From Growth Equity to Leveraged Buyout
- Making Private Equity Investments in China

By

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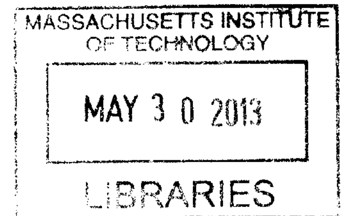
Master of Business Administration
The Chinese University of Hong Kong, 2007

SUBMITTED TO THE MIT SLOAN SCHOOL OF MANAGEMENT
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF SCIENCE IN MANAGEMENT STUDIES
AT THE
MASSACHUSETTS INSTITUTE OF TECHNOLOGY



JUNE 2013

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Submitted to the MIT Sloan School of Management on May 10th, 2013
In Partial Fulfillment of the Requirements for the Degree of
Master of Science in Management Studies

ABSTRACT

Private equity investments are divided into the five main categories: venture capital, mezzanine capital, growth equity, leveraged buyouts, and distressed investments. Currently in China, growth equity is the major type of private equity investments. The thesis will focus on the investment process of growth equity deals in China. Specifically, the thesis will analyze the challenges in deal sourcing, valuation and due diligence processes, deal structuring, and exit strategies.

Private equity sector in China is in its early stage of development and evolving quickly with huge potentials untapped. While in the developed countries like the U.S., leveraged buyouts is the main stream of private equity investments, this type of deals is emerging in China. The thesis will explore the potentials of leveraged buyouts in China through analyzing the capital market landscape of the country and the case studies.

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ACKNOWLEDGEMENTS

First and foremost, I would like to express my sincere appreciation to my thesis supervisor, Professor Charles F. Kane, who has provided me with valuable suggestions, great support and encouragement.

Also, I would like to thank Professor Victoria Ivashina of Harvard Business School, who taught me the course on Private Equity Financing, shared with me her insights in private equity investments, and gave me great advices on my thesis.

I also like to thank my mentor and supervisor Mr. Roger Moh (S.M., MIT, Class of 2003), who gave me the opportunity to work in private equity. He showed me the ropes to private equity investing in Asia, and demonstrated to me that Asia private equity investing can be conducted professionally - with rigorous due diligence and analysis, as well as uncompromising integrity.

My appreciation also goes to Mr. Chanh Phan, the Manager of MIT Sloan Master of Science in Management Studies Program (the "MSMS" Program), and Ms. Julia Sargeaunt, the MSMS Program Coordinator. Thanks very much for their strong support and care, which made my study at MIT Sloan a beautiful experience.

At the same time, I would like to express my sincere gratitude to all the people who kindly accepted to meet with me in Hong Kong and Beijing, and shared with me their valuable thoughts about China's private equity sector. Many thanks to - in alphabetical order – Mr. Alex Lee (Vice President, Baring Private Equity Asia), Mr. Alfred Jin (Investment Manager, IDG Capital Partners), Mr. Brian Chi (Principal, Blackstone), Mr. Brian Um (Vice President, Unitas Capital), Mr. Darren Massara (Managing Partner, NewQuest Capital Partners), Mr. Dennis Chang, (Executive Director, Goldman Sachs Special Situation), Mr. Drew Chen (Principal, Bain Capital), Mr. Eric Xin (Managing Director, Citic Capital), Ms. Jennifer Yen (Associate, CPP Investment Board), Mr. Lawrence Wang (Executive Director, Primavera Capital Group), Ms. Min Lin (Partner, NewQuest Capital Partners), Mr. Ming Lu (Partner, KKR), Mr. Stephen Zhang (Managing Director, Primavera Capital Group), Mr. Terry Yin (Associate, TPG), Mr. Vincent Huang (Partner, Pantheon), Mr. Xiaojun Li (Partner, IDG Capital Partners)

Last but not least, I am grateful to my mother who always emphasized the importance of education, gave me her full support, and encouraged me to chase my dream.

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Chapter 1: Background Information

1.1. Introduction to Private Equity Investments in China

Private equity is an asset class consisting of equity securities that are not publicly traded and are available only to "sophisticated" investors such as foundations, endowments, pension funds, family offices, and other investment channels. Private equity holds long-term capital commitments from investors and creates value through active management of the invested companies. Private equity is an expensive source of capital and is typically used by companies that have exceeded loan limits and have limited access to public debt and equity markets.

Private equity investments fall into five main categories: venture capital (investing in young entrepreneurial companies), mezzanine capital (preferred equity investments senior to common stock), growth equity (large but usually minority investments in stock of relatively large companies), leveraged buyouts ("**LBO**", acquiring majority control of a matured firm from existing public or private shareholders), and distressed investments (investing in company securities in bankruptcy or close to it). In general, there are three ways for private equity firms to generate positive risk-adjusted returns: operational improvement, valuation multiple expansion, and financial leverage[1]. This thesis will mainly focus on the growth equity type of private equity investment in China, which has significantly trailed the U.S. and other western regions in terms of size and depth of investment vehicles.

The following are the six main steps in the process of private equity investments.

- Planning and fund-raising

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[1] Paul A. Gompers, "Introduction to Private Equity Finance", August 17, 2012

- Deal sourcing
- Deal valuation and due diligence
- Deal negotiating and structuring
- Portfolio management
- Exit strategies

1.1.1. Planning and Fund-raising

In the planning stage, the General Partners (the "**GPs**") design fund strategy and structure, and pitch Limited Partners (the "**LPs**") for funding. The firm and its fund managers' track records as well as the investment strategies are the key selection criteria for LPs to select the GPs.

1.1.2. Deal Sourcing

In this stage, private equity firms receive investment opportunities through proprietary channels and public auctions. Proprietary deal flows are generated through personal and professional networking of GPs, LPs and advisors as well as referrals from the other departments of the same financial institutes. Proprietary deals are sold through confidential negotiations between one bidder and the target company. Public auctions are often held by the target company's advisors. The target company receives term sheets from one or more bidders and selects investors based on the deal teams submitted and agreed upon.

1.1.3. Deal Valuation and Due Diligence

Deals are screened based on the specific investment criteria of the private equity firms. The initial deal selection is a quick screening process based on basic criteria, such as deal types (growth equity or LBO deals), deal size (amount of capital to be deployed),

industry, and the leverage ratio of the target company. Selected deals then undergo a thorough evaluation process to identify the investment thesis, risks, and return profile. Private equity firms use various valuation methodologies to determine a valuation band for investment opportunities. Commonly used valuation methodologies include "discounted cash flow" ("**DCF**") method, comparable multiples, Sum-Of-Parts method and liquidation method. The valuation methods for growth equity investments in China will be elaborated in the Section 2.3.

Due diligence is the investigation and evaluation on the business performance and key management of the target company. Initial due diligence is normally conducted by the investment professionals of private equity firms. If the deals meet with the investment criteria, the private equity firm will sign a term sheet containing the key investment terms with the target company. After that, external advisors, such as auditors, legal counsels, and management consultants, will be hired to conduct a full-scale due diligence on the target company's financial statements, legal documents (e.g. major contacts and business incorporation documents), industry and business prospects, as well as backlog.

1.1.4. Deal Negotiating and Structuring

Upon the satisfactory due diligence results, private equity firms will sign the transaction documents with the target company. The transaction documents include all the deal terms, such as capital structure of the deal, the financial instruments used for financing (e.g. a combination of bank loans, high-yield debt, and convertible bonds), covenants, the capitalization structure after investments, appointment of board members, and so on. The following shows three commonly used deal structuring methods for growth equity investments:

- ***Preferred Stock***: pays a fixed dividend with priority over the dividends made on common stock. This comes in addition to any value appreciation of the preferred shares. It can be converted into common stock at the option of the holder at any time, most commonly in the event of an Initial Public Offering ("**IPO**"). If the target company generates satisfactory performance, investors will choose to get the equity share of the company by converting to common stock. If the target company fails to achieve the promised returns, it will pay back the investment principal plus dividends. This is the most widely used structure in growth equity investments.
- ***Convertible bonds***: bonds that can be converted into a pre-determined amount of the target company's equity at a certain time or after meeting certain conversion criteria, usually at the discretion of the bondholder. This is also a widely used structure in growth equity investments. Compared to preferred shares, the differences are:
  - At the end, convertible bonds are still debt, while preferred stock is still equity. The company is not obligated to pay the preferred stockholders dividends.
  - Payments on bonds is less costly as bond interest is paid before tax, which creates a tax shield; while dividends of preferred stock is paid after tax.
- ***Debt with warrants***: Warrants are attached to the debt instruments as "sweeteners" – options to buy common stock at a specific price in the future and allow the investors to share the upside potential of the firm.

1.1.5. Portfolio Management

For growth equity investments in China, private equity firms will actively manage portfolio companies and increase the enterprise value through operational improvements, such as introducing new clients, providing merger and acquisition ("**M&A**") advisory,

streamlining operations, cutting down costs, appointing key management personnel, and so on. In addition, private equity firms will act as the financial advisors to the target company, helping to select IPO underwriters, negotiating debt refinancing, advising on the subsequent rounds of financing, etc. To exert influence in the target company, it is crucial for private equity investors to secure some board seats.

1.1.6. Exit Strategies

There are four main types of exit strategies for growth equity investments in China:

- ***IPO***: sale of stock to the public market for the first time. This is the most desirable exit strategy in China, as it will typically yield the highest valuation.
- ***Trade sales***: sales of shares to strategic investors who are in the same industry or the related industries of the target company. Due to the poor performance of the stock markets in recent years and Chinese government's restriction on the amount of IPOs per year, exits through trade sales are growing fast in China.
- ***Secondary sales***: sales of shares to financial investors. This is a result of the specialization of private equity sector, where funds are getting focused on the specific stages of a company's development. There are two main types of secondary sales: sales of LP interests and sales of direct interests. Due to a limited amount of IPO quotas per year, this type of exit strategy is getting popular in China as well.
- ***Redemption***: this is the least desired exit method. If the target company fails to meet the requirements of a qualified IPO or violates the key covenants, the private equity firm may request to have their shares redeemed by the selling shareholder. Redemption also often carried related interest changes on the capital secured and then redeemed.

My thesis will study the dynamics of growth equity investments in China from entry to exit through case studies. Specifically, the thesis will analyze the challenges in the fund raising, deal sourcing, valuation and due diligence processes, deal structuring, portfolio management and exit strategies.

The private equity sector in China is in its early stages of development and evolving quickly with huge potential untapped. While in the developed markets like the U.S., the LBO is the main stream of private equity investments, these types of deals are emerging in China. My thesis will also explore the potentials of the LBO in China through analyzing the dynamics of China's capital markets and related case studies.

1.2. Development of Growth Equity Investments in China

The first direct equity investments in China happened in 1989 when the Beijing government established the China Venturetechno Investment Corp. to support the growth of local high tech companies. At that time, there was little venture capital activities in China. The government led the country's private equity investments at this time. The situation started to change in 2003 when some internet companies, backed by foreign venture capitals, were successfully listed in NASDAQ. The good returns achieved motivated foreign private equity firms to pour capital into China and create a presence. Before 2007, China's private equity sector was dominated by foreign investors with offshore fund structure (USD-denominated fund) through 2007. Growth equity investments were the main stream of deal flows. Since 2007, buyout deals have emerged. At the same time, onshore RMB-denominated funds started to grow. In 2010,

RMB-denominated funds accounted for 75% of the total funds raised[2]. The following shows the growth of private equity funds raised in China since 2000.

Source: Chenhao Zhu, Private Equity Funds in China: Structures, Opportunities and Challenges, 2012

Historically, growth equity is the main stream of private equity investments. There are limited buyout deals and even less LBO deals due to the following reasons.

- ***Great needs for growth equity investments***: with the strong growth of China's economy, privately owned Chinese enterprises are developing fast and need growth capital to expand their businesses domestically and internationally. Unlike the U.S., most industries in China are fragmented with lots of small players exhibiting high growth rates. These private companies normally choose to grow organically as there is significant market share for them to grow. Thus, there are limited M&A and buyout activities in China. Also, most of the privately owned companies are still managed by the first generation of the founding members, who prefer to run the company by themselves and not sell their assets.

[2] Asia Private Equity Review, "Course Reference Manual", 2010

- ***Limited Financing Options***: Currently, the corporate bond market is under-developed in China. Bank financing remains the main source of funding for businesses. However, the bank financing system in China is partially policy-driven and generally favors the large state-owned enterprises (the "**SOEs**"). Also, the Chinese government puts strict loan quotas and approval criteria on the banks so as to control over-heating economy and inflation risks. This further limits the loan that privately owned companies can get from the banks. Moreover, private equity firms in China have very limited access to the debt market, which is a major funding source for LBO deals.

Currently, the penetration of private equity in China as a percentage of GDP is about 0.3% as compared to North America's 0.8% and Europe's 0.5%[3]. Private equity investments play an important role in helping the businesses development. Without the participation of private equity funds, many global corporations would not have grown into what they are today. Also, private equity funds play a key role in corporate restructuring and turnaround situations. For example, in the bankruptcy case of Countrywide plc, a leading residential real estate agent in the U.K., the private equity firm Oaktree Capital Management helped the company to finish the restructuring process, saved it from the slowing down of the U.K. housing market in 2008, and turned it into a profitable business in future periods.

Looking forward, the Chinese government will continue to support the private equity investments in China. With the consolidation of many industries and the growth of bond market, we will see more M&A activities and LBO deals.

[3] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012

Chapter 2: Making Growth Equity Investments in China

2.1. Fund Structure and Fund Raising

There are mainly three types of private equity structures[4] in China:

2.1.1. Offshore USD-denominated Funds

Most growth equity funds are using this type of structure, which is formed overseas, most commonly in Cayman Islands or British Virgin Islands. Comparing with entities governed by laws in mainland China, investors have greater certainty and predictability of legal enforceability of contracts as well as the limited liability protection on LPs under the laws of Cayman Islands or British Virgin Islands.

However, this type of structure has its limitations in the People's Republic of China (the "**PRC**"). Many sectors and industries are closed to foreign investors, such as media and telecommunication. Also, all foreign investments need government approval with length process. Moreover, as USD-denominated funds with investments in RMB, the conversion of USD to RMB and the associated repatriation is time consuming. To circumvent the restrictions, foreign investors typically invested in an offshore holding entity that controls a Chinese domestic company by captive contractual arrangements (please refer to Section 2.5.3. VIE Structure). This type of investments mainly exits through overseas IPO.

2.1.2. Onshore Domestic-invested RMB-denominated Funds

This type of funds is registered in mainland China, consisting exclusively of domestic sources of capital. Due to the abundant "hot money" available in China and fewer restrictions than USD-denominated funds, this type of funds is growing very fast.

[4] Chenhao Zhu, Private Equity Funds in China: Structures, Opportunities and Challenges, 2012

Because of the currency control, RMB-denominated funds mainly raise funds domestically. The LPs are mostly National Social Security Foundation, local government funds held by provincial and municipal authorities, and high-net-worth individuals. As domestic investors, they can invest in certain restricted industries not available for foreign investors. Currently, RMB funds are taking the leads to do buyout deals in China.

However, this type of funds faces more uncertainty in enforcing contracts in the courts in mainland China. Also, unlike the USD funds that have a large group of institutional investors such as endowments, foundations, pension funds and family offices, the LP community in China is relatively limited (as listed above). In addition, due to the different corporate culture and lower pay than offshore incorporated funds, domestic invested funds find it hard to attract seasoned international investment professionals.

