national banks are inclined to grant loan to state-owned large and medium-sized shipping enterprises rather than private shipping companies. Even though national banks issued loan to well-operated private-owned shipping enterprises, the requirements for private shipping firms are fairly higher than that for state-owned ones. For instance, if a state-owned shipping firm asks for loan from a national bank, it simply needs to provide document ratified by relevant government department. Nonetheless, a private-owned firm would show an extra guarantee from some guarantor, which in no doubt adds to the difficulty and complexity of the process of bank loan for private shipping firms. In the recent year, with the progress of China economic system reform, four largest Chinese banks began to exert credit

⁹ China Society for Finance and Banking. *Almanac of China's Finance and Banking 2004*. pp.3-6

contraction and credit concentration policies for the reason of ever rising bad assets. At the same time, national banks strengthened the control over credit risk, and improved corporate responsibility risk management. Enterprises that got bank loans would assume lifetime responsibility. In some sense, the threshold of bank loan has been lifted for shipping companies, especially private shipping firms. Nowadays, most Chinese banks use indicators of big shipping companies as references to assess the credit rating of small and medium-sized shipping companies. Therefore, those small shipping firms are hard to get loans from national banks. Apart from that, Chinese banks always charge the same rate for information cost and other transaction costs regardless of the quantity of loan will be granted. In this case, big shipping companies can take advantage of lower unit cost of bank loan because of the large quantity they tend to ask for. Whereas, small and medium-sized shipping companies are put in an unfavorable place because of comparatively smaller amount of bank loan they require. The reason why Chinese banks prefer to grant great amount of bank loan to big shipping companies is that there exists potential economic interest with them. Now, we can clear understand why national banks don't show a little 'apathy' to those private shipping companies, in particular small ones.

The majority of bank loans for those small and medium-sized private shipping firms are short-term (less than one year), which is not favorable to those who want long-term financing. As a result, it restrained them from further development, let alone conducting M&A activity.

(2) Deficiencies of shipping enterprises and relevant law

Small and medium-sized shipping firms couldn't get enough bank loans not only for the reason of bank's policy but deficiencies in themselves. For instance, medium and small private shipping firms have relatively smaller scale in comparison to big national shipping companies. In addition, their businesses are so extensive that their performance status is not quite stable. Concerning management, most private-owned

shipping companies are organized in an inefficient way, and their competitiveness is not strong. Furthermore, short lifetime is another weakness with this sort of enterprises. In a general sense, the vessels of small and medium-sized private shipping companies are not in good condition, such as the old age of vessels, out-of-date facilities, and high maintenance cost. As for competitiveness of medium and small private shipping firms, we can list a couple of disadvantages with that kind of shipping firms. First of all, they don't have high quality staff. Next the organization capability in transportation and innovation is too poor for them to compete with big shipping companies. In operation aspect, high-risk, lack of funds, limited service scope, and less fixed assets all lead to unstable operation status and low capability in dealing with risk. The latter in turn results in inappropriate financial management system, defective organization structure. In consequence, financial reports are written casually and discrepancies come up here and there. Therefore, low degree of authenticity and transparency, absence of credit, and low credit rating become key points for private shipping firms to fail to meet bank loan's requirements.

High risk means corresponding high return, but Chinese banks could not do at their will due to interest rate control system that placed a cap on interest rate of bank loan. High risks, unsatisfied return rate made it hard for banks to grant loans to small and medium-sized private shipping companies.

At present, because legislation for encouraging banks to grant loans to small and medium-sized shipping firms left far behind, and the imperfection of relevant laws and regulations, it's very hard for Chinese middle and small private shipping firms to get sufficient law protection during the process of applying for bank loans. On the side of banks, without effective law protection and execution, reimbursement evasion

issue made them worry about their receivables¹⁰. Therefore, banks are reluctant to issue loans to those small and medium-sized shipping firms.

3.2.4 Investment bank

When it comes to financing market, we can not ignore the existence of investment bank. The imperfection of China investment banks is also responsible for few M&A activities took place in China shipping sector.

Investment banks in nature are non-banking financial institutions. In China, they are comprised of security firms, trust and investment corporations, assets management companies, and some other financial leasing firms, etc.

China commenced its first investment bank business only more than a decade ago. Compared to those in developed countries, we are now still at a junior phase. We still have a long way to go to catch up with foreign peers. Some demerits of China investment banks are listed as follows:

- Relatively smaller scale

In the end of 2005, total assets of 43 China main security firms were worth 178.2 billion Yuan, about 22.2 billion US dollars¹¹. At the same time, the asset of Merrill Lynch, one of world's leading investment banks, was reported at \$681.015 billion.

- A few financial service products

The business of foreign investment banks cover a wide range of financial services, such as underwriting, transaction, advisor, M&A, project financing, corporation finance, asset management, and risk investment, etc. However, China investment banks simply focus on underwriting, transaction and some self-support businesses.

With regard to M&A and advisor businesses, China investment banks are merely on

¹⁰ With connivance of some local governments, quite lot small and medium-sized firms located there often evade reimbursement to banks.

¹¹ Hu Xin (2006). Securities Sector continues to loss, innovation lead the way to the future.

a tentative phase. Furthermore, most China investment banks are incapable of raising funds overseas.

- Poor operation and management

In today's western countries, the industry of investment banks is capital-intensive and knowledge-intensive. There recruited a large number of professional investment bankers working for it. In China, apart from a few large security firms and trust and investment corporations, the rest are all suffering from the problems like inefficient management, out-of-fashion operation pattern and concepts. For one thing, the staff quality of China investment banks does not satisfy the requirement of today's investment banks. For another, the shortfall of qualified personnel is headache surrounding China investment banks. These two reasons help explain why China investment banks lacked innovation and concentrated on limited and homogenous service lines. As a result, most of them certainly couldn't offer technical support and financing arrangement what M&A activity takes.

- Other deficiencies

Limited financing channels retarded the growth of China investment banks. Currently, the main capital sources for China investment banks are from commission of underwriting and transaction, etc. In addition, poor performance of China security market in a recent couple of years has severely impacted the capital inflow of the investment banks, which made it difficulty for China investment banks to extend their business to M&A field. Meanwhile, China investment banks can't afford high risk of new businesses. So far there isn't a law that clear identifies the legal status and business coverage of China investment banks. Moreover, for most Chinese corporate managers in shipping sector, they even didn't have a clear picture what investment banks can do for them in mergers and acquisitions.

The complexity and high-risk of corporate M&A requires that investment banks should have an abundance of funds, good reputation, and professional staff. Besides,

operational level, management experience, and management system of an investment bank are determinant factors to the success of M&A. From this perspective on, most China investment banks are still far away from getting the capability of dealing with M&A issues. Therefore, China investment banks can't play a critical role in corporate M&A activities just like foreign peers yet.

3.3 Governmental behavior

In China, all shipping companies can be divided into two categories in terms of ownership, one is national enterprises, and the other is private-owned firms.

3.3.1 Interest issues

When a shipping company is in the condition of poor operation, no government department would like to lend a hand or be responsible for it. On the contrary, some government departments will scramble for the feat as a shipping company achieved outstanding outcome. Under such circumstances, a merger or acquisition with a well-performed shipping firm will stir objection from local government where this firm is located for the sake of its own interest. The reason local government doesn't want to lose it lies in the fact that such a shipping firm reflects its feat and brings 'income' to him. When this kind of M&A is in relation to a national shipping enterprise, the governments will get started to worry about whether this activity will lead to the flow-away of high quality state-owned assets.

The existence of local protectionism exerts a negative influence upon M&A, which prevents M&A from happening across provincial boundary. The typical reason behind local protectionism is finance and taxation issue. In 1994 the finance and taxation reform changed circulating tax system. According to the reform, resulting companies after M&A should hand in their income tax to new corresponding

administration departments. In this sense, M&A taking place across provincial boundary will change tax income between provinces, so local governments strongly oppose to that sort of M&A. Although it is stated in current finance and taxation system that original provincial government has right to maintain the tax level of previous fiscal year before an M&A, it doesn't solve the problem thoroughly. The increment of tax is not available to original provincial government any longer. It thus leads to the conflict between two provincial governments because of their own financial interest.

Hypothesis of 'economic man' can be applied to the organization like government as well, because it has his own interest. According to the theories of James Buchanan and George J. Stigler, if some members of government became beneficial owners of certain special interest groups, they would service for those interest groups. In this case, the government would be a 'captured government'. Generally speaking, governments whose liabilities comprehend public control, community redistribution are ideal targets for rentseekers¹². On account of the imperfection of China governmental administration and supervision system, once the government got involved in rent seeking activities, they would utilize administrative and legal power to protect their vested interests or redistribute vested interests. Such kind of rent seeking, more often than not, resorts to approaches that obstruct free competition to seize vested interests. Under perfect competition environment, enterprises take part in M&A activities through market bidding game. However, under rent seeking circumstances, some enterprises could 'borrow' government power to prevent other potential competitors from 'interfering' into an M&A activity that have substantial economic interest with them. The long-standing rent seeking phenomenon has severely impeded M&A progress in terms of number in China shipping industry.

