

# Private equity in China

Thinking global, acting local





# Foreword

More than two decades after establishing itself as the “world’s factory,” China is once again in the midst of a remarkable transformation. Years of investment in heavy industry, infrastructure and an export-led economic model have laid the foundation for the next phase in China’s extraordinary growth story – the rise of the consumer. With per capita income rising, traditionally high savings rates are poised to give way to increasing domestic demand for a vast array of goods and services.

China’s unprecedented economic expansion in a historically short period of time, combined with significant near-term upside potential, is attracting private equity (PE) firms in search of growth rates and opportunities that are largely unavailable in more developed economies. Over the last several years, dozens of globally active firms have been steadily increasing their presence in China, driven by greater regulatory openness and the expectation that PE opportunities will rise concurrently with China’s economy.

Despite the ongoing influx of new funds and increasing deal flow, China remains in many ways a blank slate regarding PE. Overall PE penetration remains extremely low relative to most developed economies. The most recent figures from EMPEA, the Emerging Markets Private Equity Association, suggest that PE investment amounts to just 0.16% of GDP in China,

compared with 0.9% in the US and 1.13% in the UK. PE penetration is low even relative to many other developing economies – less than half of its BRIC counterpart India, for example, and likewise less for Israel<sup>1</sup>. That PE plays such a limited role in such a substantial and rapidly growing economy provides the industry with a substantial set of opportunities with which to work.

Of course, investors’ desire for inroads to the Chinese market would mean little without the increasing willingness of local regulators to work with PE. Authorities are working actively to create and promote a domestic pool of capital comprised of pension funds, provincial governments, insurance companies and other institutional investors that are interested in taking an active role in shaping the China of the next century.

In this report, we examine the current trends at work in China’s burgeoning PE market – new funds being raised, profiles of PE deals, the evolving regulatory landscape and the gradual opening of a vast new market for the PE asset class.

<sup>1</sup> “Private equity penetration FY2010,” Emerging Markets Private Equity Association. 14 February 2011.



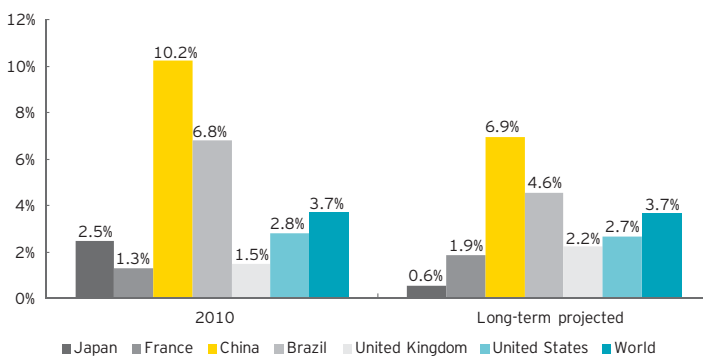
# Economic overview

## Growth rates set to outpace global averages for foreseeable future

Just a decade ago, China's economy was the seventh largest in the world. While most developed nations have experienced moderate to sluggish growth over the last 10 years, China has grown at a staggering rate, averaging more than 9% over the last 20 years, recently superseding Japan to become the world's second-largest economy. China's share in world trade has increased nearly tenfold over the last three decades, to about 9%, while its share in world GDP has risen to 13% from less than 3% (purchasing power-parity basis)<sup>2</sup>. Many economists project China could overtake the US within the next 20 years.

It's no secret that the means through which China is achieving this tremendous transformation are an export-led economy founded upon manufacturing expertise and a deep pool of labor operating at a cost advantage relative to developed markets. These factors have laid the foundation for the emergence of a new consumer class more than a billion strong, which, at current growth trajectories, could easily surpass the Japanese to become the world's second-largest consumer market sometime within the next 10 years.

**Figure 1: Real GDP growth projected to significantly outpace other economies**



Source: Global Insight; Long-term projected growth rates 2014-through 2030

<sup>2</sup> Vivek Arora and Athanasios Vamvakidis, "Gauging China's Influence," Finance & Development, December 2010, Vol. 47, No. 4, IMF website, <http://www.imf.org/external/pubs/ft/fandd/2010/12/arora.htm>, accessed 15 March 2011.

China's resilience in the face of the global downturn is one of the key differentiators between it and developed economies. The country rebounded quickly from the recent global financial crisis, with growth rates averaging more than 8% in the six quarters following the financial crisis – and is expected to continue at this approximate pace over the next five years. While growth is projected to moderate over the mid to long term, China's GDP is nonetheless expected to significantly outpace that of leading developed nations for the foreseeable future.

Managing this rapid growth is in fact one of the key challenges facing China's leadership. The country is approaching a critical juncture, attempting to balance the need for continued growth with concerns about inflation. To that end, China has undertaken a series of actions to tighten the country's monetary policy, including increasing banks' reserve ratios and raising interest rates. China's central bank has indicated that more such actions would be forthcoming in 2011, even as Western economies continue to roll out additional stimulus packages.

## Expanding consumer markets and an increasingly favorable regulatory environment driving growth

China's increasingly welcome stance to foreign investment is driven by a confluence of seven key dynamics unique in the nation's history. Although risks still remain, especially around the impact of softened exports, the specter of stimulus-driven inflation, and an increase in competitive manufacturing costs, the fundamental factors driving China's long-term growth story should remain intact.

### 1. Favorable demographics

Much of China's population of 1.3 billion is entering prime working years, as evidenced by the country's declining dependency ratio, a measure showing the ratio of dependents (aged 0-14 and over the age of 65) to the total working population (aged 15-64). From approximately 50% in the early 1990s, the ratio has steadily declined to less than 40% currently, and is not expected to rise until at least 2015<sup>3</sup>.

<sup>3</sup> "Views from the Bund: China Equity Strategy and Economics," JPMorgan, 10 June 2010, via Thomson Research.