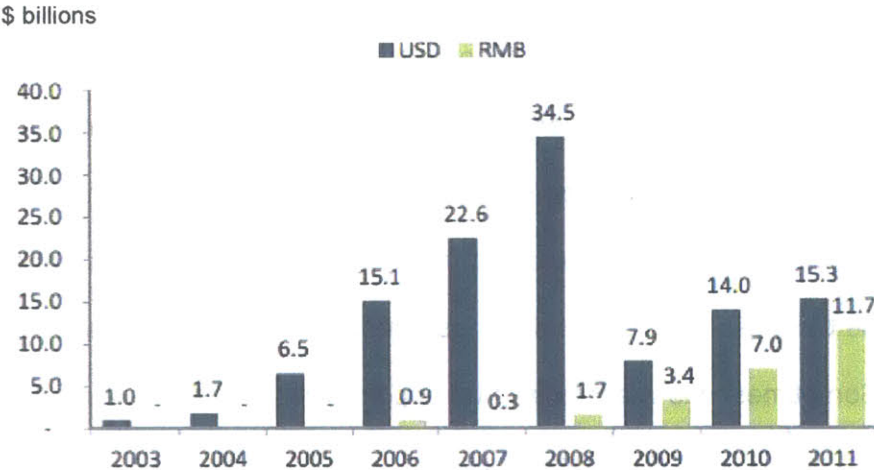
2.1.3. Onshore Foreign-invested RMB-denominated Funds

The type of funds is registered in mainland China, comprising at least partial overseas capital. It avoids some of the disadvantages of USD funds and domestic-invested RMB funds. Compared to USD funds, it bypasses the burdensome process approval by Ministry of Commerce ("**MOFCOM**") and can exit through the domestic stock market. Compared with domestic-invested RMB funds, foreign-invested RMB funds are able to attract experienced international investment professionals more easily.

A main disadvantage of this type of funds is that as foreign investors, they are not allowed to invest in certain restricted industries (as mentioned above). In addition, the local partners may not be as sophisticated as the international investors; their lack of investment experience and cultural differences may lead to conflicts with foreign partners.

Foreign-invested RMB funds are growing fast. Some multinational private equity funds are raising their RMB funds in China. For example, Blackstone is obtaining regulatory approval to launch a RMB fund in Shanghai with a target fund size of RMB5 billion. Carlyle Group has signed a Memorandum of Understanding with the Beijing government in 2010 to set up its first RMB fund in China, aiming to raise RMB5 billion as well. Goldman Sachs has announced the partnership with the Capital Operation and Management Center, which is owned by the Beijing municipal government, to set up the Broad Street (Beijing) RMB fund – a growth capital fund up to RMB5 billion.

The following chart shows a growth comparison between USD- and RMB-denominated funds in China.



Source: Chenhao Zhu, Private Equity Funds in China: Structures, Opportunities and Challenges, 2012

2.2.Deal Sourcing in China

Deal sourcing in China has several characters which differ from the developed markets.

2.2.1. Guangxi Management

The importance of relationships ("**Guanxi**" in Chinese) is widely cited by foreigners. It is often regarded as one of the most important prerequisites for doing business in China. Having strong Guanxi, or relationships, with the right people facilitates the process of the private equity investments including fund-raising, deal sourcing, getting deal approvals from the government, and so on. In many people's eyes, good Guanxi with powerful political figures, such as the government or important people closely related to them, assists a great deal in sourcing proprietary deals in China. GPs seek help from the local government to make the introductions to the local entrepreneurs. This makes entrepreneurs obligated to meet with the private equity funds in order to give face to the government.

However, private equity is a long-term business with more than a 5-year investment horizon. It is thus very important for private equity firms not to focus too much on relationship building or even get involved in bribery to earn themselves some short-term benefits. Guanxi management may go wrong if the power changes hands or bribery was disclosed; and the business will be shut down as a result. Integrity is still very important in investments. Sometimes, it is wiser to give up opportunities of making quick money at the expense of exposing the fund to Guanxi risk.

When building Guanxi with Chinese government officials, the key is to help them develop a career path and get promotions, but importantly, not anything in monetary terms. Private equity firms should deliver clear messages to the government officials as to how the investments can help develop the local economy, fuel GDP growth, increase job opportunities, help build up local brands; and improve infrastructure and people's lives. In return, the private equity firms could then request for the government's support

in approving investments and introduce them to the local entrepreneur community. More importantly, should any disputes arise between entrepreneurs and the private equity firm, senior government officials are more likely to be fair in handling the dispute if the investment will help them get promoted.

Case Study: Shenzhen Capital Group [5]

Shenzhen Capital Group Company, Ltd. ("**SCGC**") is one of the earliest domestic private equity firms in China. It was established in 1999 by the Shenzhen government to bridge the gap between the growing small and medium enterprises (the "**SMEs**") in Shenzhen and the lack of financing resources. It is regarded as a successful model of "government backed, market oriented, operated within economy rules, and head upon international practice."

By the end of July 2010, the firm had expanded into 29 provinces and built a national network of local funds that was unparalleled in China's private equity industry. Its total fund size has reached RMB20 billion. Since its inception, SCGC has invested RMB6 billion in 287 companies. It has pursued attractive investment opportunities across a wide range of industries and investment stages. It made 67% of its investments in the south and south-east regions of China, especially in Shenzhen, while the remainder was widely distributed in other regions of China.

SCGS pioneered the government-backed fund (the "**GBF**") structure in China. In a typical GBF, investments come from three parties: the local government, SCGC, and local partnership funds (mainly local private investors), with each contributing about one-third of the total fund commitment. The compensation structure is similar to the typical

[5] Paul Gompers, Shaohui Chen, Jessie Lin, Shelley Ling, "Shenzhen Capital Group", 2012

private equity firms' funds, with a 2% to 2.5% annual management fee and a 20% carried interest rate. The investments by local governments have the terms that are similar to those of a bank loan, charging a fixed annual rate based on the Chinese government bond rate (around 4%-5%). The return and principal investments to the government is guaranteed in the GBF contract. After paying the fixed return to the government, SCGC and other investors share the rest on a pro forma basis.

SCGC benefits greatly from the local governments' strong support in deal sourcing, deal execution and exiting. This structure is intended to support the growth of local enterprises and to spur the development of local economy.

Investment managers in regional offices work with local governments and regional partnership funds to identify local deals. These regional deals contributed about 60% to 70% of total leads in SCGC. Investment managers in SCGC's other types of funds, when searching deals in a national scope, might also refer deals to other GBF teams when there is a geographic fit.

By building a national network of 30 regional GBFs, SCGC can achieve comprehensive deal coverage that is superior to most foreign VC funds. Both the local governments and partnership funds are important deal sourcing channels. Compared to most VC firms, which only have offices in Beijing or Shanghai and make their investment professionals fly all over the country to source deals, SCGC's physical footholds become a strategic advantage in a competitive investment market. As a result, the SCGC is able to invest in companies that cover more than 29 provinces in China.

2.2.2. Some Potential Areas for Deal Sourcing

In the private equity sector in China, there is a saying "Too much money chasing too few deals." Investors are complaining that good deals are getting scarce and valuations are driven up by intense competition among funds. To a certain extent, the increasing number of foreign and local private equity firms made high-profile large scale growth equity deals very expensive. Also, USD-denominated funds are facing strong competition from increasing RMB-denominated funds. Some Chinese companies prefer to work with RMB funds due to a less time-consuming investment process (as discussed above). However, with the fast growth of China's economy, there are lots of potential deal opportunities besides growth equity investments, such as M&A and investing in SMEs.

2.2.2.1. M&A Opportunities

Many industries in China are highly fragmented with few dominant players. Thus, there is a high potential for market consolidation in those industries. The food and beverage sector, for example, is flooded with thousands of brands and companies, most of which are small players with poor quality products. There are huge M&A opportunities in this industry. Private equity firms could seek and invest in private companies with premium quality products and help the invested companies to acquire smaller competitors and increase their market share.

Also, the Chinese government encourages SOEs and large privately-owned enterprises to consolidate certain industries, such as securities, consumer products, and automobile

manufacturing[6]. Through helping portfolio companies conduct M&A, private equity firms can increase their deal-sourcing options to invest in smaller companies.

2.2.2.2. Investing beyond Growth Equity Deals

Currently, USD denominated- funds mainly focus on flagship growth equity deals – big companies with famous brand names, being a market leader, and having stable cash-flows. However, those types of companies normally have abundant funding sources. Therefore, they are very picky in selecting investors; and their valuation is high.

According to an article in Wall Street Journal[7], currently China has developed a "two-track" economy, with the state-owned sectors are flooded with cash; while the private sectors are starving for funding. There are about 40 million companies in China which account for 80% of the country's jobs and more than half of economic output. As a result of recent tightening of bank lending to curb inflation, as of the end of June 2011, there are about RMB288 billion ($45 billion) of loans arranged by 3,366 non-banking institutions specializing in letters of credit.

Therefore, private equity firms could be more flexible in providing financing to privately owned companies, instead of just focusing on growth equity investments in market leaders. Other types of financing structures such as mezzanine debt and high yield notes can provide private equity firms with more potential deal opportunities. Moreover, SMEs are increasingly starving for funding as opposed to large SOEs. But currently, USD-denominated funds are still skeptical about investing in these types of companies. The local RMB-denominated funds have a better understanding of the local market and

[6] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012
[7] Lingling Wei, "China's New Lenders of Last Resort," Wall Street Journal, September 13, 2011

are more likely to invest in the SMEs, which will further fuel the high growth of local funds.

2.3. Valuation

Valuation of growth equity investments in China has several issues that the developed markets do not have. Specifically, the valuation need to consider the additional complexities of investing in emerging markets, the trading comparable, and the appropriate discount rate.

2.3.1. Trading Comparable

For growth equity investments in China, trading comparable method is the most frequently used valuation method. The target company gives investors one- or two-year post-investment earning guarantees. Investors will then choose a trading multiple and multiply the guaranteed earnings to get the post-money valuation. Commonly used valuation multiples for growth equity deals in China are P/E, TEV/EBITDA, and Price/Book.

The challenge here is to find the proper trading multiples. In China, there are three stock exchanges: the Shanghai Stock Exchange ("**SHSE**"), the Shenzhen Stock Exchange ("**SZSE**"), and the Stock Exchange of Hong Kong Limited ("**SEHK**"). SHSE and SZSE are located in mainland China, where stocks traded are collectively called "A-shares". The A-share market is not entirely open to foreign investors due to tight capital account controls by authorities in mainland China; the trading currency is RMB. SEHK is located in Hong Kong. The stock traded is called "H-share". SEHK is fully open to international investors; the trading currency is HKD. The parties that trade H-shares are mostly international institutional investors. Due to the difference of capital availability and expected returns, the trading multiples between SEHK and SHSE/SZSE are different,

even for the same company. Appendix A shows a market capitalization comparison of the companies dual-listed in SEHK (H-shares) and SHSE/SZSE (A-sharers). On average, for the dual-listed stocks, A-shares have a 26% valuation premium compared with H-shares. To makes things more complicated, many Chinese companies choose to get listed overseas. Popular stock exchanges include the New York Stock Exchange ("**NYSE**"), the NASDAQ Stock Market ("**NASDAQ**"), the Singapore Stock Exchange, and so on.

Therefore, it is important to find comparable stocks traded in a stock exchange where the invested company plans to get listed. If no such comparable is available, then a valuation discount or premium needs to be applied to adjust the valuation differences among different stock exchanges.

2.3.2. Types of DCF Valuation Methods

Three types of DCF valuation methods can be used to value growth equity investments.

- Weighted average cost of capital ("**WACC**") approach: discount the cash flow to capital by adjusting the tax effects on the cost of capital, applicable when the target company's capital structure is expected to remain constant during the forecasting period (constant Debt/Equity ratio). This method is not applicable in corporate restructuring or LBO situations.

$$WACC = (Debt/Asset) * R_{debt} * (1 - tax\ rate) + (Equity/Asset) * R_{equity}$$

- The adjusted present value ("**APV**") approach: separate cash flow generated by the business and by the interest tax shields, and discount them using different discount rates. Free cash flow generated by the business could be discounted by the expected rate of return on the firm's assets – R_{asset}. Cash flow from interest tax shields could be discounted by the cost of debt or risk free rate (if the target

firm is sure about the occurrence of interest tax shields). This method is applicable in both situations when the capital structure of the target company is expected to change or to remain constant.

$$R_{asset} = R_{risk\ free} + \beta_{asset} * \textit{market risk premium}$$

- The capital cash flow ("**CCF**") approach: acknowledge the different streams of cash flows from the business and interest tax shields, but use a single discount rate – the expected rate of return on the firm's assets – R_{asset}. The main difference from the APV method is that the tax shields are discounted at a higher rate - R_{asset} (if the target firm is not quite sure about the occurrence of interest tax shields). This method is applicable in both changing and constant capital structure situations.

2.3.3. Terminal Value as a Multiple of Earnings

This method is more applicable for growth equity deals in China than the DCF method with Terminal Value as a Growing Perpetuity Cash Flow because it is hard to determine the perpetual growth rate ***g*** in a fast growing company.

China's GDP growth from 2012 to 2014 is expected to range from 7.6% to 8.4%, respectively[8]. The average net profit growth of the CSI 300 Index[9] component companies from 2012 to 2014 is estimated to be 1.2%, 9% and 12.5%, respectively[9]. The average net profit growth rate of SME Board in China was about 10% in 2011 and is estimated to be 29% in 2012 and 31% in 2013[10]. The fast growth of SMEs made the financial forecast on growth equity deals difficult. Target company's management and industry experts are normally able to make 3-Year's financial forecast. Beyond that, it is

[8] Goldman Sachs: "A-share strategy - 2013 outlook", December, 2012
[9] The CSI 300 is a capitalization-weighted stock market index designed to replicate the performance of 300 stocks traded in the SHSE and SZSE, The CSI 300 Index sample covers about 60% of total value of A Share market
[10] China International Capital Corporation Ltd., "Analysis of SME Board and GEM Board Mid-term Financial Result and Forecast", July 18, 2012

difficult to predict the growth rate of the market and the target company. Thus, it is hard to determine when the terminal growth rate ***g*** will get stabilized, which makes the method of Terminal Value as Growing Perpetuity Cash Flow not commonly used to value growth equity investments in China.

Also, the method of Terminal Value as a Multiple of Earnings is more practical for growth equity investment than the method of Growing Perpetuity Cash Flow, as the ultimate goal of the private equity investment is to exit, and the comparable multiple method reflects the market expectation of the firm value at the exit, which gives a better picture of the return profile.

The procedures of DCF method with Terminal Value as a Multiple of Earnings are as follows:

1. Estimate the time when the investment exit will take place (e.g in 5 years)
2. Forecast the firm's EBITDA or net earnings at the time of exit, use TEV/EBITDA multiples from comparable public firms or from recent transactions in the same industry to calculate the total market value of the firm at exit
3. Choose a discount rate
4. Calculate the present value of the firm
5. Do a sensitivity analysis using different discount rates

Case Study: Shenzhou International

The following shows a valuation of Shenzhou International (SEHK: 2313), a China-based manufacturer of casual wear, sportswear, and lingerie. Its major customers include Nike, Adidas, Puma, and Uniqlo. Using a WACC ranging from 11.2% to 13.2% (the current WACC is 11.2%) and EV/EBITDA multiple between 8x to 10x (the

current trading multiple is 9.6x), the target stock price is $3.5 - $4.5 (HKD27.1 – HKD34.9). As of March 22, 2013, its trading price is HKD21.8 ($2.8). The stock price has an upside potential of 40%-60%.