¹² Rent seeking is certain kind of activity in which rentseekers seek for favorable government policy. For example, they seek for governmental protection against external competition. (Joseph E. Stiglitz, 1997, pp.362-363)

3.3.2 Inefficient mechanisms

Property right delimitation is so vague that the government always substituted for national enterprises in making decision on M&A activities. The national property management model includes three levels: The most upper level is national property administrative management institutions, such as state-owned assets supervision and administration commission of the state council, state-owned property bureau, and state-owned assets administrative office. They are directly under leadership of corresponding departments of the government. The secondary level is state-owned assets managerial setup, for example, holding company, state-owned assets investment corporation, and enterprise group are all belonged to this level. The lowest layer, by all means, includes all kinds of concrete firms. Within three-level managerial system, there not only exists horizontal managerial relationship, but tight contact with all levels of government because of interest. It implies the existence of government power hardcore. Concerning a merger or acquisition which is involved with one or two state-owned enterprises, the government tends to replace an economic target enterprise with a non-economic target one. And then the government will carry out a “well-planned” mandatory M&A. In sharp contrast with substitution behavior of the government, the real main body of M&A activity (enterprises) often “neglects his duty”. As lack of fulfillment of property right with business entity, it’s very hard for enterprises to conduct an M&A for the purpose of profit maximization. Even though they got a little bit gut and motivation to do that, they had no right and power to put it into practice, because the right of making final decision was still in the hand of relevant government department. In consequence, national enterprises got inertia on strategic issues like M&A. As matter of fact, substitution behavior of the government has also impeded the development of China investment banks. When it comes to China finance and taxation system, I will mention another

phenomenon happening between different governmental finance grades. If the occurrence of a merger or acquisition altered the finance and taxation condition of two governmental finance grades, it would also result in interest conflict (between central government finance department and provincial level, or between provincial finance department and municipal finance level). In some cases, such conflict would happen between the same governmental finance grade (between two provincial finances departments or two municipal finances ones).

3.4 Unsound M&A laws

3.4.1 Imperfect law system

Within market economy, M&A is kind of senior market activity. Over a hundreds of years of M&A practices, western countries have developed plenty of relevant legislation experience. They've created a lot of prejudications and legal philosophy during that period of time. Now, their M&A-related law system is composed of a fundamental law – antitrust law, general laws, and some economic laws. In stark contrast to that of developed countries, not too many clauses with regard to M&A could be found in China Corporation Law and Securities Law. China M&A-related laws are evident to lag behind.

First of all, a fundamental law, something like antitrust law, has not been enacted in China. It is a law that gives the delimitation of M&A behavior. As for laws dealing with M&A processing, debt arrangement, taxation issue, and staff placement, you couldn't find any one of them in Chinese law system. Moreover, there isn't a social insurance law and a law in relation to foreign exchange for the time being.

Secondary, existing Chinese laws are not powerful and systematic enough. So far some laws and statutes relative to corporate M&A have been progressively issued.

Among them, except for Corporation Law and Anti-unfair Competition Act issued by the national legislature, the rest are administrative codes in various names, such as ordinance, stipulation, notice and interim procedure. Therefore, the effectiveness of execution of laws is significantly affected, and economic subjects are apt to go after short-term conduct. Within China law system, we found that the connection between existing laws relative to M&A is not so satisfactory.

Thirdly, the subject in M&A-related laws was narrowly defined. Currently, most M&A-related policies and codes treated state-owned economic subjects as regulated subjects. They paid a little attention to private-owned firms, whereby the enthusiasm of those private shipping firms to participate in M&A activities was frustrated.

The imperfection of Chinese M&A law system can also be witnessed in respect of the absence of execution details. In other words, there are no specific clauses enterprises can comply with or guide them how and what to do in real M&A practices.

3.4.2 Anxiety and pressure

The purpose of Chinese M&A law system is not only to standardize the behavior of firms in M&A practices but to safeguard the interests of the government and staff of concerned enterprises. Because HR and management issues of Chinese national shipping enterprises are subject to governmental administrative departments, the enterprises have no entitlement to decide on it when they are confronted with M&A activities. At the same time, corporate staff will get anxious about their current positions and implicit welfare; it will further lead to collective reaction against a merger or acquisition. The worst thing might happen, if it goes a step further, it will stir social turbulence. Therefore, the problem concerned with staff placement is really a headache for involved shipping companies. Moreover, inefficient Chinese

social insurance system deteriorated the current M&A situation in China shipping industry. A national shipping enterprise has ‘implicit contract’ with its employees, which guarantees basic non-monetary welfare of the employees. Once they were sacked after an M&A, it would mean the end of their ‘implicit contract’ with the national enterprise. At present one of the obligations of China government is to ensure the stability of whole society. In that sense, the government will employ all kinds of approaches to force the resulted company to ‘adopt’ those ‘redundant’ staff. It therefore adds extra burden and cost to M&A and chokes off the potential motivations for M&A activities.

Concerning Chinese private shipping firms, Labor Law states that the owners of private-owned shipping firms should compensate dismissed employees in accordance with their length of service. This clause aiming at protection of employee’s basic welfare put additional financial pressure on acquiring firm (sometimes on both participated firms).

3.5 Corporate aspect

3.5.1 The common problems of private shipping firms

In comparison with China top ten shipping companies, almost all of Chinese private shipping companies shared a common disadvantage in small size. Apart from that demerit, lack of funds and competitiveness are another two types of weaknesses for Chinese private shipping companies. On the whole, although Chinese private shipping companies have an advantage in number, the majority of them is in inefficient organization structure, and has a little specialism. Because most Chinese private-owned shipping companies haven’t established core competence in respect of management system and corporate culture yet, the M&A activities couldn’t help

boost their core competence other than economy of scale.

For Chinese private-owned shipping firms, there are some other obstacles to M&A. First, the economic status of Chinese private enterprises has not been fully reflected in China shipping industry. Next, the quality of leaders of private shipping enterprises on average is not as good as that of those of national shipping enterprises. Thirdly, medium and small sized private shipping companies often have less budgets and revenue/profit. They therefore are very sensitive to the loss and gain. The high initial input required by M&A intimidates them to a great degree. Lastly, the whole process of M&A (including post-activity integration) will be quite long in general. For Chinese middle and small private-owned shipping firms who always change their management threads, such economic and strategic activity would put them at risk to certain extent. In consequence, the final result of M&A would be rather different from that they originally expected.

3.5.2 Financial matters

The debt problem is another barrier that kept Chinese private shipping companies from participating into M&A activities. In a general way, a resulted company will take all creditor's rights and debts from two original firms. Therefore, creditors of that acquired or merged firm will pursue the debt all the way to the new entity. In this case, the merging or acquiring company will be troubled by new debts problem as well as his original creditors.

At times managers or private owners of shipping firms would hide or omit corporate debt on purpose. The estimated price of target firm will thus be higher than its actual value before an M&A. The new-entity would probably than not be trapped in a large amount of debt after an M&A. What's the worst, the resulting company could be involved in intricate debt relationship then.

3.5.3 Personal factor

The absence of M&A motivation is a real problem facing not only by Chinese national shipping enterprises but private-owned shipping firms. As a general rule, the incentives to carry out an M&A are from corporations themselves and the pressure of external competition environment. However, most Chinese shipping companies, especially private-owned firms, had a shallow knowledge about the meaning and goal of M&A. In the meantime, the shortage of funds makes them more difficulty to think of expanding service scope and scale by means of M&A.

Since managers of national shipping enterprises are appointed and removed by relevant administrative departments in charge or governmental HR departments, the managers have no power to show their influence when they are faced with a demotion or deposal caused by an M&A. In this case, they'll utilize all kinds of ways to resist against an upcoming M&A.

Within an M&A, CEOs or private owners of shipping enterprises often make their decision only based on economic interest. However, for staff of shipping firms, they pay more attention to employment, welfare and indemnification issues. Since everyone thinks of M&A from different viewpoints and their thoughts are tough to compromise with each other, it very probably brings on 'miscarriage' of an M&A attempt and further hurts potential incentives with those CEOs and private owners.