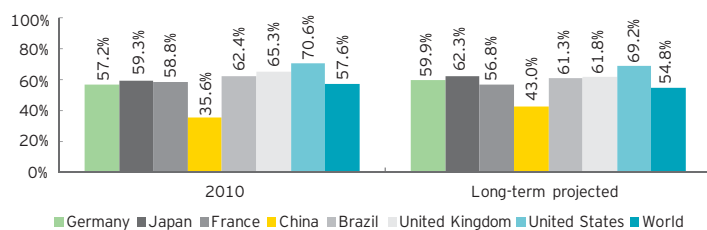
# Economic overview

“The country is approaching a critical juncture, attempting to balance the need for continued growth with concerns about inflation”

## 2. Future shift aimed for a consumption-driven economy

China's high savings rate has been an historical hurdle for companies seeking to do business with Chinese customers. As per capita income rises – tenfold since 1990 – and consumers have increasing amounts of discretionary income, China's private consumption rate is expected to grow from 35% of GDP closer to other Asian economies at around 50%-60%, giving rise to an entirely new class of consumers<sup>4</sup>.

Figure 2: China's consumption advances while others retreat



Source: Global Insight

## 3. Continued reforms

China's strong central government has a history of robust economic planning and execution of necessary economic reforms. China's 12th five-year plan has highlighted key economic and social development targets and greater emphasis on household income growth with the aim of boosting consumer demand. The 12th five-year plan should provide useful guidance for PE firms seeking to invest in China.

## 4. Rural development

Some of China's most exciting opportunities are to be found far from the more densely populated coastal regions. Rapid urbanization and government stimulus designed to advance rural development are leading to opportunities for investment in the inland regions – everything from infrastructure and agriculture, to consumer products. Over the last 20 years, rural households have

4 “The spend is high,” *The Economist*, 1 August 2009, via Dow Jones Factiva, © The Economist Newspaper Limited, London 2009.

faced a steady decline in their importance to the Chinese economy, and are now working to catch up with their urban counterparts in terms of ownership of household and other durable goods.

## 5. Economic stability and low government debt

With prudent fiscal and monetary policies and a strong balance sheet at the country, household and consumer level, China has been able to withstand economic shocks far better than most economies. Total government debt remains below 50% of GDP, well below the ratios of many developed countries, where debt ratios above 60% are common. China's household debt burden is also well below that of developed economies – the household debt/GDP ratio at the end of 2009 was 24% in China, versus 88% in the US and 65% in Japan<sup>5</sup>.

## 6. Foreign investment

China is attracting record quantities of foreign investment from companies that consider it mandatory to be involved in the region. In 2009, China attracted US\$105.7bn of foreign direct investment<sup>6</sup>. More than 450 of the world's top 500 companies have a presence in China<sup>7</sup>.

## 7. Capital markets

China has been working diligently to inspire investor confidence by enabling a broader range of exit opportunities. The last several years have marked the emergence of China as a serious player in global capital markets. A key example is the launch of ChiNext in late 2009 to compete with Nasdaq, London's AIM and Hong Kong's GEM for the listings for smaller start-ups. China closed out 2010 as the global leader in new equity issuance<sup>8</sup>.

5 “Views from the Bund: China Equity Strategy and Economics,” JPMorgan, 10 June 2010, via Thomson Research.

6 “China's annual FDI hits record 105 bln USD,” Xinhua News Agency, 18 January 2011, via Dow Jones Factiva © 2011 Xinhua News Agency.

7 *Cross-border transactions in emerging markets – Spotlight on China*, Ernst & Young, 2007.

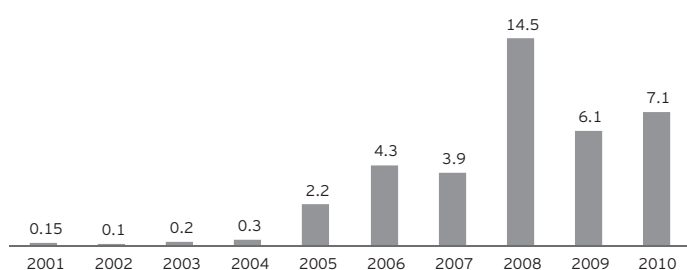
8 *Global IPO trends 2011*, Ernst & Young, 2011.

# Fund-raising

## A record year for PE in China

The last 10 years have seen more than US\$35b of funds raised by PE firms targeting investments in China, the vast majority of which has been collected over the last five years. Interest began rising dramatically in 2005, when fund-raising jumped from US\$200-US\$300m per year to more than US\$2.2b, an increase of over 600%. In 2008, fund-raising hit a near-term peak of US\$14.5b before declining in line with global trends. Fund-raising recovered in 2010, when approximately US\$7.1b was raised by funds seeking to capitalize on China's remarkable continuing growth story.

**Figure 3: China-focused fund-raising 2001-10 (annualized in US\$ billions)**



Source: EMPEA; excludes state-sponsored industrial funds

## Early years dominated by global PE funds

Until very recently, fund-raising for China-targeted activity was dominated by the global PE firms, which saw the emerging economies of Asia, and especially India and China, as the next frontier for PE. Global firms, including CVC Capital, The Carlyle Group, JP Morgan, and TPG-affiliated Newbridge Capital, all raised China-focused funds with commitments in excess of US\$1b between 2005 and 2006. Many of these early entrants achieved outstanding returns in their initial foray into the market, fueling additional interest by the global PE community. For example, Morgan Stanley and Goldman Sachs both realized significant gains when they sold their

combined 9.9% stake in Ping An Insurance for US\$1b in 2005, after an initial investment of just US\$70m. In another Morgan Stanley deal, the firm, along with co-investors Actis and CDH Investments, earned more than five times their investment in China Mengniu Dairy Company after it listed on the Hong Kong Stock Exchange in 2004.