USD in millions

	Projected FYE Dec 31				
	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
EBITDA	$ 393	$ 459	$ 557	$ 669	$ 796
EBIT	$ 349	$ 405	$ 490	$ 588	$ 699
Less: Taxes on EBIT	$ (63)	$ (73)	$ (89)	$ (106)	$ (126)
% tax rate	*18%*	*18%*	*18%*	*18%*	*18%*
Unlevered Net Income	$ 286	$ 332	$ 401	$ 482	$ 573
Add: D&A	$ 44	$ 55	$ 67	$ 81	$ 97
Less: Increase in W.C.	$ (52)	$ (70)	$ (107)	$ (123)	$ (141)
LesS: CapEx	$ (118)	$ (136)	$ (165)	$ (198)	$ (236)
UFCF	**$ 160**	**$ 180**	**$ 196**	**$ 241**	**$ 293**

Market Assumptions	
Risk Free Rate	3.00%
Equity Market Risk Premium	7.00%
Capitalization	*Pro Forma*
Cash	$ 212
Total Debt	200
Total Equity	982
Debt to Equity Ratio	20%
Financing and Tax Assumptions	
Pre-tax Cost of Debt	2.75%
Marginal Tax Rate	25%
Cash Interest Rate	0.15%

Historical Data Source: Capital IQ

	Equity Market Risk Premium Sensitivity					
Levered	**Cost of Equity**			**WACC**		
Beta	**6.00%**	**7.00%**	**8.00%**	**6.00%**	**7.00%**	**8.00%**
1.14	9.9%	11.0%	12.2%	8.5%	9.5%	10.4%
1.29	10.7%	12.0%	13.3%	9.3%	10.3%	11.4%
1.43	11.6%	13.0%	14.4%	10.0%	11.2%	12.3%
1.57	12.4%	14.0%	15.6%	10.7%	12.0%	13.3%
1.72	13.3%	15.0%	16.7%	11.4%	12.8%	14.2%

Note: Shenzhou's 5-Year Beta is 1.43 (from Capital IQ)

DCF Valuation Matrix - EV/EBITDA Terminal Value
Less: Taxes on EBIT

WACC	Terminal Value EV/EBITDA Multiple 8.0x	9.0x	10.0x	
11.2%	$ 496	$ 496	$ 496	PV of UFCF
	$ 4,171	$ 4,693	$ 5,214	PV of Terminal Value
	$ 4,667	**$ 5,189**	**$ 5,710**	**Enterprise Value**
	$ 12	$ 12	$ 12	Less: Net Debt
	$ 4,679	**$ 5,201**	**$ 5,722**	**Equity Value**
	1,260	*1,260*	*1,260*	*Weighted Avg. Basic Shares Out.*
	$ 3.7	*$ 4.1*	*$ 4.5*	*Implied stock price*
12.2%	$ 487	$ 487	$ 487	PV of UFCF
	$ 4,025	$ 4,528	$ 5,031	PV of Terminal Value
	4,511.6	**5,014.7**	**5,517.7**	**Enterprise Value**
	12	12	12	Less: Net Debt
	$ 4,524	**$ 5,027**	**$ 5,530**	**Equity Value**
	1,260	*1,260*	*1,260*	*Weighted Avg. Basic Shares Out.*
	$ 3.6	*$ 4.0*	*$ 4.4*	*Implied stock price*
13.2%	$ 478	$ 478	$ 478	PV of UFCF
	$ 3,884	$ 4,370	$ 4,855	PV of Terminal Value
	4,362.6	**4,848.1**	**5,333.6**	**Enterprise Value**
	12	12	12	Less: Net Debt
	$ 4,375	**$ 4,860**	**$ 5,346**	**Equity Value**
	1,260	*1,260*	*1,260*	*Weighted Avg. Basic Shares Out.*
	$ 3.5	*$ 3.9*	*$ 4.2*	*Implied stock price*

The discount rate used in this method is suggested to be higher than the one used in the DCF method with terminal value as a growing perpetuity cash flow, because there is an idiosyncrasy risk imbedded. The comparable multiples used here are a kind of idiosyncrasy risk, as one assumes that the target company can get an IPO in Year 5 with the same valuation multiples as the trading comparable. However, this may not be true as most comparables are public companies with a proven business model, as well as large scale and stable cash flow. It is uncertain whether the target private company will reach the same valuation multiples as the public comparable at the time of exit. Therefore, a higher discount rate should be used in the base/downside case of valuation model. Or a discount to the valuation multiples should be used to calculate the terminal value at exit.

2.3.4. Choosing Appropriate Discount Rate for Emerging Markets

There are two common ways of adjusting the calculation of DCF valuation. The first method is to incorporate the risks into the discount rate; while the second is to adjust the cash flows. Adjusting the discount rate is appropriate when the risks are not diversifiable (systematic risk) and constant over time.

"What type of discount rate to use?" This is a constant argument in the investment field. Especially in the emerging countries, this issue becomes more complicated.

2.3.4.1. Discount Rate Reflecting Investor's Required Rate of Return

Some academic research papers suggest that the discount rate should reflect the required return of the ultimate investors. For example, in China, there are USD-denominated private equity funds and RMB-denominated private equity funds. The LPs of USD-denominated funds are large international institutions such as pension funds and endowments in the U.S. These investors are generally well diversified and hold portfolios close to the global market portfolio. Therefore, it is appropriate for these investors to use the values of risk free rate, β, and equity risk premium from the global market portfolio. The LPs of RMB-denominated funds are mainly domestic financial institutes and high-net-worth individuals. In this case, risk free rate, β, and equity risk premium in China should be used.

In this method, for USD-denominated funds, the risk free rate is suggested to be the U.S. government bond rate that matches the expected length of the investment. For RMB-denominated funds, the risk free rate in China should be used. In this case, to isolate China's risk free rate, one needs to calculate the default spread (as discussed in the section 2.3.4.4.) and then subtract it from the bond rate.

The choice of equity risk premium depends on where the LPs come from. LPs of USD-denominated funds are typically large and well-diversified investors; the appropriate equity risk premium should be the global portfolio or their own portfolio. For local LPs of a RMB-denominated fund, the appropriate premium should be derived from the local equity market, such as A-share or H-share market.

2.3.4.2. Discount Rate Reflecting Investment Target's Business Risk

Other academic research believes that the appropriate discount rate should reflect the business risk associated with the expected cash flows. If the target and acquirer are in the same industry, then both parties' WACC and R_{asset} may be justified. If the WACCs and R_{asset} are likely to be different, then you need to use the target's WACC or $R_{asset,}$ because you are concerned about the risk of where the money is going, not where it comes from.

In this method, the risk free rate should be the Chinese government bond rate that matches the expected length of the investment. The market risk premium should be derived from the local equity market in China.

In practice, the discount rate reflecting the investment target's business risk is used more often in growth equity investments in China. Most USD- and RMB-denominated funds use the discount rate reflecting the target's business risk in China. Private equity investors are generally conservative. Compared to the discount rate used in the first method, the second one generally adopts a higher risk free rate and equity market risk premium. Thus it generates a higher discount rate and gives the investment target a lower valuation.

2.3.4.3. Choosing β

For growth equity deals in China, it may be difficult to find similar firms in the local stock exchanges, especially when the trading multiples in SEHK and the stock exchanges in mainland China are different. A possible solution is to assume that the firm is equally exposed to the market risk as similar firms in developed markets and use the β of those similar firms in the same industry as the target company[11].

2.3.4.4. Equity Market Premium and Country Risk Premium

A difference affecting valuation calculation in emerging countries like China is the presence of country-specific risk, as the investments in emerging countries is riskier than those in the developed countries like the U.S. The specific risks in China include risks associated with a different legal environment, uncertain legal enforcement, regulatory risk, risk of expropriation, currency exchange risk, and so on.

In practice, investors will add an arbitrary country risk premium to their discount rate. Also, making adjustments to the discount rate rather than the cash flow is less arbitrary because there are methods to derive a country risk premium using the default spread for sovereign debt. One way is to calculate bond default spread[12]. For example, the one-year dollar-denominated Chinese bond has an interest rate of 3% while the U.S. one year T-bill rate is 1.5%. Then the country premium for China is calculated as:

Country Premium of China = 3% - 1.5% = 1.5%

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[11] Paul Gompers, Victoria Ivashina, Timothy Dore, "Private Equity Valuation in Emerging Markets", 2012
[12] Aswath Damodaran, "Equity Risk Premiums (ERP): Determinants, Estimation andImplications – The 2012 Edition", March 2012

The other way is to get Credit Default Swap ("**CDS**") Spreads for the countries (governments) that yield measures of default risk[13]. The following shows the risk premia of some countries.

Enter the current risk premium for a mature equity market	6.00%
Adjust the country default spread for the additional volatility of the equity market to get to a country premium?	Yes
If yes, enter the multiplier to use on the default spread	1.5

Country Risk Premia as of January 2013

Country	Local Currency Rating	Bond Rating-based Default Spread	Total Equity Risk Premium[1]	Country Risk Premium[2]	CDS Default Spread	Total Equity Risk Premium[1]	Country Risk Premium[3]
Brazil	Baa2	1.75%	8.63%	2.63%	2.07%	8.06%	2.06%
China	**Aa3**	**0.70%**	**7.05%**	**1.05%**	**1.80%**	**7.65%**	**1.65%**
Hong Kong	Aa1	0.25%	6.38%	0.38%	1.19%	6.74%	0.74%
India	Baa3	2.00%	9.00%	3.00%	NA	NA	NA
Indonesia	Baa3	2.00%	9.00%	3.00%	2.69%	8.99%	2.99%
Russia	Baa1	1.50%	8.25%	2.25%	2.91%	9.32%	3.32%
United Kingdom	Aaa	0.00%	6.00%	0.00%	0.95%	6.38%	0.38%
United States of America	Aaa	0.00%	6.00%	0.00%	0.70%	6.00%	0.00%

Note 1: Total Equity Risk Premium = Risk Premium of a Matured Equity Market (6%)+Country Risk Premium

Note 2: Country Risk Premium (Bond Default Spread Method) = Rating Based Default Spread* Volatility Adjustment Factor(1.5)

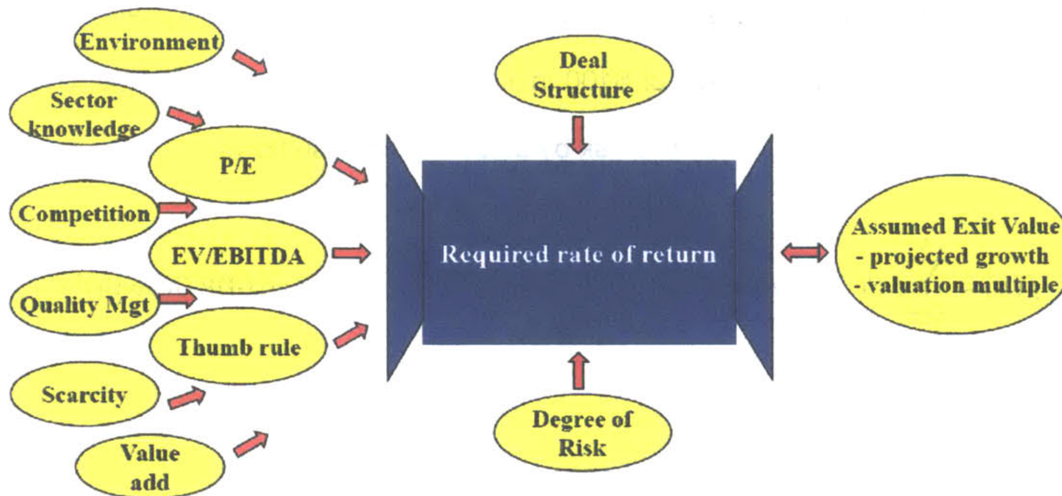
Note 3: Country Risk Premium (CDS Default Spread Method) = Rating Based Default Spread* Volatility Adjustment Factor(1.5)

Source: Aswath Damodaran, Country Default Spreads and Risk Premiums, 2013
http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

2.3.4.5. Other Factors to Consider

In practice, the discount rate will also be affected by many other issues, such as deal structures, scarcity of deal flows, degree of risk, value added by investors, quality of management, and so on. The following graph illustrate of the various factors affecting the discount rate.

[13] Aswath Damodaran, "Equity Risk Premiums (ERP): Determinants, Estimation and Implications – The 2012 Edition", March 2012



Source: Andre Loesekrug-Pietri, "Valuation," IAPEI Executive Investment Management Workshop, April 11, 2011

2.3.5. Adjusting Cash Flows

While adjusting the discount rate is to reflect systematic risk; adjusting cash flows is to reflect the specific / idiosyncratic risks. The method of adding country risk premium to the discount rate assumes that all investments in the country are affected equally. However, the probability of expropriation, for instance, is different for an oil firm than for a consumer products firm. Scenario analysis of cash flows easily allow for risks to vary over time. For example, the risk of expropriation of an oil field may decline over time. In this case, increasing the discount rate to account for the expropriation risk assumes that the risk is constant over time and will lead to an undervaluation of the investment[14].

Considering a company-specific risk – the business of a freight forwarding company is positively correlated with the economy. If the domestic GDP increases by 3%, the freight forwarder's revenue will increase by 6% (assume the revenue β is 2). Economists forecast that there is a 25% probability that the domestic economy will go into recession in the next 2 years with a GDP growth of -2%; 25% probability that the GDP growth is

[14] Paul Gompers, Victoria Ivashina, Timothy Dore, "Private Equity Valuation in Emerging Markets", 2012

0%, and 50% probability that the GDP growth will reach 3% in the next 2 years. Suppose the firm has a projected cash flow of $100 in Year 1 and $110 in Year 2. The following shows the equation to account for this risk by adjusting the cash flows.

$$f(x) = \sum_{j=1}^{N} (\, CF_{Y1} * Probability\ of\ Scenario\ j * (1 + \text{expected GDP Growth})^{t})$$

t = the year of the cash flow

The expected cash flows in year 1 would be:

100*25%*(1+2*(-2%))+100*25%*(1+2*0%)+100*50%*(1+2*3%)=$102

The expected cash flows in year 2 would be:

100*25%*(1+2*(-2%))^2+100*25%*(1+2*0%)^2+100*50%*(1+2*3%)^2=$104.22

Using a discount rate of 10%, the net present value is $178.86.

2.3.6. Valuation Obstacles in China

The valuation is typically a big obstacle in M&As and trade sales in China. Compared with the developed markets, there are a lot more disagreements between buyers and sellers in China. One of the reasons is that due to the less efficient financial market, the valuation in emerging countries is more complicated than that in the developed countries. Another reason is that local investors and entrepreneurs are less knowledgeable on valuation methodologies than those in developed countries.

The valuation given by the Chinese trade buyers are often low. The comparable and net asset valuation methods are commonly used; and the DCF method is not often used. Investors are unwilling to pay for the intrinsic value of intangible items, such as

management competency and brand name. Buyers would request an arbitrarily big discount on the valuation when using comparables in developed markets; while the sellers would not agree with the discount rate. In addition, the actual financial performance is usually different from the numbers provided by the Chinese firms, which makes the buyers even more conservative about the valuation.

2.4. Due Diligence

Due diligence is a process that critically reviews and analyzes the financial, legal, management and operational conditions of a company. It is the process through which the buyer and the seller get to know each other, a key step in private equity investments, and plays an important role in many other business transactions, including M&A, IPO, and licenses. Appendix B shows a brief Due Diligence Check List.

2.4.1. Steps of Due Diligence

The following shows the major procedures of the due diligence.

Steps	Tasks Involves
Receive Initial Teaser	Get basic knowledge of the target.
Draft Preliminary DD List	Use company's forecast models, analyst reports, company website, industry journals, website of industry associate, news search, comparable companies' prospectus and annual reports (for market and competitive analysis) to get a better understanding of the company and its market.
Conference Calls and Site Visits	Interact with the management to gain firsthand information about the operations and form direct impression of the management's capability.