4 Resolutions

4.1 Reconstruction of China investment banks

4.1.1 The introduction of Merrill Lynch

China investment banks should take a leading role in Chinese shipping companies' M&A. If we take a look at foreign investment banks, you will be impressed by their titan size in funds and operational scale. Now, let's take Merrill Lynch for example. Merrill Lynch & Co., Inc. is a Delaware corporation that, through its subsidiaries and affiliates, offers capital markets services, investment banking and advisory services, wealth management, asset management, insurance, banking and related products and services on a global basis, including:

- 1) Securities origination, brokerage, dealer and related activities;
- 2) Investment banking encompassing:
 - A. Securities underwriting
 - B. Strategic advisory services, including:
 - a. Mergers and acquisitions
 - b. Strategic valuation
 - c. Other corporate finance and advisory activities
- 3) Securities clearance, settlement, equity financing and services, including prime brokerage;

- 4) Asset management and investment advisory services;
- 5) Wealth management products and services, including financial, retirement and generational planning;
- 6) Banking, trust and lending services;
- 7) Insurance and annuity products and annuity underwriting;
- 8) Private equity and other principal investing activities;
- 9) Global investment research.

Merrill Lynch offers these products and services to a wide array of clients, including: individual and institutional investors, businesses of all sizes, financial institutions, and governments and governmental agencies.

In comparison with the businesses scope of Merrill Lynch, those so-called China investment banks, actually, only take part functions of Merrill Lynch. And almost all of them concentrated on basic low level businesses. How to improve it and extend China investment banks' business scope? There are some solutions to it. Existing China investment banks' organization and their activities must be reshuffled. It will take quite a long time to accomplish it if we only rely on industrial progress. So, the governmental power would be a best bet to shorten the process of reshuffling.

4.1.2 The reconstruction of China investment banks

(1) Staff

The reshuffling task is more complex and challenging beyond anyone's imagination. First, it requires that a couple of top China investment banks take a step forward to conduct M&A. In so doing, the whole China investment banks industry and its market will be changed and improved considerably. Secondly, some new investment banks' businesses should be introduced with the help of the government. The last point is that the staff of reborn China investment banks are supposed to be

restructured and refreshed. Plenty of experienced professionals and other qualified personnel would be recruited home and from overseas countries, which ensures that the restructured China investment banks are running in an international and professional way.

Currently, China has three options to improve the quality of its investment banks' staff. First of all, they can employ well experienced overseas professionals (including those from Hong Kong, Macau and Taiwan). Next, they can send excellent people to developed countries for a further study or training. The last one is that a feasible and effective employment mechanism would be adopted to ensure the quality of staff. What is more, a great importance should be attached to the right and interests of investment bankers when they worked for China investment banks. Meanwhile, the government and the society should also help to create a friendly environment for bringing up real Chinese investment bankers.

Training qualified staff is a major task for China investment banks right now. There is a great demand for Investment bankers with high specialty. A real investment banker, in fact, is a nice blend of management specialist, finance expert and social activist. As a management specialist, he has abundant management experience and basic knowledge about corporation operation. Being a finance expert, he is able to provide high-specialized finance service with his expertise in finance, securities and innovative concepts. Because investment bankers need to keep long-term and tight relationship with political circles, financial community, business world, and academe, he must be a good social activist. Considering that China investment banks are still in a preliminary stage, fostering a qualified investment banker team will be a challenging job.

(2) Proposed implementation scheme

A joint venture is an ideal solution to solve existing problems of China investment banks. It could be set up with inputs from China and one of world leading investment

banks in capital, staff and expertise. This is the fastest and best way for China to foster its real investment banks.

(3) Concerned laws

In western countries, there are a few M&A lawsuits in investment bank sector due to its well-established industrial practices and perfect law system. As a major intermediary of financial market, overseas investment bank often has an independent department which is dedicated to deal with M&A issues, including M&A planning, asset evaluation, negotiation, lawsuits drafting and so on.

In law aspect, China should enact and amend laws relative to investment banks. Now, Investment Bank Law is in urgent need, in which it will stipulate the setup criterion, setup procedures, liabilities, and qualification of China investment banks in details. With these regulations, the entire China investment bank businesses will perform in an effective and efficient way.

(4) Positioning

Among big investment banks in the world, they usually distinguish themselves from each other by positioning. For instance, Saloman Smith Barney focused on offering diversified financial service products and serving clients with high expertise. However, Goldman Sachs is famous for its strong market research capability and underwriting business. As for Chase Manhattan and Lehman Brothers, he is good at processing M&A activities. In the long run, China investment banks will form its own core competence just like the way foreign peers do so that they can provide more specialized and better quality financial service.

(5) Eyes at overseas market

China investment banks should eye at global capital market. At present, transnational securities and M&A businesses are almost monopolized by western countries and Japan, while we haven't seen any exciting sign of internationalization of China investment banks so far. As domestic capital source could not satisfy tremendous

need of home corporations, China investment banks should think of going beyond the border to establish an international raising funds network. In this way, China investment banks are able to give 'firm support' for China shipping companies' cross-border M&As as well as domestic ones.

4.2 Law system amelioration

4.2.1 Antitrust Law

China government should fulfill its 'due diligence' to improve and perfect laws associated with M&A. Well-established foreign relevant law systems will be a valuable reference for Chinese legislation in this area, and it can save a lot of man-hours in doing that complicated work. United States has a complete law system concerned with M&A. It used to make Sherman Act, Clayton Act and Hart-Scott-Rodino Antitrust Improvements Act to fight against monopoly and unfair competition. China got its own anti-unfair competition act in 1993, but it hasn't legislated for antitrust as yet. Thus, the main task for China legislature right now is to make 'M&A Law' and 'Antitrust Law' as soon as possible. The former elaborates detailed rules about implementation, such as M&A scope, M&A procedures and criterion, etc.

Antitrust Law is a fundamental law in M&A area in developed countries. It can help crack potential M&A which would make for a monopoly, and sustain fair competition constantly. In future China Antitrust Law, it would encompass following points:

- a) Antitrust Law would help identify the procedures of M&A and form a rigid declaration, audition system. The declarers are corporations that reach and exceed certain degree in market share. The fulfillment timing of Antitrust Law is

pre-activity rather than post-activity. The reason why we select this timing is that we can avoid extra economic loss resulted from mandatory separation of new entity after M&A event. Apart from that, the content of declaration should encompass each involved party's situation like service category, assets condition, revenue, market share and M&A reason, etc. According to Antitrust Law, antitrust department could execute their power to penalize violated enterprises in M&A activity. In addition, antitrust department has right to pass or deny an M&A declaration after two rounds of auditions.

- b) Antitrust Law would set a series of criteria for exceptional cases. Under normal circumstances, antitrust department will stop an M&A if the calculation of post-activity market share exceeds certain level. But in exceptional cases, a set of new criteria would be introduced to assess an M&A. One of them is that whether an upcoming M&A will improve current competition condition in a specific industry. Another is that whether a coming M&A will benefit the entire domestic economic system and social mutual interest.

4.2.2 Other related laws

The regulations about M&A can be classified into the general and the industry-specific. General ones are those that affect all firms, while the industry-specific only affect certain types of transactions in specific industry. For example, antitrust, racketeering, and employees' benefit laws are all belonged to general category. Shipping industry is subject to its relevant regulations, so is M&A activities in this sector. In some M&A cases, concerned parties may call on the government to transfer government-granted permits and privileges from previous enterprises to the resulting shipping company. Thus, an industry-specific law seems indispensable and suitable to deal with such intricate problem.

Regulations affecting M&A activities in China shipping sector also exist at provincial or municipal level. The regulations often differ from one province/municipal city to another, which makes it difficult for shipping corporations to comply with. In a general sense, provincial/municipal regulations often are evidences of special interests of local governments. In this case, the central government should fulfill its duty to coordinate those regulations and force local governments to abandon some improper and conservative ones. In addition, the similar action ought to be taken to solve alike problem existing at different governmental finance levels.

As a correlative law to M&A, State Property Law should be issued as soon as possible (it is under drafting now). The advent of this law will facilitate the management and monitoring job of a great amount of state-owned assets in shipping industry. Because in China shipping industry national property accounts for the majority in value, national shipping enterprises will be the main force in future M&A activities. Correspondingly, National Property Law will become essential to safeguard those precious 'strategic resources'.

Assets assessment, finance and taxation are all critical parts in an M&A activity. They not only impact the M&A process, but also influence economic performance after event. Here we need to amend existing laws with flaws and add some new items into them so that they are more efficient to handle those jobs mentioned above. At the same time, the improved laws provide a legal basis for cross-provinces M&A.

4.2.3 M&A Law

Legislation for M&A is a systematic project. It's a collection of all kinds of relevant laws. Roma was not built in one day, either did M&A law system construction. It needs time and effort to perfect and coordinate correlative laws. That is to say,

existing problems of M&A couldn't be solved right away or in the immediate future. Therefore, a law specific to M&A would be the most feasible and desirable way, because it can resolve the majority of problems once for all.