One of the key enablers for the rapid rise in fund-raising activity that began in 2005 was the steadily improving prospects for a successful exit. The record IPO of Baidu.com in a 2005 US listing was in many ways a watershed moment for PE players active and interested in China, and served to increase awareness of the opportunities present in Chinese companies among global PE firms and institutional LPs.

Another important dynamic behind the growing attractiveness of China-focused funds was the increasing comfort level of regulatory authorities with the PE model, which led to increasing flexibility in transactions involving state-owned companies. For example, in 2004, TPG-affiliated Newbridge Capital acquired an 18% stake in Shenzhen Development Bank in a first-of-its-kind deal which passed effective control of a mainland China bank into the hands of a foreign entity.

While global funds accounted for the bulk of China's early fund-raising, several domestic funds founded by local investment bankers also attracted interest among foreign investors. CDH Investments booked commitments for several of its China-focused PE funds from investors including 3i Group, the Government of Singapore Investment Corporation, and fund-of-funds manager Asia Alternatives. Similarly, Hony Capital has raised funds from investors including Goldman Sachs, Stanford University and the Bill and Melinda Gates Foundation. As the industry matures and further embeds itself in the country's economy and transaction environment, domestic players are becoming an increasingly important part of the China PE landscape.

# Fund-raising

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## Rise of the renminbi fund and the domestic LP

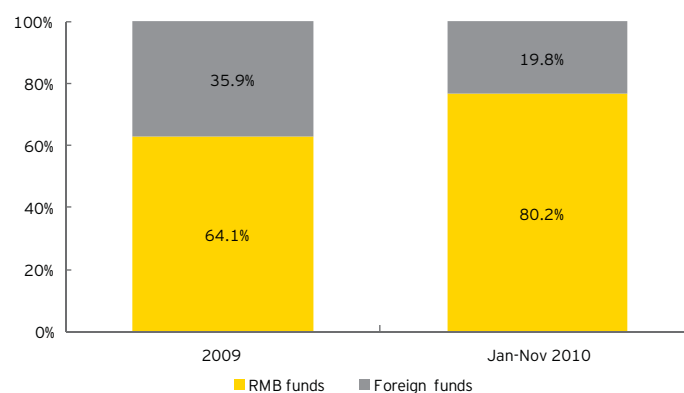
While fund-raising prior to 2008 was dominated largely by global firms with US dollar-denominated funds, the last two years have seen a dramatic shift in the China fund-raising market with the rise of renminbi-denominated funds (also called yuan-denominated funds). Traditionally accounting for just a sliver of the overall fund-raising market, these funds now represent a significant and growing force in China, representing a remarkable 64% of overall commitments in 2009, and 80.2% of total commitments through the bulk of 2010, according to *Asia Private Equity Review*.

The rapid emergence of China's local market is due largely to increasing government support and a growing regulatory framework in support of domestic activity. Regulatory authorities are currently in the midst of creating a vast new pool of capital for PE investment, approving dozens of institutional investors, including provincial government institutions, pension funds, insurance companies and others. These investors, flush with cash and in search of diversification, are seeking aggressive risk/return profiles to counterbalance holdings heavy in sovereign debt and cash.

In 2008, regulatory authorities provided approval to China's national pension fund, the National Social Security Fund (NSSF), to invest up to 10% of its assets in yuan-denominated PE funds and government-backed industrial investment funds. Given that the NSSF currently has more than RMB850b (US\$129b) of assets under management, this action alone has created significant fund-raising opportunities for PE firms<sup>9</sup>. Already, the pension fund has invested substantially in several large yuan funds, including Beijing-based CITIC Private Equity Funds Management, which raised RMB9b (US\$1.3b) for one of the largest yuan-denominated PE funds raised to date. The NSSF was the single largest investor in the fund, and was also the largest investor in three other domestic funds.

<sup>9</sup> “China pension fund says to hit 1.5 trillion yuan by 2015,” Reuters News, 8 March 2011, © Reuters Limited.

Figure 4: Yuan-denominated versus US-dollar fund-raising, 2009 and H12010



Source: *Asia Private Equity Review*

Other sources of new capital for China's PE funds include the country's securities and insurance firms. In 2007, regulators lifted a ban restricting Chinese securities firms from investing in private companies. As a result, several domestic brokerages have begun tapping the expanding pool of wealthy Chinese individuals to raise their own yuan-denominated funds. China's growing insurance industry is another new source of funds. In August 2010, regulators approved allocations of as much as 5% of insurance companies' assets to PE investments, creating a potential pool of US\$30b in capital virtually overnight.

Industrial funds represent yet another avenue for growth in the China market. Industrial funds generally focus on a particular industry, and are typically funded by provincial governments and state-owned enterprises. 2006 saw the first of these funds raised when the Bohai Industrial fund netted RMB6b (US\$750m) from several government-sponsored entities, including the Tianjin government, China Development Bank, China Life Insurance and the NSSF. Just three years later, more than 40 industrial funds had been raised, covering a broad spectrum of industries – from manufacturing to technology. Industrial funds now represent a significant portion of the yuan-denominated landscape, and their influence is poised to grow in the coming years.



# Fund-raising (contd)

Figure 5: Selected recent funds raised

Fund	Vintage	Type	Amount (RMB)	Amount (US\$ million)
Mount Kellett Fund I	2009	Buyout	17,075	2,500
CDH China Fund IV	2010	Buyout	9,951	1,457
CITIC Mianyang Private Equity Fund	2010	Buyout	9,000	1,317
Carlyle Asia Growth Partners IV	2009	Expansion	7,103	1,040
CITIC Capital China Partners II	2009	Buyout	6,317	925
New Horizon Capital Fund III	2009	Expansion	5,122	750
Capital Today China Growth Fund II	2010	Expansion	2,732	400
CID Greater China Venture Capital Fund III	2009	Venture (General)	2,732	400

Source : Preqin : Ernst & Young research

## Dynamics of yuan-denominated PE funds

Yuan-denominated fund-raising has become common in the China market with good reason – the regulatory framework clearly favors RMB funds over funds denominated in the US dollar or any other currency. Among the advantages: funds can be raised from the local investors, which broadens the potential investor base; yuan-denominated funds are not confined to foreign exchange controls affecting foreign funds; and, perhaps most importantly, transactions can be executed far more quickly than they can with foreign funds, which require levels of regulatory approval that far exceed domestic investors. Moreover, domestic PE funds enjoy a wider range of investment opportunities relative to their foreign counterparts, including the ability to invest in sensitive industries such as defense and media, which are off limits to foreign investors.