Draft Preliminary Terms (term sheet)	Outline the major material terms and conditions (please refer to Appendix C for a sample term sheet of growth equity deal). If both parties agree to the preliminary terms, 3rd parties including legal counsels, auditors, and other advisors will be engaged to conduct a full-scale due diligence process.
Full-scale due diligence	Investors get access to dataroom, management presentation, 3rd parties conduct interview, site visits and inspection.
Follow-up and Review	Review of due diligence results, assess issues discovered, impacts on valuation and investment terms.

The following shows all parties get involved in due diligence and their corresponding responsibility.

Parties	**Major responsibilities**
Private equity investors	• Review due diligence reports from the 3rd party advisors. • Assess the quality of financial forecasts by the target company, conduct sensitivity analysis, create valuation band. • Conduct conversation with the management of target company. Evaluate the capabilities and credit-worthiness of the key management. • Assess the feasibility of transaction, discover potential problems and find solutions.
Auditors	• Review financial and tax records, assess the quality and accuracy of financial statements. • Issue opinion on the company's historical financial reports and tax compliance, and give adjustment suggestions.
Legal counsels	• Review all legal documents including incorporation documents, leases, licenses, purchase and supply contracts, patents, financing agreements, employment contracts, etc. • Issue legal due diligence report regarding existing and potential legal issues.

Consultants (industry-specific, environmental, HR)	• Additionally hire consultants in specialized areas, according to industry-specific characteristics and deal features to discover, assess and give solutions to potential problems in these areas.

2.4.2. Major Considerations in China

- ***Financial Due Diligence***

Private equity firms often find the financial information of Chinese firms not reliable. A common issue faced by foreign investors in China is the different sets of accounting books that Chinese firms maintain. The recent wave of suspensions and de-listings of Chinese companies listed in the U.S. due to the accounting irregularities reveal the seriousness of this problem. How to conduct financial due diligence in China becomes a tough question for investors, as the historical information of the target company and their competitors is very limited.

Besides hiring audit firms and investment banks to aid the due diligence process, a long-term, ongoing dialogue with key management usually occurs before agreeing to develop a partnership. Through numerous meetings, phone calls and site visits, investors get a feeling of the management's integrity and business risks. In addition to that, private equity firms should seek the third-party's feedbacks on the target company, including opinions of government officials, industry experts, suppliers, and customers. To double check the accuracy of the historical revenue and to confirm the financial forecasts, private equity firms should hire management consultants to help estimate the market size, the target company's market share, and the market growth. In addition, background check on key management will sometimes be conducted to ensure the integrity of the management.

- ***Relationship with Management***

Similar to venture capital in the U.S. market, private equity in China is a local, relationship-driven business. To successfully manage and exit an investment, besides getting satisfactory results from due diligence, the cooperation between investors and management to develop the business is equally important. Therefore, whether the management is cooperative and easy to work with is a key consideration for private equity investors to select deals. Many times, a lack of confidence in management becomes a deal-breaker.

- ***Enforceability of Contacts***

Compared with the developed market, the legal system, and enforceability of contracts in China is weaker. Private equity firms in China should be aware of the risks of overreliance on contacts as a way to reduce fraud risk. A solution to reduce the risk is through a valuation adjustment mechanism and deal structuring (as discussed in Section 2.5 Deal Structuring).

2.5. Deal Structuring

Deal structuring is a set of arrangements negotiated between the private equity firm and the investee company to reconcile their different needs and concerns with respect to a specific deal. The issues to be settled include capital structure and financing instruments to be used, pricing of the deal, warranties, and covenants, investors' right, and so on.

Compared with the developed markets, deal structuring for growth equity investments in China have its own distinct features.

2.5.1. Protecting Minority Shareholders' Rights

Growth equity deals in China are minority shareholding investments. As China's legal system and enforceability of contracts are still weak, the deal structuring plays a crucial role in protecting minority shareholders' rights, achieving control to protect expected return, and avoiding any necessary liability. Appendix C is a term sheet sample for minority shareholding growth equity investments. The major material terms are as following:

Deal Structure	Functions
• Performance-Based Adjustment • Liquidation Preference (original purchase price plus declared but unpaid dividends) • Anti-Dilution Provisions	• Valuation adjustment mechanism to ensure a reasonable return given the level of risk in the deal.
• Liquidation Events • Redemption Rights • Right of Co-Sale	• Assuring liquidity of investment in the future. • Preserve principal and providing downsides protection to the investment.
• Conversion Rights • Registration Rights • Right of Participation • Right of First Refusal	• Keep the upside potentials of investment.
• Voting Rights • Information Rights • Protective Covenants	• Having sufficient influence on the development of the company. • Having voting control to be able to replace management in case of consistent bad performance.
• Indemnification	• Providing downsides protection to the investment.

2.5.2. Valuation Adjustment Mechanism

As mentioned above, private equity firms often find the financial information of Chinese firms not reliable. Thus, private equity investors in China normally enter into a valuation adjustment mechanism ("**VAM**") to protect themselves from earning surprises. The following shows some commonly used mechanisms to provide investors with downsides protection while maintaining upside potential.

2.5.2.1. Financial Measures / Earning Guarantee

If management fails to meet forecast targets, investors will receive more shares in the company, or the management will give up board seats. The initial investment valuation is normally based on the company achieving projected earnings, which is guaranteed in the transaction documents. If the audited earnings are lower than the guaranteed earning, then prevailing valuation would be adjusted by the following formula:

$$\text{Adjusted Valuation} = \text{Valuation} \times \text{Adjustment Factor}$$

The Adjustment Factor is defined as the audited earnings divided by the guaranteed earnings. For example, the investee company guarantees a net profit of $100 million in 2013 and achieved $80 million instead. The adjustment factor is $80/$100 = 0.8.

2.5.2.2. Non-financial Measures (e.g. license)

Depending on whether the target company can obtain new patents or licenses (e.g. in mining industry), the investors will determine whether to launch the second round of capital injection or to issue stock options to the management.

2.5.2.3. *Exit Guarantee*

If the target company cannot pay the cash dividends on time, they will be forced to pay stock dividends. If the target company cannot achieve an IPO within a certain amount of years, the investors can sell the stakes to a third party or require the management to buy back their stake with accrued interest.

Case Study: Goldman Sachs and China Nepstar [15]

In 2004, Goldman Sachs Private Equity Group ("**PEG**") invested $25 million via convertible preferred shares in China Nepstar Chain Drugstore (NYSE: NPD), one of China's largest retail drugstore chains. The 50 million Series A shares were bought at $0.50 per share, at which PEG would own 30.3% of the company. The following is a summary of the terms of the VAM in the Nepstar deal.

Measures	**Terms**
If diluted EPS is less than 50 cents, or EBITDA growth rate is less than 41.67% by 2004	PEG can purchase a maximum of 15 million convertible preferred shares at $0.0001 per share
Average revenue, EBIT and EBITDA in 2005 is less than 70% of the guaranteed number	PEG is able to appoint new board directors
Fails to obtain a qualified IPO by the fourth anniversary of PEG's investment	Nepstar is required to buy back all PEG's shares and pay the compounded annual interest of 8% to PEG

Under the first financial measure, which is also known as an Earn-out Agreement, Nepstar has to grow its earnings per share by $0.5, or EBITDA growth equivalent of 41.67%. If Nepstar fails to achieve the target, PEG would have the right to purchase 15

[15] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012

million more shares for $1,500 (virtually free).

The second term is a non-financial measure known as a Workout Agreement. If the company fails to achieve 70% of the 2005 guaranteed revenue, EBIT and EBITDA, PEG can appoint additional board directors to the five-member board. The current board had two members from PEG and three from Nepstar. By having this condition in place, PEG was able to add another representative to the board, causing Nepstar's management to lose the majority control of the company.

The above two terms show how PEG enforces discipline on the company to perform over the next two years. Nepstar needed to achieve the guaranteed earnings in both 2004 and 2005: revenues grew by 21%, EBIT by 191%, and EBITDA by 113%. These two terms aim to improve the company's profitability and push it to meet the listing requirements of NYSE (the company suffers from a net loss in 2002 and 2003 consecutively). Although the terms seem tough, the founders accept it, as having Goldman Sachs as a prestige investor helps when Nepstar gets listed on the NYSE.

The third term is about redemption. If Nepstar cannot get listed within four years after the investment, the company has to buy back all of PEG's convertible preferred shares at the cost plus an annual compounded interest rate of 8%. In addition, the company has to achieve a pre-IPO valuation of no less than $250 million and net proceeds from listing of no less than $50 million. If Nepstar achieves this, PEG would make a 3x investment return.

As a result, the number of Nepstar's drugstores grew from 437 in 2004 to 2,002 stores in 2007. The company turned a net loss of RMB18 million into a net profit of RMB13.6 million in 2006 and RMB148 million in 2007, which far exceeded the guaranteed net

profit of RMB100 million in 2007. Although Nepstar missed the guaranteed revenue, it met the rest of the targets and achieved an IPO in 2007. This is a successful case of VAM that helped to improve the business performance and achieve a win-win situation for the portfolio company and the private equity investor.

2.5.3. VIE Structure

As discussed in Section 2.1.1, foreign capital is prohibited from investing in certain sectors in China, such as defense, telecommunications, education, internet, media, etc. Also, USD-denominated funds are required to receive approvals from the Chinese government before making an investment in the companies incorporated in mainland China, which is time-consuming. To circumvent the regulations, VIE structures ("Variable Interest Entity") are typically adopted by the Chinese companies to receive investments from the USD-denominated funds and eventually get listed on an offshore stock exchange.

Unlike a straight-forward equity acquisition, in a VIE structure, the offshore holding company would form a new wholly owned subsidiary - Wholly Foreign-Owned Enterprise ("**WFOE**"), which would control and receive the economic benefits of the domestic company (the VIE) through a series of contractual arrangements. The shareholders of VIE, normally the majority shareholders in mainland China, would hold those licenses and assets that cannot be legally owned by the WFOE under the foreign investment restrictions in China.

The following shows a typical VIE structure. The contractual agreements[16] between the WOFE and VIE consist of Exclusive Services Agreement[17], Asset Licensing Agreement[18], Voting Rights Agreement[19], and Loan Agreement[20]. These contractual agreements effectively give the WOFE the full control and economic benefits over the operating company in mainland China. The holding company then goes public on an overseas exchange. This arrangement allows the foreign investors to bypass the regulatory approval and filing requirement under the M&A Rules in mainland China. As of April 2011, 42% of Chinese companies listed in the U.S. have used the VIE structure and thousands of private companies have adopted the VIE structure[21].

[16] David Roberts and Thomas Hall, "VIE Structure in China: What You Need to Know", October, 2011

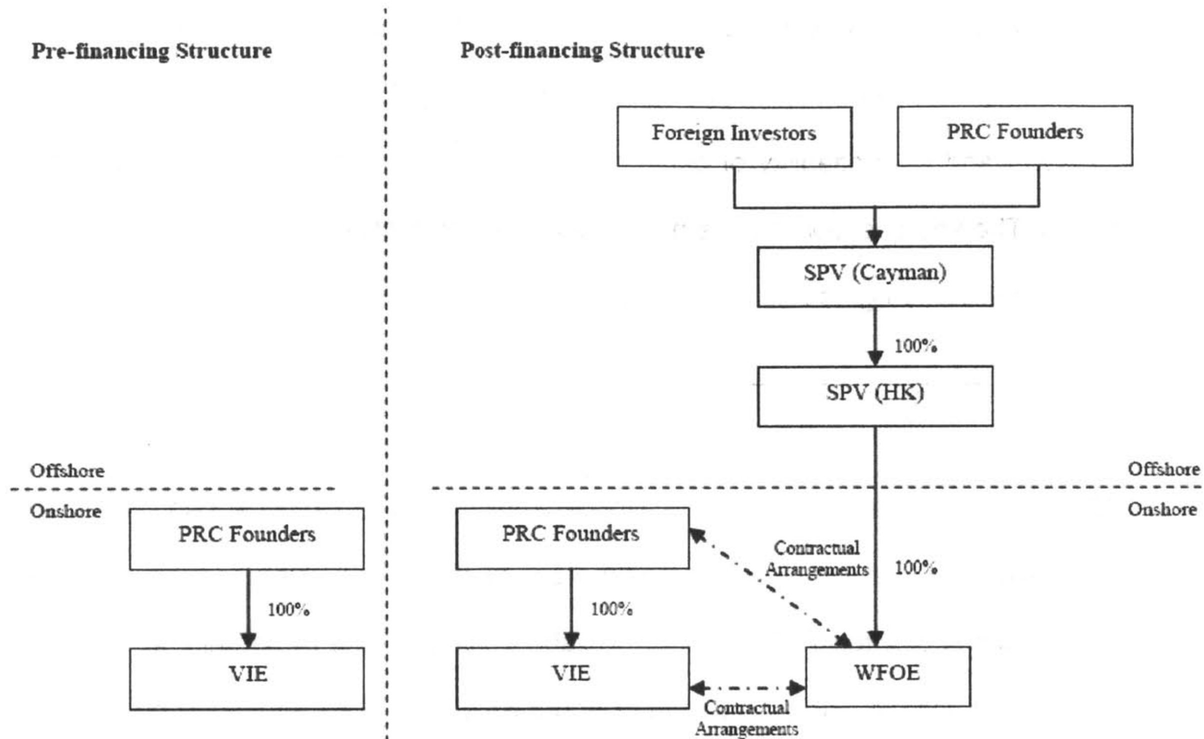
[17] Under the agreement, the WFOE provides certain services to the VIE for a fee, typically determined by the WFOE with the intended result of shifting the VIE's operating profits to the WFOE. The scope of service typically includes consulting and technical services

[18] Under the agreement, the WFOE licenses certain assets, typically including intellectual property, to VIE for royalty fees. The agreement usually allows the WFOE to terminate the license at any time. Such right of termination gives the WFOE additional control over the VIE

[19] Under the agreement, the VIE shareholders delegate their shareholder rights, including voting rights, inspection/information rights, signing rights, and election rights, to the designee of the WFOE

[20] The agreement grants a loan to the VIE shareholders to use for capitalization of the VIE. The agreement includes covenants, limits on repayment methods and acceleration clauses designed to help in enforcing the VIE structure as a whole

[21] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012



Source: David Roberts and Thomas Hall, "VIE Structure in China: What You Need to Know", October, 2011

This type of structure normally has offshore vehicles in the Cayman Islands or British Virgin Islands due to their favorable tax rates, stronger legal protection, easer equity transfer, and the ability to exit on an overseas stock exchange such as the NASDAQ or SEHK.

In the early 2000s, the VIE structure was used mainly by the companies in some restricted industries for foreign investments. With more companies adopting the VIE structure getting listed in overseas stock exchanges, investors gradually got comfortable with the VIE structure. Increasingly Chinese companies have adopted the structure, including companies in traditional and asset-heavy industries. Currently, this issue is getting the regulators' attention; and the regulatory scrutiny of the VIE structure is increasing.

The VIE structure is playing a critical role in the development of China's private sector. Billions of dollars have been invested in China in this way. Taking into account the weak legal system and enforceability of contracts in China, VIEs actually contain substantial legal risks. The key question here is how secure the contractual agreements can protect the foreign investor's rights and control on the operating company in mainland China.

Case Study: The Dispute between Yahoo! and Alibaba [22]

In 2005, Yahoo! made what turned out to be a highly profitable investment in Alibaba Group ("**Alibaba**"), the leading e-commerce platform in China. However, their relationship got sour afterwards. In 2011, Alibaba transferred the ownership of Alipay, an online payment service with a valuation of about $5 billion, to a firm owned by Mr. Jack Ma, the founder and Chief Executive Officer ("**CEO**") of Alibaba. The move eroded Yahoo!'s 43% stake in Alibaba. Yahoo! claimed that it was not notified of the transfer before the deal. Moreover, Yahoo! said that the management of Alibaba transferred Alipay without the approval from the board. Mr. Ma claimed that to receive the permit of a payment business in mainland China, Alipay has to be owned by an entity incorporated in mainland China. However, the People's Bank of China (the central bank of China) never publicly has confirmed his claim.