One requirement for M&A Law is that it can fully reflect the economic relation adjustment in M&A. In addition, M&A Law is applicable for all M&As happening to diverse Chinese shipping corporations. Finally, it provides specific instructions on M&A activities. More specifically, every detail in M&A operation can be referred in this law. Some other main contents of this law includes corporate legal liability, government regulation and protection for creditors, etc.

4.3 Financing innovations for middle and small shipping businesses

Financing issue is a headache which has bothered small and medium-size Chinese shipping companies for a long time. In this case, we have to come up some innovations to expand financing channels for those middle and small shipping businesses. Here I'll talk about it in terms of indirect and direct financing channels.

4.3.1 Indirect financing

First, we'll start with indirect financing. Too much dependence on bank loans is not a wise practice. Some new financial institutions would be good alternatives to present more financing options for Chinese middle and small shipping businesses. In Zhejiang province of China, there came along an all-new private financing organization in shipping industry in 2004. It was called bonding company. It's kind of financial company devoted to serve small and medium-size shipping companies. Membership, exclusiveness are two remarkable characteristics of such bonding

company. The exclusiveness and membership ensure that the bonding company will never be exposed to high financial risk. Moreover, the bonding company successfully combined the reputation of government and market operation of banks together as well as lowered the risk of granting loans by banks. Because the bonding company played the role of intermediary between companies and banks, it can help resolve long-standing information asymmetry problem between them. As a result, banks would not so worry about loan risk. Private bonding company is really a good practice and most likely to have good prospect in China shipping industry in the future. Unfortunately, it hasn't been widely adopted yet across the country thanks to its immaturity and some potential risks. But, anyway, commercial banks should take various measures to inspire those bonding companies with good reputations to move forward. For example, they can use discriminative interest rate to deal with it.

Here I'll put forward my suggestion to improve that private bonding company. Multiple guarantors would be a good choice for it. The practical measures could vary with actual conditions of shipping companies. If a company need long-term loan or it has relatively less collaterals, bonding companies would have right to append more available and reliable guarantors and collaterals to its list in order to reduce the moral hazard of corporate borrowers. This practice will also decrease the risk and pressure of original guarantors.

4.3.2 Direct financing

Now, let's look at direct financing area. At present, China corporate bond market is less developed owing to numerous reasons. National enterprises are main issuers of corporate bond and the government act as their guarantor by using its reputation. What the government should do in the future is to lower the threshold of issuing corporate bond and stretch the scope of qualified issuers. Furthermore, the

government should set down specific criteria by which relevant departments would abide in approving corporate bond for middle and small shipping businesses. According to new criteria, corporate scale, financial status, reputation and orientation of use of funds (how to use the money raised from corporate bond) would be main concerns rather than the ownership of enterprises.

In fact, what China small and medium-sized shipping companies need most is long-term financing which can get rid of the pressure on reconstruction and reimbursement after M&A. Chinese middle and small shipping businesses are always short of enough cash flow. Besides, bond financing needs to pay back principal plus interest, while stock financing has no similar payback requirement. Therefore, stock financing would be a better choice for those middle and small shipping companies with prosperous future. Another reason that can persuade those promising shipping firms to adopt stock financing is that high rate of debts will hold back companies' further development especially in condition of less cash flow. The stock financing alternative is viable only if an efficient stock market is out there in China.

Fund would be another financing channel for Chinese small and medium-size shipping companies. In German, rich dentists inputted their savings into dental fund, and it in turn invested in shipping industry. Furthermore, German government gives a strong support to this kind of investment through favorable tax policy. It's a good inspiration for China to set up a similar fund so that a great amount of private idle cash can be raised to finance China shipping industry, especially middle and small private shipping companies. A cost-effective exit is indispensable for such fund. In addition to that, corresponding laws and regulations are prerequisite to safeguard the interest of private investors. Indeed, China Investment on Securities and Funds Law took effect on June 1st, 2004.

Apart from official financing channel, we can also exploit the opposite way, private capital market. The lack of enough protection and rigid regulations on private capital

market leads to less development of this special financial market.

Currently, most small Chinese shipping businesses get their capital from private bond and equity market. Raising funds through this way has fashioned a unique custom. The cost of private equity market is rather lower than that of official one, and it has liquidation to certain degree (the equity of private market is often traded in a small scope). Within such market, social capital (it is collected through special relationship and family members) played a critical role in guarantor mechanism. So, the government should take some actions to bring that private capital market on an effective and legal way rather than crack down on it or let it be.

All in all, China government should encourage financing innovations for middle and small shipping businesses and keep an appropriate rein on the financial system. The key to the financing problem facing by most small and medium-sized shipping enterprises is to develop more financing channels.

4.4 Erection of widespread modern corporate system

Modern corporate system is quite necessary for almost all Chinese shipping enterprises. The ideal modern corporate system is designed in this way: legal person is main body, limited liability is core, and this joint-stock enterprise has undisputable property right, well-defined responsibility delimitation, separation of governmental functions from enterprise management and advanced managerial approach. This kind of corporate system is very suitable for M&A, and it certainly will be the lever for shipping companies' future M&A activities. Modern corporate system means more than stock-holding system. It requires that a corporation should have clear property right, and decentralization of shareholding. In addition, Shareholders can claim their right through shareholders' meeting and the board of directors. The division of right and obligation among shareholders' meeting, the board of directors and managers is

based on contracts and regulations. Corporate entities have proprietary rights to all corporate assets, including receivables. Meanwhile, they also have civil rights and liabilities. Corporations with modern corporate system take additional responsibility to insure the increment of value of investment by investors. On shareholder's side, they can use their 'vote right' to influence decisions of management.

National shipping enterprises are always obsessed by property right problem, because assets ownership and executive assignment right are all held in central or local governments' firm grip. Modern corporate system is able to cure this long-standing headache thoroughly thanks to its independent ownership and human resource right.

Sadly, there are still quite number of Chinese shipping companies haven't adopted modern corporate system as yet. In order to popularize such superior corporate system, investment banks will play a critical role to assist it, because they can facilitate the process of erecting modern corporate system and give some useful advices on it.

Professional manager system comes along with modern corporate system. If professional manager system was applied in China shipping industry, masses of shipping companies would replace current HR systems for executives with recruiting qualified professional managers publicly. The chosen managers will work with motivation and entrustment. In consequence, those managers are running a shipping company for a clear economic goal rather than administrative instructions or personnel thought in most cases. Furthermore, we will see a lot M&As in China shipping sector because of driving by profit-orientation.

4.5 Improvement for China capital market

Generally speaking, large-sized Chinese state-owned shipping companies found it

easy to get finance from national banks. But now we have more medium and small private shipping businesses in the industry. And they have to find other alternatives to get finance, because commercial banks are pretty prudential to grant loans to such type of companies. In fact, national shipping companies will benefit the most from perfection of the capital market. First, they can reduce debt in their balance sheet and establish a profit-focused management/operation pattern. Secondly, they are forced to improve the effectiveness and efficiency of funds use under the requirement of investors.

Regarding financing function, capital market is not one and only. Banks can do the same thing in that area. But an efficient and healthy capital market can pave the way for the rapid development of those promising Chinese shipping firms, especially by means of M&A.

4.5.1 Equity market

Although China issued amended Security Law in August 2004, its coverage was still confined to stock and bond. It seems myopic to the construction of future China security market, because it didn't include any regulations on private placement¹³ and secondary equity offerings, etc. Secondary offering, a shareholders' resale plan, tends to provide a chance to solve the dispute amongst big shareholders before a coming M&A. Any one that is unconfident or suspicious about forthcoming M&A will sell his shares at that moment. In order to improve financing conditions in China stock market, we should take some measures as follows:

(1) Information disclosure system

A quick and accurate information disclosure system should be set up. At present, we are highly dependent on information disclosed by listed companies, of which

¹³ Private placement: Raising capital via private rather than public placement. The result is the sale of securities to a relatively small number of investors.

financial information is the main part. Sadly, there are not mandatory stipulations to make other information publicly known, such as market plane, policy information, and non-financial information of listed companies. Therefore, for the sake of a better information disclosure system, the government ought to require that listed companies should publicize information on their subsidiaries, forecast, social responsibility, relevant transaction, corporate management structure and other stuff in tight connection with investors' interest. In the meantime, the information of market plane must be sufficient, and policy information is supposed to be issued in timely and efficient manner. All of these will be achieved in the framework of legislation.