Unlike dollar-denominated funds, however, yuan funds at present have particular structural issues that could eventually offset some of their advantages, especially among the international LP community. Chief among these issues is a possibility that a significant percentage, if not all, of the capital committed to the fund is drawn down at the start of the investment period. This is in sharp contrast to Western-style funds, where commitments are generally called as capital is invested over a period of several years. While regulators have not yet specified the initial capital draw downs, local investors are optimistic that regulators will allow some flexibility. Any requirements for large initial draw downs

could place an enormous amount of pressure on GPs to invest at a faster pace than has traditionally occurred.

One of the key dynamics currently at work in the China fund-raising market is the raising of yuan-denominated funds by global PE firms, which are increasingly working with Chinese regulators to raise and manage funds in the local currency. Firms including The Blackstone Group, which raised RMB5b (US\$736m) for its maiden RMB-denominated fund in 2010, The Carlyle Group, which raised the equivalent of US\$350m for the first closing of its RMB5b PE fund, and TPG, which recently announced two RMB-denominated funds of RMB5b (US\$736m) each, are now competing with China's burgeoning domestic industry for investors' capital.

These funds, as well as established funds by existing domestic managers, may get a fund-raising boost in the coming months as regulators provide clarity on the proposed Qualified Foreign Limited Partner (QFLP) program. The QFLP program would allow foreign LPs to convert foreign assets to renminbi for the purpose of investing in yuan-denominated PE funds. Under the proposed guidelines, Shanghai, Beijing and Tianjin would each be allocated a quota of foreign assets to be converted. Foreign LPs would be subject to restrictions in the amount which could be invested in a single fund, and would need to meet certain qualifications. Nonetheless, the regulations represent a step in the right direction in terms of getting foreign LPs involved in the domestic fund market.



## The rush to renminbi

Global PE firms are racing to announce new yuan-denominated fund-raising:

- ▶ August 2010 – TPG launches dual RMB5b (US\$740m) funds in Shanghai and Chongqing
- ▶ July 2010 – DT Capital Partners, affiliated with US-based Madrone Capital, raises RMB1.5b
- ▶ February 2010 – The Carlyle Group partners with China's Fosun Group to launch a US\$100m-equivalent RMB fund
- ▶ January 2010 – The Carlyle Group launches RMB5b (US\$740m) fund with the Beijing Municipal Government
- ▶ August 2009 – The Blackstone Group launches RMB5b (US\$740m) fund with the Shanghai Government
- ▶ Other global firms reportedly planning to launch RMB-denominated funds: 3i, KKR, Warburg Pincus and Bain Capital

Source: Preqin : Ernst & Young research

## Outlook favors continued growth

China currently occupies a unique position in the global PE fund-raising markets. With the emergence of yuan-denominated funds, China has ensured that PE fund-raising is to some extent insulated from larger global trends. With a pool of available capital that is growing exponentially and an economy projecting solid upward growth, China's market has defied global trends and made significant advancements in the face of an overall lackluster global fund-raising situation. Nevertheless, despite the recent rise and relative advantage of yuan-denominated funds over the last two years, the dollar-denominated funds will still remain a key part of the China market.

As global investors remain interested in China, many expect that we will soon reach a time when both yuan- and dollar-denominated PE funds are competing for PE deals. Indeed, some investors already report that such competition for deals is rapidly heating up. Some of the firms most affected are those with both dollar and yuan-denominated funds, which must be sensitive to the needs of both global and local constituencies in allocating deals. Ultimately, increased competition amongst PE firms in China means that as more funds flow into the asset class, they will be increasingly challenged to compete for deal flow based on the less tangible aspects of their value proposition – their experience in a particular industry, their networks of connections and their proposals to achieve growth.

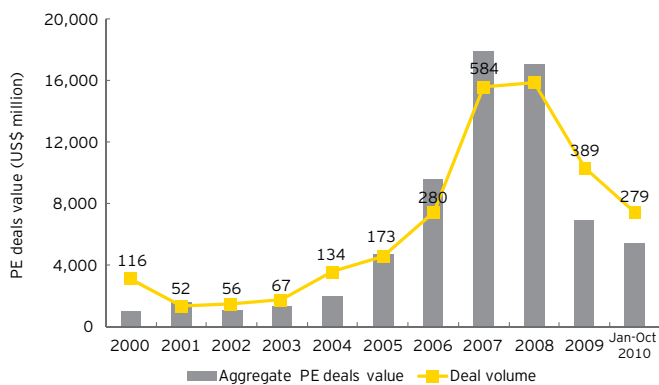


# Transactions

## Transactions rise markedly

Consistent with the growth in China-focused fund-raising, PE transactions have increased markedly in the last several years, and continue to rise as new capital enters the market and regulators become increasingly comfortable with PE. Over the 2000-10 time frame, transactions grew at an annualized rate of 53%, from between US\$1b and US\$2b per year to a peak of nearly US\$18b in 2007, making the cumulative value of PE deals over the last decade more than US\$70.6b. While activity in 2009 and 2010 has moderated, the increasing interest of global PE firms in the China market and strong fund-raising among domestic entities reflects substantial optimism for the next decade.