Alibaba's transfer of Alipay was done through the VIE structure. Although the dispute has been settled after months of negotiation, the fact that the CEO of Alibaba was able to transfer a $5 billion asset to his own company without getting the consent from the major shareholders revealed the risk of the VIE structure.

[22] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012

2.6. Portfolio Management

Portfolio management is very important for growth equity investments in China. The private equity sector is very competitive in China as there is lots of "hot money." The value added by private equity firms becomes a crucial factor for the investee company to select investors. The following shows some of the value added by private equity firms in growth equity deals.

- ***Correction of issues discovered by due diligence***: To improve the financial reporting system and making sure the accuracy of the accounting numbers, to standardize the day-to-day legal documents and reporting procedures, and to fix loopholes in contracts, employment agreements, licensing agreements, etc. These procedures are very important if the company aims to get listed in the future.
- ***Active involvement in developing the portfolio company***: To provide M&A advisory to the target company, to help recruit senior management such as the CEO and the CFO, to cut down cost and improve operation efficiency, to help bring more clients, to improve corporate government, and so on.

Case Study: TPG China and Daphne International [23]

In 2009, TPG invested into Daphne International, a producer and retailer of fashion shoes for women. The company went public on the Main Board of SEHK in 1995. By the end of 2008, Daphne has over 3,500 stores in mainland China with a revenue of over $682 million.

TPG's investment consisted of unsecured convertible bonds due in 2014 with an

[23] Victoria Ivashina, "TPG China: Daphne International", October 25, 2012

aggregate principal amount of RMB550 million (about $81 million). As part of the investment, TPG received the right to nominate one board director and one board observer. TPG also received a right to nominate the candidates for CFO and the head of supply chain management.

The cash that TPG invested in Daphne was not the sole reason of the investment as the CEO comments: "money was not an issue. There is plenty of money in China." In fact, Daphne was a cash rich company. The main attraction of the investment by TPG to Daphne was that TPG was uniquely positioned to implement operational improvements and to revamp the supply chain.

The new business model proposed by TPG was to adapt the production process to better understand and respond to consumer preferences. It was building on a "fast-fashion" model pioneered by Zara in the 1980s and successfully replicated by other retailers such as H&M and the American Forever 21. Zara operated as a vertically integrated apparel retailer, a business model that enabled it to offer trendy items manufactured quickly and at affordable prices while to keep a low inventory. The merchandise was supplied in small orders and quickly replenished. The new business model designed by TPG was expected to improve the operation of Daphne in the following aspects.

- New Merchandising Strategy

The strategy aims to compress the production cycle and to replace the seasonal full production cycle with the initial-order production with a 40% reduction in the old production amount. The new model is able to follow the fashion trend more closely; and initial orders would be made much closer to the season launch. Also, a reliable, real-time

sales database will be built to reflect the order fulfillment process, so that Daphne would place few re-orders in the first weeks of a season.

- Improved R&D

While the previous SKUs ("stock-keeping units") selected for production were essentially the replicas of top international brands modified by Daphne's suppliers, the new business model requires having an internal, high-caliber designer team focusing on fashion trends and brand positioning.

- Supply Chain Management

This strategy aims to compress manufacturing time from over 90 days to less than 30 days to allow for rapid replenishment of merchandise. Also, it helps to shorten the time for re-ordered SKU to arrival at stores within 6 weeks, about a third of the previous re-order time of 18 weeks. Moreover, the strategy will abandon large batch orders, which would increase per unit cost and reduce current capacity utilization, but optimize logistics for speed and flexibility of the manufacturing process. In addition, the strategy replaces the current (mostly manual) processing with an automated and integrated IT platform with high data capability.

- Inventory, Stock-outs, Sales mix

This initiative helps reduce inventory days to less than 120 days, shift inventory mix to mainly comprise of top selling styles without much discount. It also remodels the inventory system to ensure adequate supply of the top best-selling SKUs that contributes 65% revenue and over 90% of profits. In the old model, the top styles almost

sold out in the first few weeks

- Labor Management

Through the training of senior and junior store managers and better allocating sales staffing during peak hours and non-peak hours, the new model is expected to reduce the number of employees per store while improving sales.

- Forecasting Model

The strategy helps build the forecasting model that takes into account the factors influencing customer demands, including:

  - Price sensitivity of the demand through the season
  - Regional differences
  - Impact from holidays
  - Other factors such as fashion trends and extreme weather conditions

The new business model introduced by TPG brought several visible areas of improvement. In 2010, Daphne's sales grew by 14% year-over-year. Aged inventory reduced to an all-time low of 19% at the end of 2010. Average inventory turnover was 128 days, as compared to 156 in 2009 and 171 in 2008. The gross profit margin of Daphne increased from 52.7% in 2008 to 61.1% in 2011; EBIT margin increased from 12.9% in 2008 to 15.4% in 2011. TPG, despite a minority shareholder, successfully improved the business operation of Daphne.

2.7. Exit Strategies

2.7.1. Current IPO Market for Chinese Companies

Possible exit mechanisms include IPOs, trading sales, buy-back arrangements, cash distributions, asset swaps, distributions in kind, and liquidation. In the past, private equity firms exit their portfolio companies mainly through an IPO. It is estimated that about 90% of exits in Chinese investments are made through IPOs[24].

The most acute need for exit will be investments made before 2008. But many private equity firms are still adopting the strategy of "wait and see", hoping that that Hong Kong's once-vibrant IPO market for Chinese companies will return to the old days soon. However, the IPO flood of Chinese firms in Hong Kong almost came to a halt in 2012. The U.S. stock market is expected to remain pessimistic about Chinese companies for a long time due to accounting scandals happened in recent years. IPO through A-share market in mainland China is now suspended with an approval backlog estimated to take three to five years to clear[25]. To make things worse, China Securities Regulatory Commission ("**CSRC**") has suspended the IPOs in A-share market at the beginning of 2013. As of May 1, 2013, there are still no IPOs. CSRC further announced that they have no time schedule to re-launch IPOs in 2013.

Partly because of the bearish IPO market, the total value of China's private-equity deals decreased by 27% to $21.9 billion in 2012, with only 473 transactions, the lowest level since 2005. Private equity funds in China are still holding 82% of the companies they have invested in since 2007. Blackstone Group LP, one of the world's biggest private-equity firms, hasn't made a single investment in China outside the property sector since

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[24] Victoria Ivashina, TPG China: Daphne International

[25] China First Capital, "China Private Equity Secondaries", January 16, 2013, http://www.chinafirstcapital.com/blog/archives/4994

2011. Mr. Antony Leung, Blackstone's chairman for Greater China, said that "conservative sometimes may not be a bad thing"[26].

As such, the real challenge for private equity in China is to achieve more trade sales and secondary sales.

2.7.2. Secondary Sales

Compared with the developed markets, the secondary sales market in China is less active. Compared to IPOs, this type of exit historically generated a lower valuation in China (as discussed in 2.3.6). Therefore, investors prefer to invest directly in a company than to buy it from peers. In 2013, the IPO markets are all but shut down for Chinese companies. However, many Chinese private companies are still seeking prices dating back in 2007 when the listed firms traded in A-share markets at an average P/E multiple of 30x-40x. Compared with the developed markets, entrepreneurs in China are less experienced with the capital market. They are not accepting the valuation discount even as the number of private-equity deals in China fell an unprecedented 43% and domestic IPOs tumbled 70% in 2012[27].

In the current difficult situation, secondary transactions provide a valuable exit solution. The need for the diversification of exit becomes urgent. Many private equity firms that wisely invested across a range of industries, vintage years and deal sizes, have become overly relying on one single path to exit - IPO. There is another good potential exit for

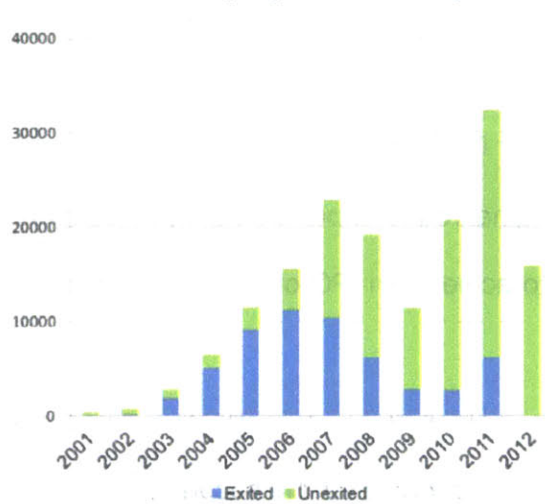
[26] Cathy Chan, "China Private Equity Chilled by 'old Days' Asking Prices", Bloomberg, Feb 5, 2013
[27] Cathy Chan, "China Private Equity Chilled by 'old Days' Asking Prices", Bloomberg, Feb 5, 2013

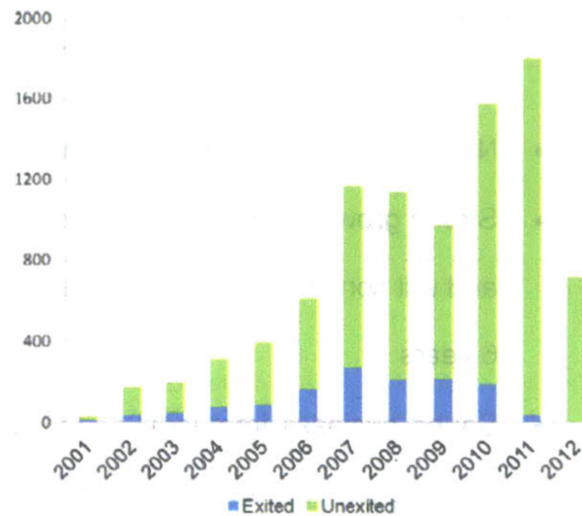
both deal sellers and buyers - “Quality Secondaries”, which is a group of private equity invested companies that fulfill four criteria[28]:

- Not in IPO approval process, domestically or internationally
- Strong growth (+25% a year) since the original round of private equity investment, and will continue to grow and potentially to achieve an IPO or trade sale exit in 3-6 years
- Sound business from legal and regulatory perspective, have effective corporate governance, with a majority of shareholders supportive for the secondary sales
- The current private equity investors seek secondary exit due to fund life or portfolio management reasons

The following shows the number of unexited deals in China since 2001. The total number of private equity deals that are not exited is about 7,500. China First Capital[29] estimated that there are at least 200 companies that meet with the criteria of Quality Secondaries.

[28] China First Capital, "China Secondaries, The Necessary & Attractive Exit For Private Equity Deals in China", 2013
[29] China First Capital is a leading China-focused investment bank and advisory firm for private capital markets and M&A transactions in China





Source: China First Capital, "China Secondaries, The Necessary & Attractive Exit For Private Equity Deals in China", 2013

The number of Quality Secondaries is expected to grow by about 15%-25% per year, as more funds are reaching the later stage of their lives, and other exit options remain somewhat limited. Compared to the primary deals, the due diligence risk of Quality Secondaries is significantly lower, and contingent risks (opportunity costs and legal risks of pursuing other non-IPO exits) are lower as well. Therefore, secondary transactions are estimated to grow from the current low level to a meaningful share of all private equity exits in China.

China First Capital estimated that the RMB-denominated funds and the second tier private equity funds will be the major net sellers to the secondary market. Top tier private equity firms are likely to be net buyers. The industry is expecting a consolidation.

Chapter 3: Look Forward- LBO Opportunities in China

A LBO deal employs financial leverage to acquire a company. LBOs allow private equity firms to make large acquisitions without having to commit a lot of equity capital. Private equity firms' return is partially from high leverage. Debt financing in a LBO is typically a combination of bank loans (the majority), high-yield bonds/notes, mezzanine debt, and asset-backed securities[30]. LBO deals in the U.S. and Europe often involves 60%-80% of debt financing. Debt financing is crucial for the LBO deals.

Capital markets are divided into equity markets and debt markets. Currently in China, the equity market is developing very fast; while the debt market is relatively under-developed. Bank loans are the primary source of debt financing for corporates in China. Commercial banks are playing a crucial role as a lender in the loan market and as an investor in the debt market. Bank loans account for over 80% of the funding for non-financial companies; while the remaining 20% are enterprise bonds, treasury bonds, and equity financing (excluding IPOs)[31].

In the following sections, we will assess the potentials of LBO investments in China through analyzing the capital market landscape of the country and case studies.

3.1. Acquisition Financing Provided by Banks in China

3.1.1. Policy Overview

In December 2008, the China Banking Regulatory Commission (the "**CBRC**") issued a guideline that removes the long-standing restriction on the granting of bank loans for equity investments in China. The Guidelines for the Risk Management of Merger and Acquisition Loans Granted by Commercial Banks (the "**Guideline**") permits commercial

[30] Paul A. Gompers, "Introduction to Private Equity Finance", August 17, 2012
[31] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012

banks incorporated in mainland China to make loans to domestic enterprises to conduct both onshore and offshore M&A activities. The Guideline replacing the prohibition set out in the "General Principles of Loans" by CBRC issued in 1996, prevented the banks in mainland China from providing loans to domestic borrowers for the purpose of M&A investments[32].

- ***Onshore acquisitions***: both domestic and wholly foreign-owned enterprises now have access to alternative sources of funding for both equity and asset acquisitions. Before the issuance of the Guideline, Chinese companies have had to go through the cumbersome registration of capital increase process to get the limited offshore funding to finance their onshore acquisitions
- ***Offshore acquisitions***: the Guideline provided private domestic companies an alternative source of funding from the major policy banks[33]. Before the issuance of the Guideline, most of China's offshore M&A activities are undertaken by the SOEs which are able to obtain preferential funding from the policy banks.

However, though the Guideline brings deregulation to the Chinese regulatory environment by allowing banks to provide acquisition financing to domestic enterprises, it remains vague how the Guideline can be practiced. The following shows some major restrictive clauses of the Guideline relevant to LBO investments.

- ***Borrower qualifications:*** Acquisition financing can only be undertaken by "domestic enterprises", including companies owned by Chinese nationals, Sino-

[32] Norton Rose, "The Foundations for LBOs in China - Note on new Chinese M&A acquisition finance rules", March 2009

[33] There are three "policy" banks in China: the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China. They were established in 1994 to take over the government-directed spending functions of the four major state-owned commercial banks. These banks are responsible for financing economic and trade development and state-invested projects. Agricultural Development Bank of China provides funds for agricultural development projects in rural areas; China Development Bank specializes in infrastructure financing, and Export-Import Bank of China specializes in trade financing.

foreign joint ventures, and WFOEs. In this regard, RMB-denominated funds in China appear to be allowed to leverage investments in China. However, it remains to be tested in practice how other foreign "enterprises" (such as foreign invested holding companies and USD-denominated private equity funds in China) could benefit from the Guideline[34].

- ***Strategic relevance***: when assessing any given M&A transaction, the lenders must consider the "industry relevance", "strategic relevance" and any potential synergy between the acquirer and the target. An acquirer must be able to improve its core competitiveness through the proposed transaction by acquiring strategic resources like R&D capability, key technology, trademarks, royalty rights, supply and distribution networks. Though commercial banks are allowed to offer acquisition financing services, the CBRC will still keep a strong control on the acquisition finance deals in China.
- ***Term of loans, leverage ratio, and provisions:*** the term of the acquisition loan is limited to 5 years; and the total value of a loan must not exceed 50% of the total acquisition price. Also, specific provisions are required to be included in M&A loan documentation, such as stringent securities to support the loan (by ways of mortgages, pledges and the third party guarantees), financial covenants, mandatory prepayment, change of control, restrictions on asset disposal, etc.