Meanwhile, rigorous supervision is needed to ensure that securities information is being disclosed in right and proper way. Currently, the job for monitoring securities information disclosure is mainly left in hands of governmental administrative departments. We might learn experience from foreign securities practitioners, the supervision functions of Securities Association of China, securities exchanges, and China Securities Regulatory Commission should be further identified and adjusted so that a complementary supervision system will be set up. In this new supervision system, China Securities Regulatory Commission will pay all his attention to clamping down on under-the-counter transactions and violations of securities information disclosure regulations. The core of securities exchanges' supervision is to make sure that listed companies comply with information disclosure regulations, and is in charge of daily information publicity. As for Securities Association of China, the main task of which is to set down internal self-discipline codes and penalize those members who violated the rules.

(2) Supervision mechanism

Supervision function of securities supervision institutions should be further strengthened. First and foremost, corporate management structure must be improved. Extensive modern corporate systems should be established as soon as possible. To

assess corporate management structure and publicize corresponding results regularly, dedicated evaluation institutions are supposed to be set up as well. Next, current dynamic supervision system need to be further improved. Considering that most supervision actions were taken after event, a real-time supervision system thus is essential for everyone who make a deal in stock market. This system can help avoid large-scale intensified punishing campaigns, because with this system supervision institutions are able to take actions in advance before things are getting worse. Furthermore, it can also alerts participants of stock market to their conduct, especially listed companies. In this case, those who have intent to make violations will be intimidated. Dynamic supervision system ought to be applied for information disclosure system as well. For example, a report system about insiders is probable to be taken into account. Finally, an effective responsibility investigation system should be established. In view of the fact that some insiders or holding shareholders control and scoop out some listed companies jointly. So, administrative means seems necessary to restrain and penalize such crime. If this sort of crime did happen, big shareholders and managers with great shares should bear unlimited liability, and the management of concerned companies will be indicted for both civil and criminal liability.

(3) Ownership right culture and sustainable development regime

Ownership right culture must be cultivated so that China stock market will ride on a highway. The foundation of this kind of culture is good faith. Corporate management should pay enough attention to shareholders' interest, and pursue the maximization of shareholders' interest. In addition, corporate management structure has much to do with such culture. For listed companies, the restraint imposed by the society, public shareholders, intermediaries, media and supervision institutions do account for this culture. Therefore, only if all of these restraints are independent and objective, ownership right culture is probable to be shaped.

Effective corporate restructuring and bankruptcy processes are the last straw for investors to protect their interest in civil law. If there are not such processes, corporations will be given a free rein in raising money regardless of what high the financing cost of equity is. In consequence, rational investors will lose confidence and will not invest in stock market any more. At present, there isn't a formal Corporate Bankruptcy Law in China. A great deal of precious funds has been wasted by trash companies in capital market. Therefore, the urgent affairs facing by China legislature is to enact a feasible and effective Corporate Bankruptcy Law.

Lastly, we want a long-term investment mechanism to ensure the stability of entire stock market. In America, people sell stocks based on their medium and long-term study on the market. If anyone speculates in stocks, he will be charged with unjust enrichment in most cases. Therefore, the mechanism like that is very useful for today's China stock market which is full of all kinds of speculation behaviors. The foundation for the setup of this mechanism is strict supervision system and perfect law protection.

4.5.2 Corporate bond

Strict supervision and information disclosure mechanism are also needed in China corporate bond market. In so doing, investors will be well protected and be more confident in investing in corporate bond.

Under the current situation of China financing market, corporate bond financing is more favorable for those corporations who just get into securities market. As of the end of February 2006, American corporations with high credit ratings have issued corporate bond worth 98.5 billion dollars ever since the starting of 2006, because there will be many M&A activities there in 2006. In sharp contrast to the fact of America, only 65.4 billion Yuan (roughly 8.16 billion dollars) was raised through

corporate bond in China in 2005.

Concerning China corporate bond, I have a couple of suggestions for it as well.

(1) Safeguard the interest of investors

In the first place, we should establish and promote bond sinking fund which is very popular in western countries. In order to guarantee due repayment, the corporation who issues bond will annually pay a portion of principal plus interest to bond trustee as bond sinking fund. Here the amount of annuity is decided in contract according to corporate credit ratings. So corporate sinking fund can reduce the risk and safeguard the interest of corporate bond investors.

Secondly, an impartial corporate credit rating system is critical to China bond market in the future. At the present time enterprises often interfere in credit ratings process in all manner of ways for the purpose of smooth issuing or higher issue price. Moreover, some government departments do the same thing as well. In this case, rating agencies are losing its independence and neutrality gradually, which in turn leads to the loss of investors owing to information asymmetry and inefficient capital allocation. Therefore, the staff and property of credit rating agencies should keep its independence so that they can get away from external impact. A complete scientific rating system is required to reflect the objectiveness of corporate bond credit rating process. As there is not generally accepted credit rating criterion and authoritative credit rating agencies in China, almost all corporate bond issues need guarantees. As a result, credit risk is shifted to bonding organizations. Only if all of things above have been resolved, a corporate bond market with credit grades will come along naturally.

Thirdly, I'll discuss intermediaries' supervision function. If we simply rely on dedicated supervision institutions exerting their supervision function on corporate bond market, it would be not enough. So, credit rating agencies, accounting firms, investment banks, those who are responsible for underwriting businesses should all

take part in supervision team. The world famous credit rating agencies like Standard & Poor's and Moodys Investor Service, their credit ratings are influencing investors across the border all the time. However, it's a different story in China. Credit ratings couldn't discriminate the quality of enterprises. Therefore, it's important for China to improve credit rating agencies and consolidate their position in supervision system. Since corporate accounting information is not so reliable that receivers couldn't make correct decisions or analysis on it, independent accounting firms seem to be critical in dealing with such issue. They would oversee the process of corporate financial data so as to give out credential corporate information. Investment banks are another supervision force to safeguard investors' interest. They can investigate into corporation condition before corporate bond issue, and they are capable of tracking the conditions of enterprises with their professional staff after issue.

Finally, a trustee system is necessary to protect dispersed individual investors' interest. More specifically, a corporation needs a trustee when it wants to issue corporate bond. In western countries, commercial banks or trust organs of investment banks often serve as trustees. Presently, in China, this task can be assigned to underwriters who are responsible for corporate bond issue. The relation between trustees and issuers is established according to the terms of contract. The trustee can claim the right on behalf of bond holders if issuers didn't fulfill their obligations.

(2) Extend corporate bond market, products and issue conditions

In China Security Law, the comprehension about securities market is restricted to security exchange; moreover, there are not any detailed clauses on OTC¹⁴ (over-the-counter) trading and OTC market. In reality, only national bond is traded in OTC market in China. In United States, OTC market is a main platform for the

¹⁴ OTC: A security which is not traded on an exchange, usually due to an inability to meet listing requirements. For such securities, broker/dealers negotiate directly with one another over computer networks and by phone. OTC stocks are usually very risky since they are the stocks that are not considered large or stable enough to trade on a major exchange. They also tend to trade infrequently, making the bid-ask spread larger. Also, research about these stocks is more difficult to obtain, also called unlisted.

transaction of corporate bond. Apart from corporate bond with high credit rating, the rest are all traded in OTC market there. The reason why so many American corporations prefer to OTC trading is not only the comparatively lower trading cost but the restricted access to security exchange. The participants of OTC market are made up of marketmakers as well as investors. The marketmakers are, actually, independent brokers who have sufficient operational funds. They compete with each other to find bond sellers and buyers under fair competition rule. Meanwhile, electronic communication network is a good assistant for marketmakers to find more investors.

The current audition policy for corporate bond issuing should be changed. We would replace present administrative examination with approving approach. At the same time, the restraint on the use of funds from corporate bond should be unleashed. Apart from propping up industrial development orientation designed by the government, the funds raised from corporate bond could be employed to adjust corporate debt structure and even conduct M&A activity, etc. What is more, issue volume, interest rate, maturity and the way pay back the capital plus interest need to be more flexible. For example, interest rate of corporate bond is supposed to be determined by corporate credit rating rather than government departments. Private placement is another feasible and promising means for Chinese medium and small-size shipping companies to issue corporate bond. In the real practice, we may make experiments with this new issue method so that a large-scale private placement campaign will be launched smoothly. For shipping enterprises, private placement can be arranged more easily than public placement.

Lastly, corporate bond products should to be broadened so that it can attract a wide variety of investors. For instance, we can try to issue coupon bond¹⁵ and warrant

¹⁵ A coupon bond is the same thing as a Bearer Bond. A bond that is unregistered and therefore payable to whomever is in physical possession. Coupons are affixed to the bond itself. The holder/owner of the bond sends in one of the coupons at a set time and receives an interest payment for the bond.

bond¹⁶ at the proper time. As the time goes on, floating-rate bond¹⁷ might be taken into consideration. In so doing, there would be diverse corporate bond products available on the corporate bond market, which in turn improve the liquidity of corporate bond on the whole.

