Week in China

# A record bid for America's top pork producer isn't quite as it first appears

"What I do is kill pigs and sell meat," Wan Long, chairman at Henan Shuanghui Development, told Century Weekly last year.

It's an admirably succinct job description for a man who has been lauded by China National Radio as the "Steve Jobs of Chinese butchery" (Jobs, a vegan, probably wouldn't have approved).

Starting out with a single processing factory in Luohe in Henan province, Shuanghui is now the largest meat producer in China, having benefited in recent years from a shift in the Chinese diet away from rice and vegetables towards more protein.

So the announcement that it is now making a bid for the world's largest hog producer, Smithfield Foods from Virginia in the US, prompted a flurry of headlines about the significance of the deal; its chances of getting security clearance from the Committee on Foreign Investment in the United States (CFIUS); and the broader implications for the meat trade in both countries if the takeover goes through.

Yet although Wan makes his profession sound like a simple one, Shuanghui's bid for Smithfield turns out to be rather more complicated than many first assumed. Far from a case of a Chinese firm swooping in on an American target, the takeover reflects more complex trends too, including some of the peculiarities of the Chinese capital markets.

**What first made headlines on the deal?**

Privately-owned Shuanghui International has bid $7.1 billion for Smithfield Foods (including taking on its debt) in what the media is widely presenting as the biggest acquisition yet by a Chinese company of a US firm.

Shuanghui has processing plants in 13 provinces in China and produces more than 2.7 million tonnes of meat each year. But the plan is now to add Smithfield's resources to the mix. "The acquisition provides Smithfield the opportunity to expand its offering of products to China through Shuanghui's distribution network," Wan announced. "Shuanghui will gain access to high-quality, competitively-priced and safe US products, as well as Smithfield's best practices and operational expertise."

**What's behind the move?**

Most analysts have chosen to focus on Shuanghui's desire to secure a more consistent supply of meat. Currently, it raises 400,000 of its own hogs a year, only a small share of the 11 million that it needs. That makes it reliant on other breeders in a country where the latest scare about contaminated meat is never far from the headlines. In the most recent case in March, the carcasses of thousands of pigs suddenly started floating down the Huangpu river upstream of Shanghai, after an outbreak of disease in nearby farms and a clampdown on the illicit sale of infected meat (see WiC186).

Now Shuanghui is said to be looking further afield to secure meat, and from a source that would allow it to differentiate its product range from that of its competitors.

"They're a major processor who wants to source consistent, large volumes of raw material. You want to look at the cheapest sources and in the US, we're very competitive," Joel Haggard from the US Meat Export Federation told Bloomberg. Average hog prices in China are currently about $2.08 per kilo or a third higher than in the United States, Haggard also suggested.

**How about changes in the industry in China?**

A second theory is that Shuanghui is developing a more integrated supply chain in China and wants Smithfield's help to complete the process.

This was something that C Larry Pope, chief executive at Smithfield, cited as a key factor in its willingness to pay a 31% premium for Smithfield stock. If so, that's something of an irony: Continental Grain, Smithfield's largest investor, has been pushing for a break up of the business to unlock more value for investors.

Still, an argument can be made that industry conditions are different in China, where the supply chain is shifting away from its reliance on more traditional household farming (the Mandarin character for "home" depicts a pig under a roof, for instance) to one in which large-scale, industrialised production begins to dominate.

Food safety concerns and the need to improve quality standards are also driving change across the industry. Yet despite signs of consolidation in hog breeding and slaughtering, integration across the full supply chain is a challenge. Shuanghui has already been trying to develop more of its own cold chain rather than rely on third parties (it operates seven private railways to transport its goods to 15 logistics centres, for instance, and has also invested in hundreds of its own retail outlets). But the Smithfield acquisition could help further with the integration effort, especially in areas such as adopting technology that tracks meat from farm to fork.

Paul Mariani, a director at agribusiness firm Variant Capital Advisors, told the Wall Street Journal last week that these systems have huge food safety benefits, allowing producers to track meat back to "where it was grown". By contrast, Chinese suppliers struggle to achieve the same level of control, especially for meat sourced from the large number of smaller, family-owned firms.

**How about in the US? Are Americans pleased with the deal?**

The bid has already been referred to CFIUS, the committee that reviews the national security implications of foreign investments in US firms. But Smithfield's Pope sounds confident, saying that he doesn't expect "any concern" from the regulatory committee.

"We're not exporting tanks and guns and cyber security," he told reporters. "These are pork chops."

All the same, the regulators will look at Smithfield's supply contracts with the military, as well as whether any of its farms and factories are close to sensitive locations, an issue that has led to transactions being blocked or amended in the past.

For instance, the Obama administration intervened in the purchase of four Oregon wind farms by a Chinese acquirer this year because they were too close to a naval base.

"There's a difference between a foreign company buying Boeing and one buying a hot dog stand," Jonathan Gafni, president of Compass Point Analytics, which specialises in security reviews of this type, told the New York Times. "But it depends on which corner the stand is on."

The committee will also look at whether Shuanghui could be in a position to disrupt the distribution of pork to American consumers. Indeed, Charles Grassley, the Republican Senator of

Iowa, has already urged regulators to look closely at whether the Chinese government has any influence on Shuanghui's management.