**Figure 6: PE transactions in China 2000-10**



Source: Thomson Reuters

While deal sizes have slowly trended higher over time, China's PE market remains dominated by small and mid-market transactions – deals less than US\$20m have accounted for more than 70% of total value over the last decade, while mid-market deals

(US\$20m-US\$100m) and large deals (US\$100m and up) accounted for just 24% and 5% of the overall market respectively. Structural limitations on large deals – namely, regulators' aversion to majority-stake transactions, especially in sensitive industries – are a key concern in China. Having raised significant commitments from LPs anxious to share in China's evolution, the relative difficulty of deploying significant amounts of capital in high-quality deals, and the resources needed to do so, remains one of the limiting factors in China's PE growth story.

## Pre-IPO investments drive large deals

While smaller deals prevail, one way PE investors have been able to deploy substantial amounts of capital is through pre-IPO investment strategies. For companies with public listings in their future, PE firms can provide the capital and expertise required to present the company in the best way possible to public market investors.

Pre-IPO investments can accelerate companies' expansion plans, solidify strategic planning, increase revenues, improve margins and prove to investors that companies can operate at the level required of publicly listed institutions. One example is Blackstone's investment in China Shouguang Agricultural Products. In March 2010, the firm led a consortium that included Warburg Pincus, Atlantis Investment Management, and Capital International that invested US\$600m into the company in exchange for a 30% stake. The company operates in the transportation logistics space, which is defined by widely disbursed transportation hubs scattered throughout China – investment in logistics could reduce the country's chronically high agricultural transportation costs. The company could execute a listing in Hong Kong as early as the second quarter of 2011, raising US\$1b.

# Transactions

“PE firms can provide the capital and expertise required to present a pre-IPO company in the best way possible to public market investors”

## Cornerstone investments

In addition to providing capital and experience, pre-IPO investments can provide companies with an important source of credibility, which is essential in attracting local and international investors. Over the last several years, PE has played such a role for some of China's most important institutions.

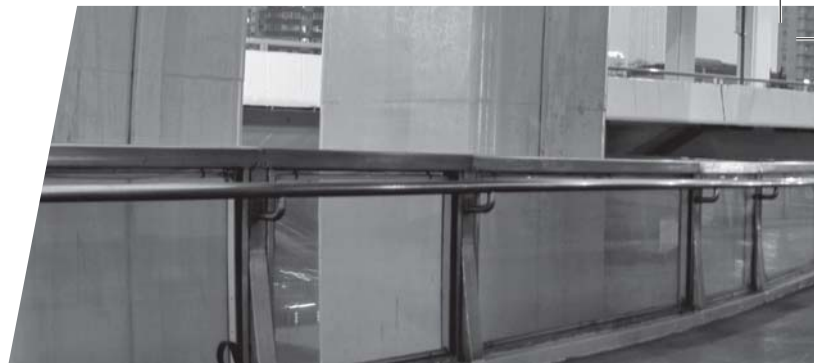
In the financial sector in particular, significant structural changes in the Chinese market drove several substantial and reportedly lucrative investments in China's large banks, where PE firms and other financial sponsors made cornerstone investments ahead of

some of the largest IPOs in history. Among these was a US\$3.78b investment in Industrial and Commercial Bank of China (ICBC) by a consortium of investors including Goldman Sachs, American Express and others. ICBC is the world's largest lender by market value, with approximate total assets of RMB11.8t (US\$1.74t). Goldman Sachs reportedly acquired a 4.9% stake in the company ahead of its October 2006 IPO, which raised US\$16.1b. Goldman Sachs divested portions of its stake in May 2009 and September 2010 for a substantial premium over the firms' entry price.

**Figure 7: Top announced deals 2005-10; largest transactions driven by global firms**

Company name	Date	Investors	PE deal value (US\$ million)	Sectors
Industrial and Commercial Bank of China	4/28/2006	Goldman, Sachs & Co., American Express and others	3,780.0	Financial Services
China Everbright Bank Co., Ltd.	11/27/2007	China Safe Investments	2,707.5	Financial Services
Beijing-Shanghai High-Speed Railway Corporation	12/27/2007	Ping An Insurance and others	2,190.1	Railways
Honiton Energy Holdings, Ltd.	7/7/2008	Arcapita and others	2,000.0	Industrial/Energy
Bank of China, Ltd.	2/17/2006	Temasek Holdings Pvt., Ltd.	1,520.0	Financial Services
Shanxi Coal Logistics Holding Co., Ltd.	9/16/2008	Shanxi Energy Industrial Fund	1,462.2	Industrial/Energy
Belle International Holdings, Ltd.	5/23/2007	Morgan Stanley and others	1,106.9	Consumer related
Ting Hsin International Group	11/19/2008	ITOCHU Finance Corporation	731.4	Consumer related
Bank of China, Ltd.	1/16/2009	Hopu Investment Management	700	Financial Services
Rightway Real Estate Development	1/14/2008	DLJ Capital Partners	700	Real Estate

Source: Thomson Reuters



# Transactions (contd)

## Landmark TPG investment

TPG's 2004 investment in Shenzhen Development Bank was another successful investment in financial services, and represented a landmark transaction in that it was the first time that a foreign investor had a controlling interest in a mainland bank. TPG implemented strategic improvements which ultimately helped the institution to triple its assets and reduce its underperforming loan ratio from double digits to less than 1%. As noted, TPG's control stake was the exception to the rule, as PE firms have found that achieving control stakes in Chinese companies can be exceedingly difficult, and minority stake investments remain far more common.