4.6 Governmental influence

4.6.1 Function conversion of China government in M&A

Since China market economy is under the condition of imperfection, it's quite natural for China government to intervene in M&A events. But too much intervention will slowdown the normal process of such corporate strategic activity. Faced with increasing competition stress from foreign shipping companies, China government should draft an elaborate road map for domestic shipping industry and create a group of shipping enterprises with economic scale and core competence.

The role of the government is supposed to be an 'assistant' rather than a 'host'. He should put more effort into how to ameliorate current legal system on M&A and perfect China financing market. Besides, the government could use taxation and finance means to promote M&As in shipping industry. In foreign countries, their tax policies are equilibrium for both home shipping companies and overseas ones. In effect, these tax polices are a little bit favorable for home shipping companies to support their own shipping industry. However, on the one hand, China government gave ultra national treatment to foreign shipping companies. On the other hand, domestic shipping enterprises were levied high duty. Thus, there is a need for China government to create a fair-competition environment through imposing reasonable

¹⁶ Warrant bond is kind of debt securities that incorporate warrants, which give the holder the option to purchase equity in the issuer, its parent company, or another company during a predetermined period or on one particular date at a fixed contract price.

¹⁷ Floating-rate bond is a bond with variable interest rate.

duties on both sides regardless of the nationality of shipping enterprises. So and so only, everyone can compete on an equal basis, and then there will come up a great number of M&A activities in China shipping sector. What is more, in order to stimulate more domestic shipping corporations to participate into M&A, the central or local government should offer a short period tax-free preferential treatment for the new entity after M&A.

4.6.2 Protection and stabilization measures

Social security system is critical concern to China government. This system includes endowment insurance, Medicare and unemployment insurance, etc. A well-rounded social security system will lead to fewer backlashes from employees of two concerned parties in M&A. Now the government can draft overall social plan and set up individual account. In addition, social security fund should be substantially expanded by way of multiple raising-funds channels. Finally, in the future M&A Law, it will encompass some clauses on compensation for staffs' loss resulted from M&A activities.

When it comes to an M&A involving a private and a national shipping company, the worry about state property flow-away will pop up right away. Actually, such anxiety would be totally unnecessary, if there existed modern corporate system. Sadly, not all Chinese shipping companies have clear property right relationship at present. In accordance with the concept of modern corporate system, the new entity after M&A is a blend of shares. The profit and asset division of a corporation is based on the premise of shares owned by investors (nation of course is a member of investors). A professional managerial team is required to be built in national property administrative management institution. This team will be comprised of lawyers, professional managers and financial experts, and they are being accountable for

overall management of national property.

4.6.3 Cracking down on protectionism and violations

The central government ought to break or penalize local protectionism. For example, if an M&A was to take place across provincial boundary, it would be reported to related organs of Ministry of Communications rather than local government as it did previously. And then the organs will answer for all the things relative to that M&A. They also bear the duty to ensure that the entire M&A process is free from all kinds of external disruptions, especially from those local governments with vested interest in that M&A. If necessary, the officials of Ministry of Communications can wield legal weapons to punish the violations in M&A.

Besides, China government should strengthen its law execution and clamp down on corruption crime. Only through this way, masses of healthy M&As will appear in China shipping sector. Besides, in the future, China government ought to keep an eye on the number of M&A in shipping industry in case of overheated M&A activities. Because China is in the progress of reform, it is very probable that frauds would happen in the form of M&A, which would in turn substantially frustrate M&A intentions of shipping corporations. In this case, the government should use administrative and legal means to prevent such things from taking place. Moreover, the government departments are supposed to keep in tight touch with not only national financial institutions but non-national financial organizations so that the government can fulfill his duty more effectively and efficiently. ‘M&A between giants’ will be a trend in future Chinese shipping M&As. This M&A pattern can create desired shipping enterprises with economic scale and core competence. Here ‘giant’ refers to that is of certain kind of scale, good management structure, certain degree of market share, and fair financial condition. Thus, such M&A will be

vigorously supported by China government without doubt. But it doesn't mean we don't need other types of M&A at all, as long as they have economic sense.

4.6.4 New M&A environment and practice.

A healthy and fair-competition environment for Chinese middle and small private shipping businesses should be fostered with the help of the government. Under certain rational rules, the private shipping companies are supposed to share the same rights with national shipping enterprises in privilege, bank loans, taxation, and social security treatment, etc. That is to say, the government and relevant organizations should abolish old-fashioned discriminative treatment mechanism toward different types of shipping companies. The new criterion of treatment are based on the quality (various types of financial ratios), credit ratings published by independent authoritative agencies, capability of making profit and so forth. In so doing, Chinese private shipping firms will feel free to bring about a large-scale M&A wave in shipping sector.

With the preconditions above ready, an all-new M&A style for China shipping industry would come along. That is formally known as roll-up, which means that the combining of multiple small companies in the same industry to one large company. For a small privately owned shipping company, he can use roll-up as a way to accelerate its growth, and then go public. With roll-up method, a great number of Chinese small shipping companies stand chance to become a bigger one with little limitation to financing, because they will have more collateral in assets and more available guarantors. As a result, this is a method whereby a great deal of M&As will come up in China shipping sector.

5 Conclusions

The globalization led to a new wave of M&A in shipping industry in 2005, that year world shipping giants aimed at quicker expansion and bigger market share by way of mergers and acquisitions. In this recent round of M&A fever of shipping industry, some shipping enterprises hoped to consolidate and strengthen their core competence through M&A, others wanted to be sold at a good price at the heyday of global shipping sector.

In China shipping industry, two kinds of situations exist simultaneously. Some middle and large shipping companies are enjoying the benefits brought by the prosperity of global shipping industry in recent years; they want to take a big leap in the immediate future. Nonetheless, most Chinese medium and small-sized shipping companies are undergoing an unsatisfactory operation experience due to smaller scale and lack of core competence. What all Chinese shipping companies need to do is to carry out M&A to change or improve their current situation.

An effective M&A will give Chinese shipping companies various desired stuff. The financial synergy of M&A can provide a larger internal capital pool and much more collaterals for bank loans. The former means corporations will have more available cash flow than before after M&A. The operation synergy of M&A offers economy of scope and economy of scale. Here we are talking about related M&A, so the economy of scope refers to that a shipping firm extend its business into a relevant sector, such as logistics. In addition to that, the operation synergy can also help get

rid of overlapped businesses of concerned shipping enterprises. Increasing market share is the most, among others, concerned advantage brought by an M&A. Apart from that, other benefits from M&A encompass adding value to the brand of resulting shipping company, elimination of barriers on organizational learning, and building or boosting core competence of a company. The reason why Chinese shipping companies need cross-border M&A is that they can penetrate into alien shipping market at lower cost and quicker way compared with establishment for themselves.

Although there are so many advantages come along with a successful M&A, there are only a couple of mergers and acquisitions taking place in past a decade in China shipping industry. There are a variety of causes responsible for this phenomenon. On the whole, they can be classified into six big categories.

First, Chinese culture influence is one of them. It formed some mindset affecting CEOs of Chinese shipping corporations in making M&A decisions.

Next, China financing market is so imperfect that the financing of Chinese shipping enterprises was impacted. China stock went through a long period of bear market in last a couple of years, which severely affected normal financing function of the market. In China corporate bond market, it is virtually monopolized by Chinese big national enterprises. It's very unfair to other listed shipping companies who have intention to raise money through this way. As for bank loans, there existed a long-standing discrimination toward middle and small private shipping companies. In addition, high risk and unsatisfactory return added to difficulty of lending money by commercial banks. China investment banks are still in preliminary stage, they hence cannot fully engage in M&A business. The absence of a main M&A intermediary led to a few M&A activities in China shipping sector.

Thirdly, some kinds of governmental behaviors, such as local protectionism, prevented a large number of M&A from taking place in China shipping sector.

Fourthly, the incomplete China law system relative to M&A activity confused and frustrated shipping companies with M&A ideas. So far antitrust law hasn't been enacted, which is fundamental law in M&A law system.

Lastly, the flaws of shipping enterprises themselves were also responsible for a small number of M&A activities in China shipping sector.

In view of the fact I mentioned above, I therefore put forward my suggestions to the problem. They have six points too.

First of all, I gave some advices on China investment banks. If China investment banks can reach the level that foreign peers are, the headache about M&A process will be cured to a certain degree. In order to obtain that goal, China investment banks should be revamped thoroughly in respect of staff, correlative law or regulations, and positioning.

In the second place, a complete law system relative to M&A is needed in urgent. This law system is established on the foundation of Chinese own Anti-trust Law. The core of this law system is M&A Law, which will clarify all the details concerned with M&A. As a consequence, Chinese shipping corporations involved in M&A can follow it in a legal and right way.