More ominously on Wednesday the chairwoman of the Senate's Agriculture Committee expressed her concerns. Debbie Stabenow said those federal agencies considering the merger must take into account "China's and Shuanghui's troubling track record in food safety". She further added that those agencies must "do everything in their power to ensure our national security and the health of our families is not jeopardised".

Despite such concerns, the food security argument looks limited in scope, although some of the Chinese newspapers don't expect the review to pass without issue. "Even the conspicuous absence of national security factors can hardly guarantee that US protectionists will not poke their noses into it," the China Daily suggested pointedly.

Back in Washington, Elizabeth Holmes, a lawyer working for the Center for Food Safety, has also called for regulators to consider the bid from the wider perspective of food safety. "They're supposed to identify and address any national security concerns that would arise," she warned. "I can't imagine how something like public health or environmental pollution couldn't be potentially construed as a national security concern."

The implication is that the takeover might damage Smithfield's operations in the United States in some way, even leading to contamination among its locally sold products. Hence the fact that Shuanghui was forced to recall meat tainted by the additive clenbuterol two years ago has been seized upon by the deal's critics.

Again, the Chinese media response has tended to be indignant, with widespread reference to Smithfield's own use of ractopamine, an additive similar to clenbuterol that's banned in hog rearing in China but not by authorities in the US.

According to Reuters, Smithfield has been trying to phase out its usage of the drug, presumably to clear the way for an increase in sales to China. And in response to American anxiety about food safety post-takeover at Smithfield, both parties have gone out of their way to reiterate that the goal is to export more American pork to the Chinese, and not vice versa. Smithfield's chief executive Pope has argued the case directly, citing the superiority of American meat. "People have this belief…that everything in America is made in China," he told reporters. "Open your refrigerator door, look inside. Nothing in there is made in China because American agriculture is the most competitive and efficient in the world."

Similarly, Shuanghui executives are insisting that nothing will change in how Smithfield serves up its sausages to American customers. The company will continue to be run on a standalone basis under its current management team, no facilities will be closed, no staff will be made redundant and no contracts will be renegotiated. Food safety standards will remain as today. "We want the business to stay the same, but better," Wan said.

**So it sounds like the Smithfield deal could turn out to be a major coup for the Chinese buyer?**

Not really, says Peter Fuhrman, chairman of China First Capital, a boutique investment bank and advisory firm based in Shenzhen. He thinks that much of the analysis of the bid for Smithfield has completely missed the point. That's because Shuanghui International – the entity making the offer – is a shell company based in the Cayman Islands. It isn't a Chinese firm at all, he says.

Shuanghui International also has majority control of Shuanghui Development, the Shenzhen-listed firm that runs the domestic meat business in China. But it is controlled itself by a group of investors led by the private equity firm CDH (based in China but heavily backed by Western money) and also featuring Goldman Sachs, Temasek Holdings from Singapore and Kerry Group.

The management at Shuanghui, led by Wan, holds a small stake in the new, offshore entity. But as

far as Fuhrman is concerned, Shuanghui International has no legal or operational connection to Shuanghui's domestic operations.

"If the deal goes through, Smithfield Foods and Shuanghui China will have a majority shareholder in common. But nothing else. They are as related as, for example, Burger King and Neiman Marcus were when both were part owned by buyout firm TPG. The profits and assets of one have no connection to the profits or assets of the other."

Of course, this raises questions about how the bid for Smithfield is being debated, especially its portrayal as the biggest takeover of a US firm by a Chinese one to date. It prompts queries too about the national security review underway in Washington, particularly any focus on the supposedly Chinese identity of the bidder. As it turns out, the Shuanghui bidding vehicle simply isn't constituted in the way that people like Senators Grassley and Stabenow seem to believe.

So what is going on? Fuhrman says the bid for Smithfield is actually a leveraged buyout, made during a period in which private equity firms have been prevented from exiting their investments in China by blockages in the IPO pipeline (see WiC176 for a fuller discussion on this).

Instead, the investors that own Shuanghui are borrowing billions of dollars from the Bank of China and others to fund their purchase, with Fuhrman noting speculation that the plan is to relist Smithfield at a premium in Hong Kong in two or three years time.

How Shuanghui International is going to meet the interest payments on its borrowings in the meantime is less clear. But one possibility is that it will lean on Shuanghui Development, the operator in the Chinese market, to share some of the financial load. That could be problematic, raising hackles at the China Securities Regulatory Commission. It also prompts questions about the potential conflicts of interest ("among the most fiendish I've ever seen," says Fuhrman) in the relationship between the investors that own Smithfield and the fuller group of shareholders at Shuanghai in China.

Ma Guangyuan, an economics blogger with more than half a million readers, takes a similar view. "If Shuanghui International acquires Smithfield Foods and sells the meat at high prices to

Shuanghui Development, this will increase profits for the privatised Smithfield, but may not do much to help Shuanghui Development," he predicts.

A further possibility is that having to service the LBO debt could curtail much of the investment envisaged by those who see the Smithfield purchase as a game-changing move for the industry.

Of course, if it all goes to plan, the bid for Smithfield might turn out to be a game-changer for a small group of highly leveraged investors.

But the jury must still be out on whether it will be quite so transformational for China's domestic meat industry at large.

http://www.weekinchina.com/2013/06/one-little-piggy-comes-to-market/