## Reinventing the model – what defines success?

China plays host to a unique set of dynamics that have necessitated a reimagining of the traditional PE model by investors in the region – with the doors largely closed on large-scale buyouts, PE firms play a very different role in China than they do in the West. In sharp contrast to transactions predicated at least in part upon re-engineering a balance sheet, the vast majority of transactions in China are minority stake investments where PE works in partnership with majority owners to leverage PE's significant experience in effecting operational improvements and implementing new strategic initiatives. This process of enhancing governance in companies that have been operating with varying degrees of formality for decades requires significantly more time and energy on the part of PE firms, but the upside is significant. While the market is rapidly evolving, key components marking successful investments include:

## 1. Comfort with shared control

Perhaps the most important characteristic for firms investing in the Chinese market is comfort with the non-control stake ownership model. In contrast to most deals in the developed markets, PE firms operating in China must work closely with owners and other key stakeholders to ensure that interests are properly aligned and that all parties are actively working toward the same goals. This extends not only to operational milestones, but to the understanding that, at some point in the future, the desired outcome is a successful liquidity event for the GP. As such, pre-investment discussions can take a significant amount of time – often years. Risks associated with minority stakes can often be effectively hedged through creative deals structures intended to ensure that minority stake investors are treated fairly throughout the holding period. This can include hurdle targets tied to performance or a potential IPO, which can align an entrepreneur's vision with the benefits that PE can bring.

## 2. Boots on the ground

Having local resources in place that are familiar with the nuances of the market is essential. Many of the leading firms have well-established offices in China staffed by investment professionals with a lifetime of experience in the market. The Carlyle Group, which has been active in China for more than a decade, has two local offices – one in Shanghai and another in Beijing. The firm reportedly has over 100 investment professionals in the region. Similarly, other active firms project a strong presence – The Blackstone Group has more than 20 investment staff in Asia; KKR has more than 30; and TPG has over 45.



### 3. Connections

Perhaps in no other market in the world is a robust network of local relationships as important as it is in China. Firms with formal relationships to the local business community and regional governments may well be considered for high-quality deals and expedited approvals for transactions from regulatory officials. The acceleration of RMB fund-raising in recent months and the nascent QFLP program are likely to reinforce the importance of managing firms' networks. Firms will need to maintain a delicate balance to ensure that their actions do not cross the line into territory that falls under the purview of anti-corruption policies, which can potentially result in severe penalties for non-compliant firms and individuals. Regulatory officials in the US in particular are stepping up their enforcement activities, with a close eye on the Chinese market.

### 4. Local empowerment

Closely related to having the right team in place, is ensuring that local teams are suitably empowered to make the decisions necessary to effect the change. While complete decentralization of the investment process is neither necessary nor prudent, and having suitable controls in place on an enterprise-wide basis is critical, ensuring that local teams have sufficient autonomy to "deliver the firm" is essential to credibility in the Chinese market.

### 5. Industry selection

While most large firms operating in China are relatively sector-agnostic, China has traditionally focused most of its resources on heavy industry. As such, a significant amount of PE investment likewise followed – between 2000 and 2010, PE firms invested more than US\$10b in industrials, including China's robust energy market. However, investors are now more focused on China's emergence as an expanding market for consumer goods. Along with finance and industrials, these three sectors have accounted for approximately 57% of aggregate PE deal value in China<sup>10</sup>.

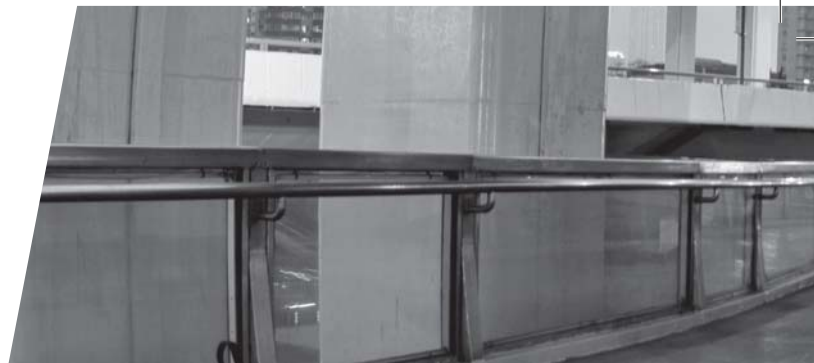
<sup>10</sup> Thomson Reuters

Going forward, PE firms will continue to pursue the secular trends. As China's population rapidly scales up in terms of consumption, investors will continue to seek opportunities to capitalize on this growth – retail, health care, pharmaceuticals and technology are expected to see significant investment from firms as they put to use the billions they have acquired in LP commitments.

### 6. The right company

Asset selection is a critical component of value creation across the PE spectrum, but China in particular represents an opportunity to invest in market leaders to a degree that is largely absent in developed markets. While PE has made successful investments in China's large state-owned enterprises, the majority of China's sellers are entrepreneurs or family owned businesses which often have headroom for significant growth and where PE can play a significant role in providing growth capital and professionalization. In these instances, ensuring proper alignment of interest is critical, and PE firms must often spend significant time and effort working closely with majority owners to ensure that all parties are in agreement regarding the strategic direction of the company, the allocation of resources, and important milestones and performance metrics. Perhaps the most important of these issues is the timing of the exit – in the typical minority-stake investment, PE firms have little control over their ability to exit. Ensuring that majority owners concur that a liquidity event for the PE firm is an ultimate goal at the outset of a deal can save significant headaches several years down the road.

Warburg Pincus' investment in Red Star Furniture, one of the country's largest home-improvement retailers, was one such deal where PE played a significant role in providing the capital and expertise to support strategic growth initiatives intended to take a business to the next level. Warburg reportedly invested US\$200m in the company in 2007, and along with co-investors CITIC, Fosun Group, and the Bohai Industrial Fund, the firm added an additional US\$380m into the company in June 2010 to fund expansion and help Red Star prepare for an eventual IPO. The company, which has grown at an annual rate of 15% per year, operates 66 locations and is seeking to expand to as many as 200 locations over the next several years.



# Transactions (contd)

## **PIPEs playing a role**

Another important dynamic in the China PE market is the increasing importance of PIPE (private investment in public equity) deals. According to *Asia Private Equity Review*, PIPE transactions increased from just 8% of the China PE market in 2006, to more than 40% of the market by 2009.