In the third place, limited financing channel is a real M&A trouble facing by most Chinese shipping enterprises (small and middle shipping businesses constitute the majority of China shipping sector). So, we need to standardize and legalize existing dedicated financing channels for Chinese small and medium-sized shipping firms. The other solutions include corporate bond issue, going public, and investment fund.

In the fourth place, in order to improve China capital market, modern corporate system should be applied extensively. Besides, a rigid supervision system and a sound information disclosure system are the must for China capital market, because they can reduce and clamp down on any violations in the capital market. OTC market will be a good choice to complement current security exchanges in China corporate

bond market due to its lower cost and flexible access. Meanwhile, a variety of corporate bond products are needed so as to attract more investors.

Finally, China government should take action to stimulate more M&As in China shipping industry. Favorable tax policy, a perfect social security system, smash on local protectionism and firm enforcement of law are all the content that China government is supposed to do.

Here some of my advices on improving current M&A situation of China shipping industry would not be adopted for ever for some reasons. But the macroenvironment of M&A in China is moving toward a better level. For example, in May 8th 2006, Securities Issue Measures for Listed Companies was put into effect. It gives out a clear scheme to refinancing issue of listed companies.

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Appendices

Appendix 1 M&A concepts

The mergers are, actually, the grouping of two entities or more, to become stronger together by merging the resources. Acquisitions is defined when a firm buy another one and get the total control of the new entity constituted.

Most of the authors divide the process of acquisitions in two phases; these are the planning of the acquisition and the integration.

The phase of acquisition typically starts from the process of preparation and negotiation. The elaboration and the observation of the main motives of the firms are considered as the pre-acquisition phase. In this thesis the main motives of the firms are: financial synergies through low cost access to capital, operational synergies through economy of scope and scale, and market share through penetrating into a new or bigger related market. The phase of integration within post-acquisition is characterized by many operational and cultural changes. The changes relative to the operation start to appear when agreement is effective, which means as soon as the announcement of acquisition or merger is done.

A firm can undertake FDI in a host country in either one of two ways: greenfield investment in a new facility or acquiring or merging with an existing local firm. The local firm may be privately or state owned: privatizations involving foreign investors count as cross border M&As, which entails a change in the control of the merged or acquired firm. In a cross border merger, the assets and operation of the two firms belonging to two different countries are combined to establish a new legal entity. In a cross border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter. (United

Nations Conference on Trade and Development [UNCTAD], 2000, p. 99)

Mergers and acquisitions, which are likely the most to succeed, are often those, which involve related companies, i.e. sharing key fields, such as shipping service, similar or complementary objectives... The new performing profitability, generated by new competencies or additional activities, can constitute a significant source of creation of value in mergers and acquisitions. Thus, the goal of mergers is to obtain means for creating more wealth. The creation of value results from the combination of synergies, which reduce the costs and, from competing strategies, which involve the performances and the growth of the company.

Appendix 2 Horizontal and vertical integration

Horizontal integration is sort of the acquisition of addition business activities at the same level of the value chain. Horizontal growth can be achieved by external expansion through mergers and acquisitions of firms offering similar services. It often brought about benefits as follows:

- 1) Economies of scale — achieved by providing more of the same service, for example, by geographic expansion.
- 2) Economies of scope — achieved by sharing resources common to different service. Commonly referred to as ‘synergies’.
- 3) Increased market power — having the capability to input enough service resources
- 4) Reduction in the cost of international service by offering local resources to the local market.

Sometimes benefits can be gained through customer’s perception of linkages between services. For instance, in some cases synergies can be achieved by using the same brand to promote multiple services.

Everything has pros and cons, so does horizontal integration. Horizontal integration by acquisition of a competitor or a complimentary operator will increase a firm’s market share and market power. However, if the industry concentration of post-entity rises significantly then anti-trust issue may arise.

Vertical integration refers to that a firm expands into upstream or downstream activities. In other words, vertical integration intends to integrate businesses at different stages within the same line of operation. Vertical integration can have a significant impact on a business unit's position in its industry with respect to cost, supply chain integration, and external risk avoidance, the vertical scope of the firm is

an important consideration in corporate strategy.

The concept of vertical integration can be visualized using the value chain. Consider a firm whose service is about container shipping. Viewed within the context of vertical integration, the strategies of lines are related to terminal management, intermodal services and logistics services.

Appendix 3 Reasons for M&A

The financial synergy

Financial synergy refers to the impact of M&A on the cost of capital of the acquiring firm or the newly formed firm resulting from the mergers or acquisition.

The opportunities concerns the lower cost of capital due to larger company's size and the establishment of an internal capital market, which could be operated on superior information and more efficient capital allocation system. the new entity combines actually the financial resources of both companies in order to create an 'internal pool of capital'. The management of these resources would create positive synergies for two main reasons. First the financial resources can get around from one entity to another very easily, and the fluidity only depends on the willingness of the responsible manager, who decides when and whom can benefit from these resources. Secondly, the transaction costs to acquire these resources are very low compared the external market price. The internal market of financial market enable them to use the phenomenon of "cross-subsidization", it means the excess of cash of one entity can be use to finance the development of another entity in trouble. (Salter & Weinhold, 1979, pp. 204-223)

Financial synergies can also do a favor to existing small and medium-size shipping firms across China if they became larger by way of mergers or acquisitions. The typical example is that cost of capital can be reduced resulting from lower securities and transaction costs (Levy and Sarnat, 1970, pp. 668-675). Larger firms should be able to issue debt at a lower average interest cost and also lower average cost to issue the debt because registration fees, legal fees, and printing costs are spread over the firm's larger bond issue. Similar logic applied to issuing common equity.

Moreover, lower cost of capital; it will come out when a big shipping company absorbs a small one. There is asymmetric information in the credit market, implying that small or medium-size companies may not get into debt at their rate in an inefficient capital market. If small and medium-size shipping corporations are under takeover by public companies, such as COSCO SHIPPING CO, LTD, China Shipping Development Company Limited or something like that, they are able to get financing with new effective financial instruments and lower cost.

Table 3 shows the neoclassic arguments over financial synergies as motives for mergers and acquisitions.

Table 3 —Neoclassical arguments about financial synergy

Short-term financial synergies	Long-term financial synergies
i. EPS or PE ratio effect ii. Increase in liquidity iii. Tax effects	i. Increase of leverage capacity ii. More efficient capital use iii. Reduce indebtedness, reduce bankruptcy risk

Source: Diego ABELLÁN MARTÍNEZ (2004). *Mergers and acquisitions: a survey of motivations*. Unpublished doctorate thesis, Universidad Complutense Madrid, Madrid, Spain.

(1) Short-term financial synergies

- i) PE ratio, it is calculated using the stock price divided by the earnings per share (EPS) of a company. In Aswath Damodaran (2005, pp. 29-30), the stock price for acquirers will go up after acquisitions if they put earnings accretion¹⁸ front and center while doing acquisitions;
- ii) Another short-term financial synergy is about liquidity improvement. Companies may acquire excess cash from other companies through an M&A activity;

¹⁸ An accretive acquisition is one where the earnings per share of the acquiring firm will increase after the acquisition.

- iii) Tax shield is a legitimate source of financial synergy for the acquiring firm. For example, if the target firm has amounts of tax-loss carryforwards, an acquiring firm can take the advantage to reduce its tax. Moreover, if the target firm's assets are stated below its market value, the acquiring company may be allowed to "writeup" the assets and enjoy the depreciation tax over a period of years;
- (2) Long-term financial synergies
- i) Increase in debt (leverage) capacity will be seen after the consolidation because of more stable or predictable cash flows;
 - ii) More efficient capital use, this may include the ability to utilize capital in an cost-effective way;
 - iii) After an M&A, a company can enhance its financing capabilities by virtue of the stronger demonstrated profitability and collateral capability. In this sense, indebtedness and bankruptcy risk will be reduced significantly.

The operational synergy

Operational synergy refers to the bidders that acquire target from related business (Sudarsanam *et al.*, 1996, pp. 673-698). Relatedness of business refers to if the bidder and target are operating in the same industry with very high overlap in their principal activities. This variable is a proxy for potential economies of scale and scope and market power that will benefit the bidder after takeovers the target.

Operational synergies do not only concern direct available resources of the firm but also indirect and intangible resources. Here the operational synergies will be seen as a means to reduce the average unit transport cost of the goods for shipping enterprises. Operational synergies may come from combining operations of hitherto separate processes or from knowledge transfer (Porter, 1985, pp. 424-465). Nevertheless, both strategic synergies aim at reducing the cost of the involved

processes.