3.1.2. The Development of the Bank Acquisition Financing in PRC

In February 2009, Aluminum Corporation of China ("**Chinalco**") and Alcoa Inc jointly acquired 12% of Rio Tinto Plc with a total investment of $14.05 billion. China Development Bank (a policy bank in China) provided the acquisition financing to

[34] King&Wood Mallesons, "New acquisition finance rule to boost Chinese M&A market", December 15, 2008, http://www.mallesons.com/publications/marketAlerts/2008/Documents/9734385w.htm

Chinalco. This is the first bank acquisition financing deal in China. In November 2010, the Bank of Beijing, the Bank of China (the "**BOC**") and the China Construction Bank (the "**CCB**") together provided a RMB3.5 billion acquisition loan to Beijing State-Owned Capital Management Center ("北京国有资本经营管理中心") to acquire 45% of China Securities Co. Ltd., which is one of the largest banking acquisition financing deals in Chinese history.

The major challenges faced by banks when providing acquisition loans are as follows:

- The valuation of M&A deals and the amount of loan to be provided
- The risk management and the prevention of non-performing loans

The following shows the major bank acquisition financing deals since the issuance of the Guidance.

Date	Sponsor	Deal	Size	Sponsor Background	Acquirer Background
01/09	China Development Bank	CITIC Group and CITIC Guoan to acquire Silver Group	RMB1,630M	Policy bank	SOE
02/09	Industrial Commercial Bank of China ("ICBC")	Brilliance Group to acquire SIIC Business	RMB400M	State-owned commercial bank	SOE
03/09	CCB, Bank of Communi-cations	Bao Steel to Acquire Ningbo Steel	RMB1,550M	State-owned commercial bank	SOE
03/09	BOC	Huaneng Group	RMB680M	State-owned commercial bank	SOE
03/09	BOC, Bank of Beijing, Citic Bank	China National Machinery Industry Corp. to increase % shares in YTO Group Corp.	RMB850M	State-owned commercial bank	SOE

03/09	Industrial Bank Co. LTD	Huayuan Property	RMB600M	Joint stock commercial bank	Sino-Foreign joint venture
09/09	Agricultural Bank of China	China Materials Development Investment Co.	RMB198M	State-owned commercial bank	SOE
07/10	BOC	Henan Coal Chemical Group	RMB385M	State-owned commercial bank	SOE
11/10	Bank of Beijing, BOC, CCO	Beijing State-Owned Capital Management Center to acquire 45% of China Securities Co.	RMB3,500M	State-owned bank	SOE
06/11	China Development Bank	Chongqing Textile Group to acquire SaarGummi Group	€35M	Policy bank	SOE
06/11	Agricultural Bank of China	Guodian Yongshou Coal integration LLC	RMB294 M	State-owned bank	SOE

Source: ChinaVenture, "Future of Banking Acquisition Financing in China", August 2011, http://report.chinaventure.com.cn/r/f/405.aspx

The following shows some common practices of bank acquisition loans in China.

Industries Encouraged by Government to Conduct M&A	Non-ferrous metal, steel, automobile, ship-building, petro-chemical, textile, logistics and transportation, heavy machinery manufacturing, news media, pharmaceutical retailing
Term	3-5 years
Interests	Similar to the rate of the ordinary commercial loans
Collateral / Guarantee	Higher than that of the ordinary commercial loans, including pledge of assets and equity, third-party assurance, etc.
Management of Acquirer(s)	At least 3 years of M&A experience

Deal Selection	Provincial bank branches source deals and then report to head office

Source: ChinaVenture, "Future of Banking Acquisition Financing in China", August 2011, http://report.chinaventure.com.cn/r/f/405.aspx

From the above information, we can see that most of the financial sponsors are policy banks and state-owned banks, while the acquirers are SOEs. The bank loan policies in China still tilt towards SOEs. There is a long way to go for privately owned companies to get access to the banking acquisition loans. Also, from the above list, we can see that all of the loans are provided to strategic investors (mainly SOEs) to conduct onshore and offshore M&As. Moreover, banks will give priority to industries and companies that are supported by the Chinese government to conduct M&As, such as steel and automobile industries. Therefore, the chance of a LBO financing provided by Chinese banks to private equity firms is limited in the near future.

However, the successful deals conducted in the recent years have established good practices for the bank acquisition financing sector in China, helping banks to improve their risk management system and to get prepared for providing financing to a variety of acquirers in the long term.

The following shows a pioneer bank acquisition financing deal in mainland China. From the case, we can see that Chinese banks are still very conservative in selecting deals.

Case Study: Bank Acquisition Financing for North China Pharmaceutical [35]

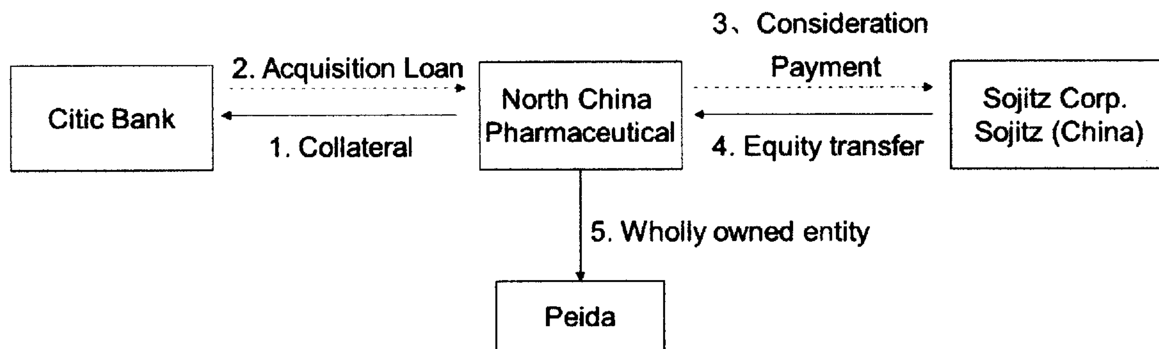
In 2009, China Citic Bank provided an acquisition loan of RMB60 million to North China Pharmaceutical Co. Ltd. ("**North China Pharmaceutical**") to acquire 30% shares of North China Pharmaceutical Peida Co. Ltd. ("**Peida**") owed by Sojitz Corporation and

[35] China Citic Bank, "Case Study of North China Pharmaceutical Acquisition Financing", October , 2009

Sojitz (China) Co., Ltd. respectively, so as to own 100% of the company.

On March 19, 2009, in order to introduce advanced technology and to expand production, North China Pharmaceutical signed a strategic cooperation agreement and a restructuring agreement with DSM (a Holland-based life and materials science company). The two parties will set up three joint ventures that assume the equity and liability from Peida, a subsidiary of North China Pharmaceutical. DSM will acquire 9.77% shares of Peida at a price of RMB189 MM and become a new shareholder. Before bringing on the new strategic investor, North China Pharmaceutical needs to acquire the 30% shares from the two existing shareholders of Peida - Sojitz Corporation and Sojitz (China) Co., Ltd. - at a price of RMB122.7M.

The acquirer - North China Pharmaceutical is a SOE, listed in SHSE with a total revenue of RMB4.9 billion ($) in 2008. The target company Peida is a joint venture among North China Pharmaceutical (70%), Sojitz Corporation (15%), and Sojitz (China) Co. (15%), with a revenue of RMB579 million in 2008. The following shows the transaction chart.



The following table shows some transaction details:

Collateral	No less than 30% shares of Peida.
Source of Repayment	• Plan A: Peida will sell its assets to the joint ventures established by North China Pharmaceutical and DSM, and use the proceeds to pay dividends to the parent company - North China Pharmaceutical. The dividends received will be used to pay for the acquisition loan. • Plan B: If Plan A fails, North China Pharmaceutical will use its balance sheet cash to pay off the loan.
Investment Thesis	• Industry dynamics: The pharmaceutical industry is regarded a "Sunrise Industry" in China, with an annual growth rate of 17.5% in the past 20 years. Also, the Chinese government supports the industry consolidation, which will help eliminate small players. • The financial position of the acquirer: the acquirer is a leading SOE in the pharmaceutical industry with a strong balance sheet and sound profitability. • M&A synergy: DSM is expected to bring advanced technology to Peida and help increase its competitiveness.
Potential Risk	Citic Bank believes that the major risk is the compliance legitimacy of the transaction, as it is the first acquisition financing deal done by the bank.

Source: Citic Bank

3.2. Bond Market in China

3.2.1. Market Overview

China's bond market is the fourth largest in the world at about RMB21.73 trillion ($3.41 trillion)[36]. However, compared to the developed countries like the U.S. where corporate bonds consist of 50% of corporate financing[37], bonds only account for 13% of corporate financing in China, while the bank lending accounts for 82%[38]. The bond market in China is mainly made up of government bonds, central bank bills, financial bonds issued by China's policy banks, and enterprise bonds issued by SOEs. The corporate bond market for private companies consists of a very small portion of the total issuance outstanding (about 2% in 2012).

There are two major bond markets in China:

- ***The Interbank Bond Market***, mainly regulated by the People's Bank of China. The transactions account for more than 95% of total outstanding bonds in mainland China, reaching $35 trillion in 2012[39]. It is an over-the-counter market, quote driven and mainly made up of institutional investors.
- ***The Public Exchange Market***, regulated by CSRC. Corporate bonds are mainly traded here.

There are four major types of bonds traded in China's bond market[40]:

- ***Government bonds:*** issued by the Ministry of Finance in a range of maturities to finance government spending. It is the largest segment of the bond market in China.

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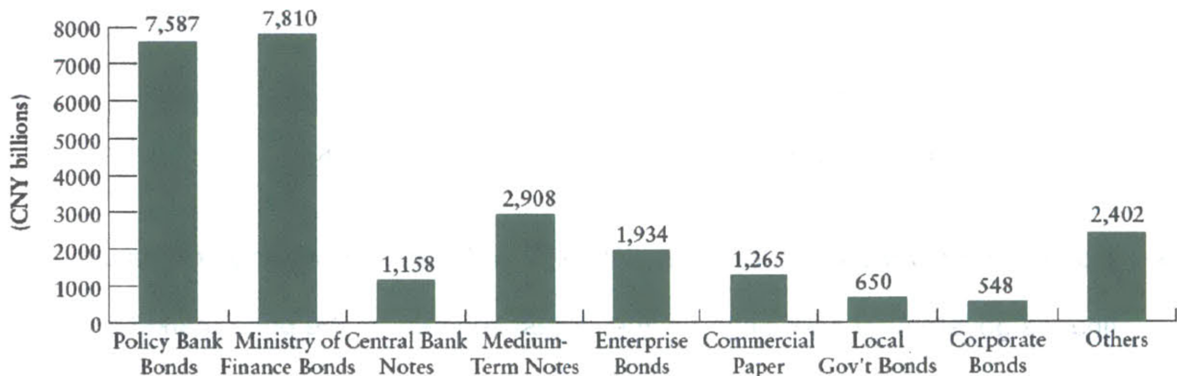
[36] Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013
[37] Nils Hakansson, "The Role of a Corporate Bond Market in an Economy – and in Avoiding Crises" , 1999
[38] Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012
[39] Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013
[40] Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013

As of December 2012, the size of government bonds is about RMB7.81 trillion ($1.25 trillion), consisting of about 30% of the total bond market. Local governments also issue bonds, similar to the municipal bonds in the U.S.

- ***Central Bank notes:*** short-term securities issued by the Peoples Bank of China (the Central Bank in China) as a tool to implement monetary policy. As of December 2012, it is the second largest bond segment in mainland China with about RMB7.59 billion ($1.22 billion), consisting of 29% of total market size. Central bank notes are the most actively traded sector in the bond market due to the large amount outstanding and the regular weekly issuance (which is unique in China).
- ***Financial bonds:*** issued by policy banks, commercial banks and other financial institutions. The policy banks, such as the China Development Bank and the Export-Import Bank of China, are the largest issuers. Only policy bank bonds are backed by the central government.
- ***Non-financial Corporate bonds:*** include a wide variety of bonds. The largest sector is the Enterprise Bonds issued by the SOEs.

The following shows the size of various bond sectors in China as of December 2012.



Source: Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013
Ministry of Finance, as of December 2012

The following shows the instruments, participants, and regulatory bodies in China's domestic bond market.

	Interbank Bond Market	Exchange Market
Instruments	• Government bonds • Central Bank notes • Financial bonds • Commercial paper • Medium-term notes • Enterprise bonds	• Some central government bonds • Some enterprise bonds • Corporate bonds
Participants	• Banks • Insurance companies • Mutual funds • Security houses • Other institutional investors	• Individual investors • Insurance companies • Mutual funds • Security houses • Other institutional investors excluding banks
Regulatory Body	• People's Bank of China • National Association of Financial Market Institutional Investors	• China Security Regulatory Commission

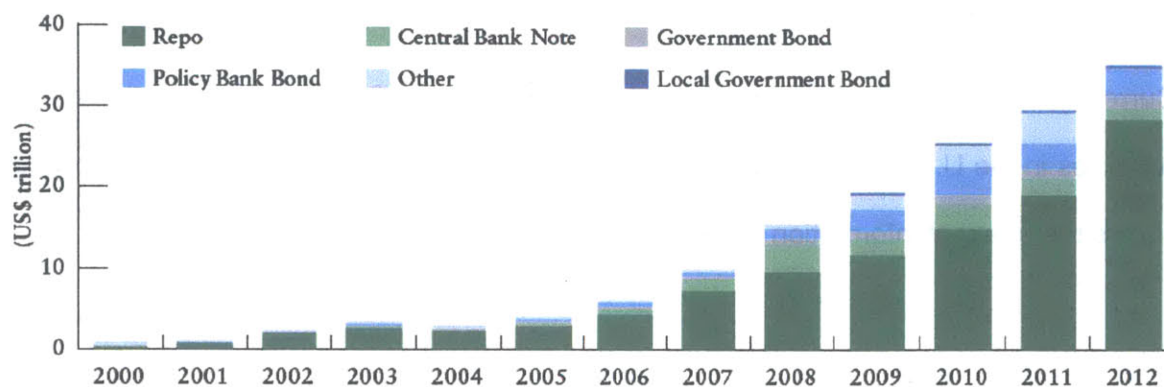
Source: Yong Kwek Ping, "Private Equity in China: Challenges and Opportunities", 2012

Currently, there are four major credit rating agencies in China. Similar to the credit agencies in the U.S., they charge fees from the target entities being rated. The following shows the relevant information of the four credit rating agencies.

Credit Agency	Background Information
China Cheng Xin International Credit Rating Co. Ltd.	49% owned by Moody's
China Lianhe Credit Rating Co., Ltd.	49% owned by Fitch
Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.	Strategic cooperation agreement with Standard & Poor's
Dagong Global Credit Rating Co. Ltd.	One of the few notable non-US based credit rating agencies. 60% owned by – Mr. Guang Zhongjina, a Chinese national

3.2.2. Development of the Bond Market in China

Commercial banks dominate trading activities in China's inter-bank bond market, accounting for about 70% of trading volume, as they have limited investment channels and are restricted from investing in equities and the futures market. The trading activities of China's bond market grow rapidly, reaching about $35 trillion in total trading volume in 2012[41]. However, the majority are repo bonds issued by the People's Bank of China. The following shows the bond trading volume and segment breakdown from 2000 to 2012.