Among these was Bain Capital's investment in electronic retailer Gome Electrical Appliances in June of 2009. Bain reportedly invested US\$233m for a roughly 10% stake in the company at a time when the company was in the midst of a leadership crisis – the founder was facing charges of bribery, corruption and insider trading – and the company's brand was languishing in the marketplace. Bain worked closely with Gome to make significant operational improvements, including expense reductions, improvements in customer service and increasing the retailer's footprint in underserved markets. Thus far, these efforts have paid off – the stock has recently traded just short of three times Bain's original entry price.

## **State-owned enterprises (SOEs) and privately owned enterprises (POEs)**

Both SOEs and POEs represent significant, but different, sets of opportunities for PE firms in China. Continued reforms among China's SOEs and efforts at accelerated consolidation will provide further opportunities for PE firms, while growing awareness and acceptance of PE among China's emerging entrepreneurial class and family owned businesses will provide long-term opportunities in the POE space.

Over the last several years, China has been actively working to consolidate and restructure many of the SOEs, an initiative in which PE has played a key role. Going forward, PE firms can continue to add value through selective strategic investments in China's SOEs. One catalyst for emerging opportunities is the recently launched China Guoxin Asset Management Company, which is tasked with working with scores of China's smaller SOEs to restructure balance sheets, improve market positions and for many, ultimately seek public listings. The company was officially launched in December 2010, and is already reported to be working to consolidate the number of centrally controlled SOEs from more than 120 to less than 100 over the next three to five years. For PE, these efforts at consolidation and performance improvement could represent golden near-to-mid-term opportunities to deploy significant amounts of capital in some of China's most important companies.



Over the long term, however, investments in POEs will likely define the future of PE in the region. There are currently more than six million private companies in China, up from just 140,000 in 1992<sup>11</sup>. While many represent formerly SOEs the vast majority are small and medium-sized private businesses and their influence is growing. Ambitious private companies are seeking funding and expertise, both strategic and operational – to increase their market reach, scale up operations, or effect consolidative moves in less-concentrated markets.

According to a report from the All-China Federation of Industry and Commerce, POEs account for approximately 70% of the nation's technical innovations, and 60% of its patents, and employ one-fifth of the country's workforce. Paradoxically, however, access to capital for many of these companies is extremely constrained; making the capital that PE can deploy the difference between stagnation and growth.

Additionally, many of China's high-growth companies have a significant need for the robust business management disciplines and focus on liquidity in which PE firms have experience, and many of the entrepreneurs behind China's high-growth ventures are determined to take their companies to the "next level" – often an IPO. The emphasis on operational improvements, the introduction of experienced operating partners, and the ability to leverage PE portfolio operations teams represent a viable means to achieve these ends. The dual need for growth capital and, perhaps more importantly, for professionalization, gives PE firms significant influence despite holding only minority stakes, and represents the value that PE brings in China and across the emerging markets.

<sup>11</sup> "China sees fewer new private firms," China Knowledge Press, 26 March 2009, via Dow Jones Factiva, © 2009 China Knowledge Online Pte.



# Exits

## Maturing capital markets key to exits

With an increasing global appetite for China-based assets by global acquirers, a robust domestic M&A market and a number of options for public listings, PE investors have more options than ever in securing an exit for Chinese investments.

## Multinationals vie for position in China's growing markets

The value of China-targeted M&A increased 36% between 2007 and 2010<sup>12</sup>. At the same time, global M&A declined by 36%. Much of this activity was driven by cash-rich multinationals increasingly seeking acquisitions in high-growth emerging markets. One transaction of this type was French chemicals company Rhodia SA's acquisition of Bain Capital-backed Feixiang Chemicals for US\$428m in June 2010. It was among a series of purchases the French company made in the region; Rhodia's Asian division now accounts for approximately one-third of its net sales<sup>13</sup>.

## Domestic acquirers on the rise

Perhaps of greater interest to China's current influx of PE investors is the increasingly robust pool of domestic acquirers. In 2000, domestic companies represented just one-third of acquirers in domestic M&A deals while last year they represented over 75%<sup>14</sup>. TPG's aforementioned sale of Shenzhen Development Bank to Ping An is the largest of this type, but hardly the only – in 2010, Chinese companies have spent more than US\$1.3b acquiring companies from PE investors in China<sup>15</sup>.

## IPOs – moving toward truly global markets

Strong investor interest in Chinese IPOs across the globe is markedly increasing exit options, and rendering IPOs the exit of choice for PE investors in China. In many instances, investments are entered into with an IPO exit already in mind. The improvements in corporate governance, internal controls, transparency, and in some cases, onboarding an effective management team can impart the investor confidence necessary to maximize valuations, regardless of the listing venue.

Over the last two years, 58 PE-backed issuers based in China have raised nearly US\$11.5b in listings, both domestic and abroad, accounting for approximately 30% of total PE-backed IPOs.

## US a receptive venue for mainland companies

Rising globalization among the world's capital markets has many PE firms looking beyond their regional venues. This is especially the case in China, where mainland companies are increasingly exploring foreign listings. IPOs by China-based companies listing on the NYSE and the Nasdaq was a powerful trend throughout 2010 – there were 20 such deals, accounting for approximately US\$2.5b in aggregate proceeds and representing 7% of global PE-backed issuance<sup>16</sup>. Investor demand for new issuance from companies with high-growth potential has led to rich valuations for many, such as Chinese internet video site Youku.com. In December, the Bain Capital-backed company raised US\$233m. High demand led underwriters to price the IPO at US\$12.80, well above its expected range of US\$9.00-US\$11.00. The stock exploded in aftermarket trading, opening at US\$27.00 and closing out its first day up more than 160%, making it one of the best debuts in years. The stock closed out December up more than 170%.