In case of related acquisition, both the bidding and the bided firms offer similar or substitutable service. The combination of each own resources will show up some sources of economies in term of intangible, tangible or financial resources: either they can be shared or lead to operational cutting (duplications...) or they are under-exploited until the acquiring firm uses them more efficiently.

The ability to exploit these new potential sources will actually determine the concrete gain of the merged activities. Several means are at disposal of the new entity:

- a) The experience effect or BCG's "learning curve" (Åman, 2001): the experience is an intangible asset, which is difficult to copy, and which can be used if the target firm has not reached the same level of practice. Vice versa, the bidding firm can learn it from its acquired or merged company if he lacks that sort of experience (local knowledge...).
- b) The specific know-how: one of the firms has developed core competencies, which can improve the administrative or technical management of under-exploited resources. (Gasmi, 1998)

Economy of scope and scale

(1) Economy of scope

According to Panzar & Willig (1981, pp. 268-272), the economy of scope represents the cost savings due to the combination of two or more service, where the service would be more expensive to provide independently. Economies of scope exist when for two firms X and Y; the cost of combined service is lower than the sum of the cost of each independent entity offering it. For example, a shipping enterprise extends their service to logistics by merging or acquiring a 3PL company.

(2) Economy of scale

There are economies of scale if the reduction of the unit transit cost in the new entity after M&A results from a raise of activity volume. They come from the advantages of more vessels available to delivery shipping service, or the spreading of the fixed costs on a larger volume of economic activities.

Developing market share

In this part, I'm going to develop the theory relative to the horizontal external growth impact on the bidder market share (new entity).

This impact has two distinct times: immediate effect on the acquisition and the medium and long-term effect. (Gasmi, 1998)

(1) Immediate effect on the acquisition

The market share growth results on the transfer of the market share from the target to the bidder. This increase corresponds to the mechanic effect of the horizontal external growth.

(2) Medium and long-term effect

The market share association permits to constitute an internal market of resources, which the potentialities are higher than the internal market of the bidder and the target, during the competitive time. Consequently, the internal market of the new entity offers more opportunities to develop together some strategies of the bidder and the target, as the decrease of the high costs (operational synergies), the differentiation and the domesticity. These strategies permit the new entity (bidder or/and target) to generate more market share (growth). In this case, the growth is not automatic (mechanic effect absence).

Other driving factors behind M&As

(1) Brand value, managerial experience and special reason

Brand name establishment and enhancement is an important consideration before mergers and acquisitions. No matter what two involved companies do to their brand names during the process of M&As (maybe they remain one of two brand names, also they can create a new name for the new entity), the value of that brand name adopted by the new entity or resulted company is more than the sum of those of previous two firms. Eventually, the increment of intangible value in respect of brand name adds to total market value of that new-born corporation.

Accepting the fact that the acquiring or acquired company has a more effective and performing managerial system – otherwise it would not launch an acquisition process - managerial synergies are realized when either of them possesses superior management abilities that will benefit the resulted company performance (Trautwein, 1990, pp. 283-295).

From this point of view on, the resulted firm can enjoy the better managerial system inherited from acquiring/acquired firm or both, we can thus conclude that skill and know-how synergy can be realized in this way.

Shleifer and Summers¹ suggest a number of other motives for mergers and acquisitions in which the shareholders/owners may gain at the expense of other stakeholders/owners. For example, some target firms may seek acquirers to escape financial problems or to break unfavorable contracts. Other firms may seek leveraged purchases of their targets to increase the surviving firms' risk-return profile at the expense of existing debt holders.

(2) Core competence and organizational learning

M&A is an ideal means to build corporate core competence. A shipping enterprise

¹ Shleifer & Summers (1988), Breach of Trust in Hostile Takeovers, in Auerbach (Eds.), Corporate takeovers: causes and consequences (pp. 120-144).

can overcome its weaknesses or strengthen its current competitive advantage by merging/acquiring another shipping enterprise which has desired sources in both physical and intangible competitive power. For example, in the case of China Shipping Group last year, what China Shipping Group is interested in CP Ships is target company's tremendous commercial fleet and shipping market of South America. The former precious source can bring China Shipping Group to world's top 5 ranking in the near future. The latter is exactly what China Shipping Group craved for, which can complement its weak position in South America market.

This kind of M&A enables a company with little core competence to acquire competitive advantage in cost-effective way. In addition, it can consolidate existing strong position of a company by obtaining a great amount of competitive resources from a target firm, or it amplify a company's current competitive power by spreading such power into a target firm.

The M&A strategy on the basis of core competence that helps merging/acquiring companies get competitive advantage and new development room will be the trend in China shipping sector.

In the view of organizational learning, M&A in essence is internalization of outside learning. More specially, by way of M&A, an enterprise absorbs a target company so as to control the administration of it, and then this enterprise digest acquired valuable knowledge and know-how. In this way, the efficiency of organizational learning will be improved compared with outside learning, which reflects in the following way:

- 1) M&A put two separate entities together to form an integrity one. The competitive relation between two enterprises disappears along the M&A, and trust between each other is intensified to a great extent. As a consequence, the barriers to organizational learning will vanish as well.
- 2) The nature of knowledge determines the difficult of copying from one party to another, which is one of main obstacles for outside learning. Corporate M&A

will solve it to a great degree by providing an effective inside channel.

Motivations for cross-border M&As

(1) Rapid access to proprietary assets and new markets

Apart from the general explanations of the paradigm, there are some specific motivating factors for firms choosing cross-border M&As as a vehicle for investment in foreign locations. Among others, speed and access to proprietary assets are particularly important.

Cross-border M&As are the fastest means for domestic large shipping firms to expand their service and markets internationally, when time is vital, markets internationally. When time is vital, takeover of or merger with an existing shipping firm in a new market with an established operation and service system is far more preferable to developing a new local operation and marketing network. For a latecomer to a market, cross-border M&As can provide a way to catch up rapidly. With the acceleration of globalization, enhanced competition, there are increasing pressures for firms to respond quickly to opportunities in the fast changing global economic environment. This is highlighted by the fast development of information and communication technology.

To access proprietary assets is another important motivation for firms to undertake cross-border M&As. Merging with or acquiring an existing company is the least-cost, and sometimes the only, way to acquire strategic assets, such as vessels, know-how, brand name, local operation permits, and customers' networks, because they are not available elsewhere and they take time to develop. Such assets may be crucial to increasing a firm's income-generating resources and capabilities (Dunning, 2000, pp. 163-190).

Although speed and access to proprietary assets are the main advantages of

cross-border M&As, other factors also affect the decision to undertake cross-border M&As, such as the search for new markets and for market power, efficiency gains through synergies, size, and financial motivations.

The search for new markets is a constant concern for Chinese large-scale shipping firms, because of intensive competition of domestic shipping market and weak competitiveness in themselves. Through cross-border M&As, shipping firms can quickly access new market opportunities. By taking over an existing company, the acquiring firm can immediately have access to the local network of customers. Cross-border M&As can also be motivated by the pursuit of market power.

(2) Efficiency , size and stock gains

Efficiency gains can be found through synergies in cross-border M&As. Synergies can be static or dynamic. Static synergies include the pooling of management resources, revenue enhancement by using each other's marketing and customers' networks, placing order on new vessels synergies, economies of scale in operation leading to cost reductions, and solving oversupply or shortfall of delivery capability on some routes. Dynamic synergies involve the matching of complementary resources and skills to enhance a firm's service capabilities and competitive power with long-term positive effects on market shares and profits.

Size is important in operations requiring economies of scale, large expenditures for vessels/shipping capability and the expansion of customers' networks. Large size can create financial, managerial and operational synergies that reduce the operational vulnerability of firms. Another advantage of size is that larger firms with multiple operations across geographical locations can have an advantage in the collection of new information about market.

There can be financial motives behind cross-border M&As. Stock prices do not always reflect the true value of a firm. Bad management, imperfections in the capital market and major exchange rate rearrangements may provide short-term capital gains

through acquiring an undervalued firm. This motivation is particularly important in the case of cross-border M&A and in those economies which have less developed capital markets, such as China.

(3) Changes of world regulations and capital markets

Changes in the policy and regulatory environment during the past decade have provided more space for international shipping service to expand. The important changes in policy and regulatory environment are the liberalization of FDI and trade regimes, privatization and the deregulation of various markets.

Cross-border M&As have been facilitated by changes in world capital markets. More specifically, the liberalization of capital markets since the mid-1980s had already greatly facilitated the growth of cross-border M&As, most industrial economies now have completely liberalized their capital accounts, with virtually unrestricted facilities for cross-border loans and credits, foreign currency deposits and portfolio investment. In some sense, Chinese shipping firms can benefit a lot from international capital market because a great deal of idle fund and more friendly investment environment are out there.