Source: *Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013*
Wind, as of December 2012

[41] Goldman Sachs Global Liquidity Management, "FAQ: China's Bond Market", 2013

The debt market in China is strictly controlled. A majority of debt issuance requires governmental approval and a large state-owned bank as guarantor. This limits the access of private firms to issue debt. Therefore, private firms are forced to turn to bank financing, which is controlled largely by state-owned banks and gives preference to SOEs. There is a great urgency to diversify in corporate financing sources and to build a strong debt market to reduce the dependence of corporates on state-owned banks for financing. Also, a developed bond market will help to diversify investors' portfolio and to improve corporate governance, since the valuation of bonds are highly dependent on the external ratings by credit rating agencies, which increases the scrutiny on firms looking for capital in the debt market.

Realizing the limits of an under-developed debt market, the Chinese government is increasingly taking steps to diversify the bond market and introduce new products. The following shows the milestones of China's bond market in recent years.

- ***Asset backed securities***: In 2005, a pilot program to test the asset-backed securities (the "**ABS**") was launched. In 2012, the new regulations announced by CSRC expand the class of assets that can be securitized to include loans, receivables, infrastructure dividends, commercial paper, stocks, bonds, and real estate properties. Once the assets are securitized, the tradable securities can be bought and sold on legally recognized exchanges[42].
- ***Onshore RMB-denominated Panda Bonds***: In 2005, a pilot program of Panda Bonds was launched – allowing foreign corporations and financial institutions to raise funds by issuing RMB-denominated bonds on the SHSE. Those funds could then be

[42] Samuel Shen and Pete Sweeney, "China Supports Issuance of Asset-backed Securities", Reuters, Feb 26, 2013

used to support domestic operations of the issuer, or to be converted into other currencies and used for corporate purposes outside China[43].

- ***Offshore RMB-denominated Dim Sum Bonds***: In 2007, China Development Bank issued the first dim sum bond in Hong Kong – bonds denominated in RMB but issued outside of mainland China. Dim Sum bonds are attractive to foreign investors who want to get exposure to RMB-denominated assets, but are restricted by China's capital controls on foreign investments in domestic debt markets. The issuers are mainly entities based in mainland China and Hong Kong. The issuance of Dim Sum bonds started strongly in 2013, with nearly RMB10 billion ($1.6 billion) of orders chasing three dim sum bonds in January 2013, eventually raised a combined RMB2.9 billion ($468 million). Issuance volume in 2013 is expected to increase by 20 - 30%, reaching about RMB320 billion[44].
- ***SME Private Placement Bonds***: In June 2012, CSRC initiated the private placement bond pilot projects for the SMEs in China, aiming to broaden the financing channels for them. This will help meet the high market demand of high-yield bonds. Regulatory permits will not be required for issuing the bonds, but the placement agents should file relevant materials to the stock exchanges for record purpose. Due to the lack of threshold requirements on issuers' net assets and profitability, SME private placement bonds are fully market-oriented credit bonds.

The following is an overview of the major debt instruments issued by corporate issuers.

[43] King & Wood Mallesons, "China Opens Door to Panda Bonds", May 11, 2005
[44] Reuters, "Dim Sum Bond Market Shrugs Off China Worries", Jan 23, 2013

	Commercial paper ("CP")& Medium-term notes ("MTN")	Enterprise Bonds	Corporate Bonds	SME Private Placement Bonds
Regulator	National Association of Financial Market Institutional Investors	National Development and Reform Commission (**"NDRC"**)	CSRC	Securities Exchanges
Regulatory Mechanism	Registration	Regulatory approval	Regulatory approval	Registration
Eligible Issuers	Nonfinancial companies	Unlisted companies	Listed companies	Unlisted SMEs (excl. financial & real estate sectors)
Issuance Method	Public offering	Public offering	Public offering	Private placement (within 200 investors)
Maximum Issue Size	Up to 40% of net assets	Up to 40% of net assets	Up to 40% of net assets	No limit
Maturity	CP: up to 1 year MTN: 3-5 years	Medium/long term	Long term	1-3 years
Major Markets	Interbank market	Interbank market, security exchange	Security exchange	Security exchange

Source: Takeshi Jingu, "China's Growing Corporate Bond Issuance", November 12, 2012

China's domestic bond market is increasingly improving. The initiation of Dim Sum Bonds, the pilot programs of Panda Bonds and the issuance of SME Private Placement Bonds are creating a beneficial environment for the development of the high yield bond market in China. However, these programs are still in the initial stage of development; a large portion of issuers are large SOEs and policy banks in mainland China as well as

big corporations in Hong Kong, which want to get financing from credit markets for self-development purposes. So far, there is no LBO deal getting financed from the bond market in China. There is a long way to go before a well-functioning high yield bond market is developed in China.

3.3. LBO in Chinese Companies

The LBO deals with the Chinese companies as buyout targets are mainly companies listed overseas. The equity financing are normally provided by international buy-out funds such as the Carlyle Group and Baring Private Equity Asia Group; and debt financing are mostly provided by multinational banks such as Citigroup, Bank of America, and Credit Suisse. In the following section, we will take a close look at the emerging LBOs in overseas listed Chinese Companies.

3.3.1. Challenges in Developing LBO Market in China

An important criteria for making successful LBO investments in China is to find a suitable target - companies with stable cash flows, so that the investee companies are able to pay off the big amount of interest and maximize their interest tax shields. However, in China, the cash flow rich companies are mostly large SOEs or joint ventures with SOEs, which are unlikely to go LBO. Also, as discussed above, the debt market in China is still under-developed, making it more difficult for private equity firms to structure attractive LBO deals in China. Moreover, the debt markets in mainland China have preferential policies for SOEs, which makes it even harder for privately owned companies to be acquired via LBO deals.

A lot of infrastructure needs to be developed before LBOs become common in mainland China. Secured lending laws are still under-developed. Lenders cannot be granted a perfect charge over all assets of a LBO target. Also, where a security interest can be

taken, the enforcement process is often unclear or subject to the consents from local government. Also, Chinese companies are not permitted to guarantee the debts of their shareholders. Moreover, as most private equity funds in China are USD-denominated funds (as discussed in Section 2.1), the private equity vehicle holding the debt are mostly incorporated offshore and are isolated from the company holding the assets.

3.3.2. LBO Opportunities in Overseas Listed Chinese Companies

As of March 31, 2013, LBO investments in Chinese companies are mainly happening in the overseas exchanges. A common concern among foreign investors in China is the various sets of accounting books that Chinese companies notoriously own. In the recent years, many Chinese companies listed in the U.S. get involved in the issues related to accounting irregularities that led to a wave of suspensions and de-listing of their shares. Moreover, several due diligence-based equity research firms are established with an aim to discover the fraudulent accounting practices in Chinese companies. Their research reports and the accounting scandals of some Chinese firms made foreign investors lose confidence in Chinese companies. The short-selling from institutional investors drag down the overall valuation of Chinese firms listed in the stock exchanges in the U.S.

Further study shows that a majority of the companies in accounting scandals have listed their shares through reverse takeovers – a swap-share transaction with a listed shell – which would bypass a security regulator's scrutiny as compared to a front-door IPO. Chinese firms listed in the U.S. through IPO still have sound accounting quality. Also, most arguments in the research papers questioning the accounting irregularities of the Chinese companies are based on assumptions and logic deduction instead of facts. These research papers are not always true. Realizing this, many private equity investors

saw the potential buyout opportunities and started to help privatize the undervalued Chinese companies.

However, the selection of the LBO targets is still an issue. Non-SOEs in China are mostly small in market capitalization. The bigger companies listed overseas are largely in the technology sector, especially new media and clean tech, which may not be attractive buyout candidates due to their volatile cash flows as well as cyclical and asset-light businesses. Another major challenge for this type of deals is the offshore holdco structure (the VIE structure) that receives financing. As discussed in the Section 2.5.3, for the cross-border financing by Chinese companies, the offshore holdco structure is a major risk for potential lenders to repatriate dividends from the onshore operating company, which is the only way to service the LBO debt.

Case Study A: Harbin Electric Going Private: Chinese LBO Pioneer [45] [46]

On June 20, 2011, the board of Harbin Electric ("**Harbin**", NASDAQ: HRBN), a China-based manufacturer of electric motors (linear motors, micro motors, and rotary motors) used in a range of applications from mail sorting machines to automobile seats, agreed to sell the company to a group including its chairman and CEO, for $24 per share. Shares rose 59% with a closing price of $13.35 on June 20, 2011. Harbin Electric became a public company in 2005 after completing a reverse merger[47].

The acquisition is funded by loans from the China Development Bank and Abax Global Capital Ltd ("**Abax**"), the manager of a $900 million private equity fund backed by Morgan Stanley. Chairman and CEO, Mr. Tianfu Yang and Abax were Harbin's two

[45] Belinda Cao, "China's Harbin Electric Jumps on Buyout Offer", Bloomberg, June 20, 2011
[46] Tim Burroughs, "Harbin Electric shareholders approve MBO", Asian Venture Capital Journal, Nov 1, 2011
[47] Chinese companies go public in the U.S. using a backdoor listing strategy by which they buy a public shell company and assume its ticker

biggest shareholders. Yang owned 40.7%, while Abax held a 5.4% stake.

Tech Full Electric, a Cayman Islands-based company controlled by Mr. Yang, purchased all the Harbin stock that he and Abax had not already owned, for about $463.8 million in total. The transaction was funded through a $400 million acquisition loan from the Hong Kong branch of China Development Bank, $38.8 million in equity financing and $25 million in short-term debt from Abax. Abax remains a minority shareholder of the company.

The $750 million deal for Harbin came just a week after the company's stock price plummeted as a result of a report from the short-seller Citron Research[48], which questioned Harbin's financials. Before the announcement of the management buyout deal, the shares of Harbin dropped below $6 from more than $15. Short-sale positions were 14.7% of the company's total outstanding shares, compared with 7.7% at the beginning of 2011. Following the buyout news, the share price jumped nearly 63% to $13, but still significantly below the proposed takeover price, indicating that the investors lacked confidence in an ability to close the LBO deal.

Mr. Mark Tobin, the co-director of research at Roth Capital Partners, pointed out that events preventing the shares from reaching the $24 price target include "numerous steps in the privatization process, some of which could lead to delays in completing the transaction" and "a slowdown in China's economic growth, which could impact the company's sales and margins".

On November 1, 2011, the deal went through and Harbin was taken private. Mr. Yang said in a statement:" A significant amount of information that is false and misleading as

[48] Citron is one of a few research firms aiming at reverse mergers that involve Chinese companies

well as defamatory has been introduced into the market, and has clearly affected market trading of the company's stock."

The following shows the stock price chart of Harbin from April 5th to November 1st 2011 (the last trading day).

Source: http://www.wikinvest.com/

Case Study B: China's Biggest LBO in Focus Media [49] [50]

In December 2012, Focus Media Holding Ltd. ("**Focus Media**", NASDAQ: FMCN), a Chinese advertising company, agreed to be bought by a consortium of investors led by the Carlyle Group ("**Carlyle**") in a $3.7 billion deal, which would be the country's largest LBO deal. The buyout group (the "**Group**") also includes CEO Jason Nanchun Jiang and the private equity funds - FountainVest Partners, Citic Capital Partners and China

[49] Ye Xie, Victoria Stilwell, "Focus Media Makes Deal in Biggest China Leveraged Buyout", Bloomberg, December 19, 2012

[50] Prudence Ho, "A Fresh Push for LBOs in Asia", The Wall Street Journal, January 28, 2013

Everbright Ltd. (SEHK: 165). The transaction is expected to be closed by the second quarter in 2013.

Bank of America, Deutsche Bank, UBS, China Development Bank, ICBC and China Minsheng Bank joined the three original banks on the deal – Citigroup, Credit Suisse Group, and DBS Bank - to provide syndicated financing for the buyout deal. The financing size is US$1.525 billion, made up of a cash bridge loan, a long-term loan, and a high-yield bond. The size of the loan-term loan has been increased to $1 billion from about $700 million. The nine banks are selling $1.08 billion in smaller chunks to other banks.

The board of Focus Media has approved the offer from the Group to acquire the company for $27.50 per American depositary share. The price was $0.50 more than the Group offered in a non-binding proposal in August 2012. The shares jumped 6.7% to $25.52 after the board accepted the deal, the highest close since April 12. Mr. Jiang, the management and Fosun International Ltd. (SEHK: 656), which together held 36% shares, have voted in favor of the deal.

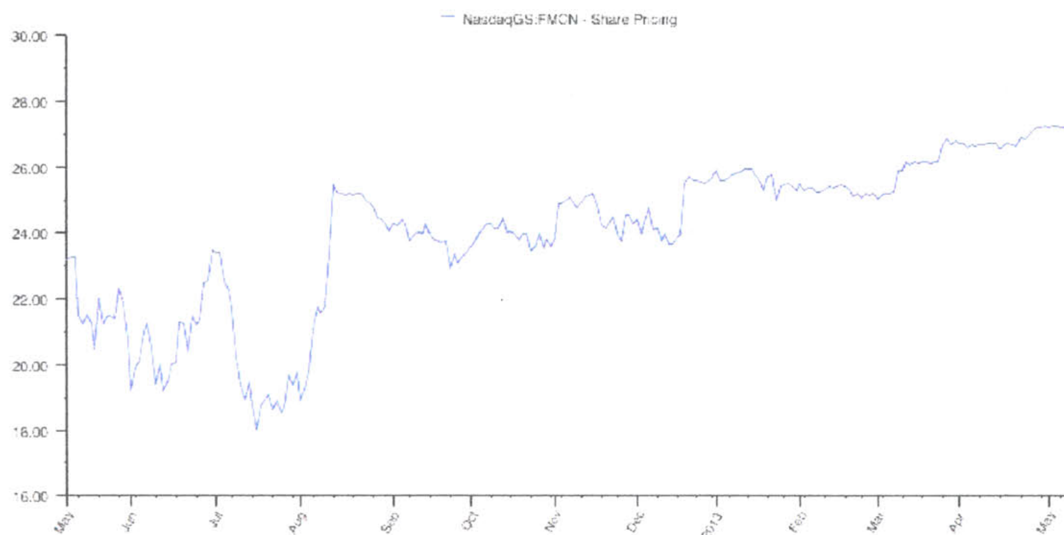
Focus Media, founded in 2003, went IPO on the NASDAQ Stock Market in July 2005. After accused by the short-seller Muddy Waters LLC[51] of overstating the number of screens used to display advertisements in China, the company joined an increasing number of Chinese companies seeking to withdraw from the U.S. exchanges, as the corporate governance concern from the public depressed their stock valuations. Since April 2010, 19 of the 49 companies that announced an intention to go private have completed the transactions, while four failed, according to a report by Roth Capital

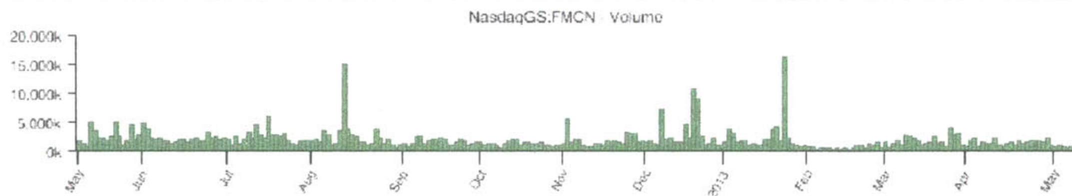
[51] A due diligence-based equity research firm with a focus on Chinese companies

Partners on November 5, 2012.

A major challenge for this deal is Focus Media's lack of hard assets in the underlying business. The deal shows that private equity firms are targeting opportunities in overseas-listed Chinese stocks after a series of corporate governance scandals eroded investors' confidence and slashed the valuations. The financial sponsors of the deal indicated that a re-listing may eventually happen – possibly in Asia.