<sup>12</sup> Dealogic

<sup>13</sup> Rhodia, 30 July 2010 news release. <http://www.rhodia.com>

<sup>14</sup> Dealogic

<sup>15</sup> Dealogic

<sup>16</sup> Dealogic

“Perhaps of greater interest to China’s current influx of PE investors is the increasingly robust pool of domestic acquirers”

**Figure 8: Significant recent exits**

Company	Year	Sponsor	Acquirer	Deal value (US\$ million)
Shenzhen Development Bank	2009	TPG	Ping An Insurance	2,388
Meihua Biotechnology Group Co Ltd	2009	CDH China Holdings	Wuzhou Minovo Co	848
Zhejiang Hengyi Petrochemical Co Ltd	2010	CDH China Holdings	Centennial Brilliance Science and Technology	620
Jushi Group Co Ltd (49%)	2010	Hony Capital	China Fiberglass	430
Feixiang Chemicals (Zhangjiagang) Co Ltd (87.5%)	2010	Bain Capital	Rhodia SA	428
Heijan Technology (Suzhou) Co Ltd (85%)	2009	Daiwa Private Equity	United Microelectronics Corp	285
Windrace International Co Ltd	2009	New Horizon Capital, General Atlantic, Newbridge Capital	Exceed Co	231
Lenovo Mobile Communication Technology Ltd	2009	Hony Capital	Lenovo Group	200

Source: Dealogic

### Shenzhen and the ChiNext

In addition to foreign listings, investors are watching closely the rising influence of local exchanges. In a little over a year of operation, China’s new venue for small, high-growth companies, the Shenzhen ChiNext exchange, saw nearly 200 companies list US\$22.4b, making it one of the most active exchanges for new issuance in the world. While there have been only a handful of PE-backed listings thus far on mainland markets – just 11 over the last two years – several sponsored companies that debuted on the ChiNext have attracted significant attention from investors. Among these was Wuhu Token Science, which raised US\$111m in a May listing. The company is backed by Haitong-Fortis, a joint venture between brokerage house Haitong Securities and Boston-based Fortis Investment Management. The retail offering was more

than 100 times oversubscribed, and the issue opened to a 50% first-day jump, and closed out 2010 up more than 112%. Another IPO, Warburg Pincus-backed Lepu Medical Technologies, was one of the best performing PE-backed IPOs of 2009. The medical device maker raised US\$174m in its initial offering, giving the company a market capitalization of US\$1.7b at its offering price. Like Wuhu Token Science, the institutional and retail offerings were each reportedly oversubscribed more than 100 times.

As PE continues to mature as an asset class in China, the increasing array of exit options will figure prominently in the country’s attractiveness and long-term viability to PE investors.



# Outlook

## Will supply meet demand?

Clearly, the outlook for PE in China favors continued growth, as a confluence of favorable factors, including advantageous demographics, rising consumer consumption and low PE penetration all come together to create one of the most exciting opportunities in the history of the industry. PE firms are responding to this opportunity by building significant stores of dry powder – more than US\$25b over the last three years alone, and the industry's LPs have signaled that China should expect even greater fund-raising success going forward. In a recent survey of globally active LPs conducted by Collier Capital and EMPEA, China was ranked as the number one destination for emerging markets investment for the second year in a row. More than half surveyed indicated they planned to begin investing or expand their existing allocations to the country. Rapidly increasing involvement from China's local investors is also increasing the supply of capital awaiting allocation to PE funds.

## Awaiting regulatory clarity

Fund-raising and access to deal flow are only two of the challenges facing PE firms in China. And, as they do throughout the emerging markets, China presents a unique set of challenges for investors. China's remarkable growth story is attracting PE houses from across the globe and fostering the development of local firms staffed by industry professionals with robust knowledge, deep connections and extensive experience.

Likewise, state-sponsored entities including China's industrial funds are taking an ever more active role in the economy at regional and national levels. This influx of investment, while on balance positive for China's PE development, is stimulating increased competition for high-quality deals and increasing pricing in some industries. Investors report that valuations are beginning to creep higher in some industries and geographies, an issue exacerbated by the relatively small average deal sizes in the current Chinese market. As LPs increasingly demand exposure to the China market, PE firms will be challenged to navigate the fine line between satisfying investor expectations, and exercising patience for the right deals at prudent prices.

Additionally, China's paradigm of minority-stake transactions in many ways limits critical aspects of the core PE model – the ability to direct a company's fate through overt control, and the ability to time exits optimally. As the industry moves forward, it will need to find ways to address these issues, either by expanding the range of deal options, or successfully working within their existing confines.

Understanding the rapidly evolving regulatory landscape presents yet another set of challenges. While regulatory changes are re-shaping the PE industry across the globe, nowhere is this more evident than in China. Without any real framework or historical precedent, China's authorities are hard at work writing the rules by which PE firms will operate. The decisions they make in the next 24-36 months will have a profound effect on the way that capital is raised and deployed, the ways that China's budding entrepreneurial scene grows and develops and in many ways, the direction that China's economy will take as it undergoes its exciting transformation from producer to consumer.

## Going forward

Authorities' increasing openness to working with PE is a testament to the value that PE can bring. Far more than just another source of capital, PE effects operational changes that cannot only improve single companies, but enrich entire industries. Through comprehensive assessments of market opportunities, strategic positioning, sector expertise and a keen eye toward leveraging efficiencies and maintaining operational discipline, PE can implement a level of professionalization in the companies it acquires and owns. These positive results can ripple throughout the economy, from which China as a whole stands to benefit.

As China enters the next phase of its growth story – as more consumers enter the middle class, as China's technology, health care, energy and other critical industries mature and as the economy continues to grow and evolve – PE firms active and interested in the region will themselves also grow and evolve. While obstacles clearly remain, PE will continue to advance as an active partner taking an ever-greater role in China's economic success.



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