The following charts show the stock price and trading volume of Focus Media from May 9th 2012 to May 8th 2013.





Source: Capital IQ

Case Study C: Carlyle-Led $688 million Buyout Deal in 7 Days Group [52] [53]

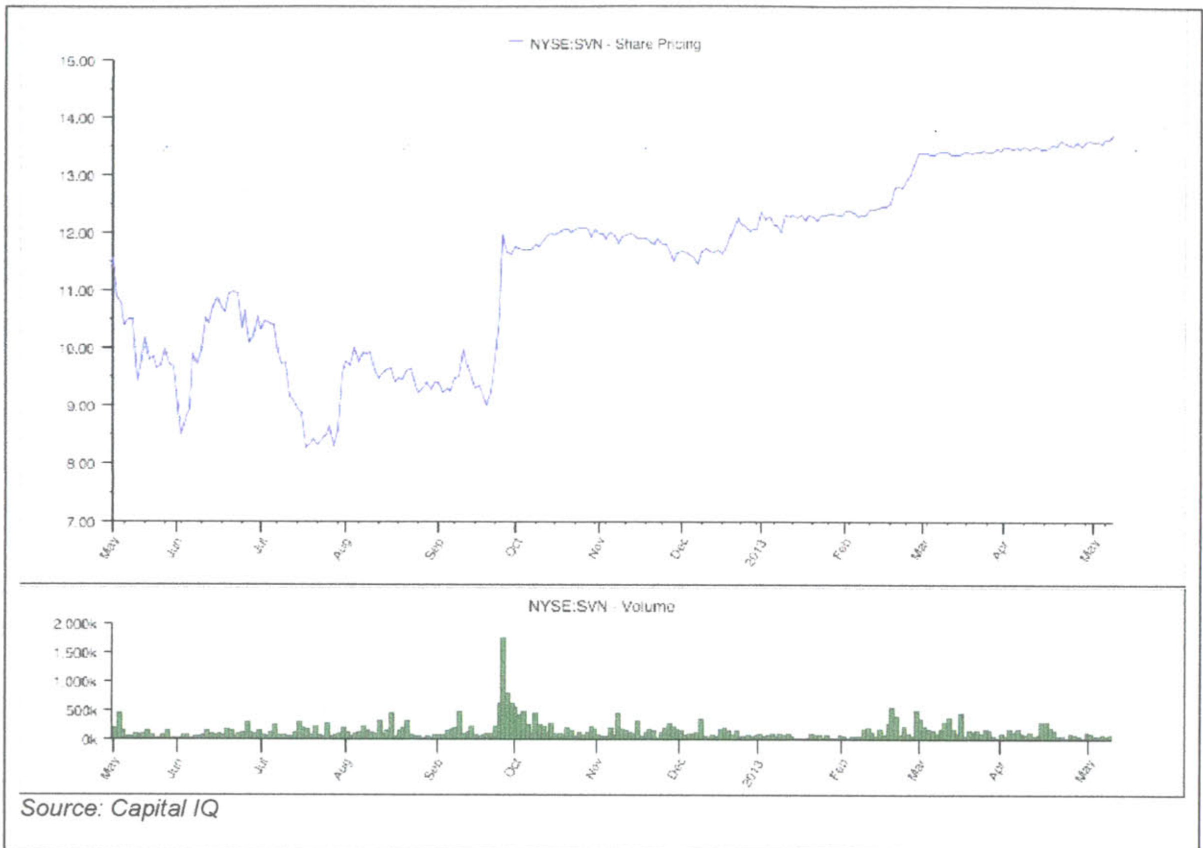
On Feb 28, 2013, the Chinese budget hotel chain 7 Days Group ("**7 Days**") has accepted a take-private offer from a consortium led by the Carlyle Group ("**Carlyle**") and 7 Days' co-chairmen Boquan He and Nanyan Zheng, which values the company at about $688 million. The deal is expected to be closed by the end of the third quarter in 2013.

Under the terms of the deal, Carlyle will issue cash payments of $13.8 per American Depository Share, a 30.6% premium to the last closing day price before the submission of the offer on September 25, 2012. The transaction will be financed through a combination of cash contributions from Carlyle, Sequoia, Actis and Mr. He, as well as a $120 million loan facility provided by Cathay United Bank, Chinatrust Commercial Bank, Nomura International, Ta Chong Bank and Taipei Fubon Commercial Bank. Once the deal has been completed, 7 Days stock will cease to be traded as a public company and become a majority owned subsidiary of Carlyle.

The following charts show the stock price and trading volume of 7 Days from May 9th 2012 to May 8th 2013.

[52] Stephen Aldred, "Carlyle-led consortium agrees to buy 7 Days for $688 million", Reuters, February 28, 2013

[53] Tim Burroughs, "7 Days board agrees to PE-backed buyout", Asian Venture Capital Journal, March 1, 2013



Source: Capital IQ

3.4. Developing LBO Market in China

As discussed above, funding for LBO deals in Chinese companies is mainly provided through offshore holding companies, which makes most banks skeptical about the repayment of loans. The resulting limited loan financing has restricted the deal size of LBOs in Chinese companies and increased the amount of equity that private equity firms have to invest.

However, as Mr. Brett King, a partner at Paul, Hastings, Janofsky and Walker in Hong Kong, said: "There's not a large amount of leverage in offshore vehicles for PRC buyouts, leading to typical debt-to-equity ratios of 0.75x/1x, compared to 3x/5x in Korea, 3x/4.5x

in Hong Kong and 5x/6x in Europe. Nevertheless, now that high-yield debt can be issued in all Asian jurisdictions, it makes leveraged buyouts far more attractive."[54]

The following shows a credit statistics comparison between the large corporate LBO deals in the U.S. from Q1 2011 to Q3 2012 and the recent LBO deals in overseas-listed Chinese firms since 2011. From the following table, we can see that on average, the LBOs in Chinese companies has a lower leverage ratio, higher equity contribution, higher bank debt portion (secured debt), no high yield bond financing, and a relatively simpler capital structure than those in the U.S.

	LBO deals in U.S. (Q1/11-Q3/12)	**Harbin Electric**	**Focus Media**	**7 Days**
Debt-to-EBITDA Multiple	4.6x-5.8x	4.1x	5.24x	1.3x
Average Equity Contribution	33%-45% (long term average: 37%)	43%	59%	83%
Price Multiples	7.8x-9.8x	7.3x	10.4x	7.4x
Price Premium	28.1% (since 1980)	185%	17.6%	30.6%
Debt/Asset before LBO	25%	21%	12%	13%
% Bank Debt	30-50% (5-8 years maturity)	53% (5-years maturity)	41%	17%
High-Yield Bond	20-30% (7-10 years maturity)	No high-yield bond	No high-yield bond	No high-yield bond

Source: Steve Miller, "LBO Credit Stats: Leverage, Purchase Multiples Rise As Yields Fall", Forbes, October, 9, 2012
S&P Capital IQ LCD
S&P Capital IQ Companies

[54] Simon Osborne, "LBOs to Join Growth Deals in Chinese Private Equity", AsianInvestor, June 2006

The following shows a comparison of some general credit statistics in the U.S. and China since 2011.

	The U.S.	**China**
Yield of Leveraged Loan	6% - 8%	6.5% - 8.5% (similar as the ordinary commercial loan as investment targets are mainly large SOEs with sound financial position)
Yield of High-Yield Bonds	8% - 11%	9.5-13.5%
LBOs by Type	During Q3 2012: • Sponsor to sponsor: 61% • Public-to-private: 17% • Corporate divestiture: 12% • Others: 10% During Q3 2011: • Sponsor to sponsor: 22% • Public-to-private: 45% • Corporate divestiture: 18% • Others: 15%	Mainly Public-to-private deals

Source: Steve Miller, "LBO Credit Stats: Leverage, Purchase Multiples Rise As Yields Fall", Forbes, October, 9, 2012
S&P Capital IQ LCD
Hexun Bond, http://bond.hexun.com/

LBO is a common type of private equity investment in the developed markets. However, it is still in the initial stages of development in China. To develop a functional LBO market in China, the top-down policy changes are recommended:

- To give more flexibility to the banks in providing acquisition financing and syndicated loans for M&As.

- To further develop the debt market and allow more issuance of corporate bonds by private companies.
- To loosen up the convertibility of the RMB.
- To abandon the restriction on capital inflows and outflows from the country.

The private equity landscape in China is gradually moving from growth equity investments to buyout deals. With the development of China's debt market, more LBO deals are expected to be executed.

Appendix A – A/H shares Valuation Comparison

	H-shares			A-shares			H- VS. A-shares
Name	Symbol	Price (HKD)	Chg(%)[1]	Symbol	Price (RMB)	Chg(%)[1]	Premium (%)[2]
ANHUI CONCH	00914.HK	26.15	0.00	600585.SH	17.86	1.48	18.33
JIANGSU EXPRESS	00177.HK	7.69	-1.66	600377.SH	5.43	-0.18	14.45
CHINA COMM CONS	01800.HK	6.63	-0.60	601800.SH	4.71	-0.42	13.76
PING AN	02318.HK	60.4	-0.58	601318.SH	43.11	-0.12	13.23
CHINA RAIL CONS	01186.HK	7.14	-0.97	601186.SH	5.17	0.00	11.62
CPIC	02601.HK	25.9	-0.39	601601.SH	18.86	0.00	10.99
CHINA RAILWAY	00390.HK	3.96	-0.75	601390.SH	2.91	-0.34	9.97
TSINGTAO BREW	00168.HK	48.3	0.73	600600.SH	35.75	-0.11	9.19
CITIC SEC	06030.HK	17.88	-0.89	600030.SH	13.31	-1.19	8.57
ANGANG STEEL	00347.HK	4.65	-2.11	000898.SZ	3.47	-0.29	8.29
CCB	00939.HK	6.17	-0.64	601939.SH	4.71	0.21	5.87
ABC	01288.HK	3.77	-1.05	601288.SH	2.88	0.00	5.81
SH PHARMA	02607.HK	17.16	0.23	601607.SH	13.24	-0.15	4.75
CSR	01766.HK	5.69	0.53	601766.SH	4.41	-0.45	4.27
CHINA SHENHUA	01088.HK	28.35	-0.70	601088.SH	22.06	0.00	3.87
GUANGSHEN RAIL	00525.HK	4.15	4.27	601333.SH	3.25	4.17	3.21
ICBC	01398.HK	5.32	-0.38	601398.SH	4.18	0.24	2.86
CM BANK	03968.HK	16.56	-0.48	600036.SH	13.13	0.00	1.93
CHINA LIFE	02628.HK	21.25	-0.93	601628.SH	17.47	-1.08	-1.69
BANKCOMM	03328.HK	5.89	-0.17	601328.SH	4.86	0.00	-2.05
AIR CHINA	00753.HK	6.85	1.48	601111.SH	5.8	0.69	-4.54
BANK OF CHINA	03988.HK	3.51	-0.57	601988.SH	2.98	0.00	-4.80
HUANENG POWER	00902.HK	8.13	2.39	600011.SH	6.95	0.43	-5.45
ZTE	00763.HK	13.96	-2.79	000063.SZ	12.02	-3.22	-6.14
PETROCHINA	00857.HK	10.24	-1.35	601857.SH	8.89	-0.45	-6.91
WEICHAI POWER	02338.HK	25.75	-2.65	000338.SZ	22.63	-2.16	-8.04
SINOPEC CORP	00386.HK	8.75	0.23	600028.SH	7.72	2.66	-8.40
NCI	01336.HK	27.65	3.17	601336.SH	24.43	0.21	-8.53
CHINA SOUTH AIR	01055.HK	4.39	0.46	600029.SH	3.9	1.04	-9.03
FOSUN PHARMA	02196.HK	12.94	0.94	600196.SH	11.92	1.27	-12.27
BYD COMPANY	01211.HK	24.95	1.42	002594.SZ	23.4	-0.43	-13.83
ZOOMLION	01157.HK	9.03	-2.90	000157.SZ	8.51	-0.70	-14.25

GAC GROUP	02238.HK	6.34	1.77	601238.SH	6.08	-0.65	-15.73
MAANSHAN IRON	00323.HK	2.03	-0.49	600808.SH	1.97	-0.51	-16.74
CIMC	02039.HK	13.3	-1.34	000039.SZ	13.01	-0.91	-17.38
ANHUIEXPRESSWA	00995.HK	4.05	-2.41	600012.SH	4.04	0.00	-18.98
CHINA EAST AIR	00670.HK	3.42	-1.44	600115.SH	3.45	0.29	-19.89
HAITONG SEC	06837.HK	11.34	-1.05	600837.SH	11.48	-0.78	-20.16
DONGFANG ELEC	01072.HK	14.6	-1.48	600875.SH	15.1	-0.72	-21.86
CHINA COSCO	01919.HK	3.92	-1.26	601919.SH	4.07	-0.73	-22.16
MINSHENG BANK	01988.HK	10.38	-0.95	600016.SH	10.9	-0.37	-23.04
CHINA COAL	01898.HK	6.93	-0.43	601898.SH	7.37	-0.41	-24.01
ZMJ	00564.HK	8.99	2.51	601717.SH	9.84	-0.30	-26.16
CHINA SHIP DEV	01138.HK	4.09	-0.73	600026.SH	4.53	0.22	-27.03
CHINA OILFIELD	02883.HK	15.52	-2.39	601808.SH	17.29	-0.46	-27.45
SHENZHENEXPRES	00548.HK	3.02	-0.98	600548.SH	3.37	0.60	-27.58
CITIC BANK	00998.HK	4.76	-1.04	601998.SH	5.35	-0.93	-28.10
CSCL	02866.HK	2.22	-0.45	601866.SH	2.53	2.43	-29.07
BBMG	02009.HK	6.26	-0.32	601992.SH	7.23	1.83	-30.03
GREATWALL MOTOR	02333.HK	28.1	-1.06	601633.SH	32.81	-2.06	-30.78
HUADIAN POWER	01071.HK	3.77	2.17	600027.SH	4.56	-0.65	-33.18
GUANGZHOU PHAR	00874.HK	25.1	6.36	600332.SH	30.66	10.01	-33.84
DATANG POWER	00991.HK	3.65	-0.55	601991.SH	4.48	0.00	-34.15
GOLDWIND	02208.HK	4.58	2.69	002202.SZ	5.71	0.35	-35.17
SICHUAN EXPRESS	00107.HK	2.54	-0.78	601107.SH	3.33	0.60	-38.35
SH ELECTRIC	02727.HK	3.19	-0.93	601727.SH	4.2	-1.18	-38.62
JIANGXI COPPER	00358.HK	17	-0.47	600362.SH	22.64	-1.14	-39.31
FIRST TRACTOR	00038.HK	7.29	-1.88	601038.SH	9.75	-0.92	-39.57
MCC	01618.HK	1.52	-0.65	601618.SH	2.07	0.00	-40.65
ZIJIN MINING	02899.HK	2.57	0.39	601899.SH	3.52	0.29	-40.99
CHENMING PAPER	01812.HK	2.92	0.69	000488.SZ	4.01	3.35	-41.15
CHALCO	02600.HK	3.17	0.64	601600.SH	4.43	0.23	-42.16
DONGJIANG ENV	00895.HK	45.45	1.00	002672.SZ	68.89	1.31	-46.68
DALIAN PORT	02880.HK	1.81	-2.16	601880.SH	2.78	0.73	-47.38
BEIJING N STAR	00588.HK	1.9	1.60	601588.SH	3.09	-0.32	-50.30
GUANGZHOU SHIP	00317.HK	6.76	-1.17	600685.SH	11.84	-0.92	-53.86
YANZHOU COAL	01171.HK	10.78	0.56	600188.SH	18.91	1.02	-53.93
JINGWEI TEXTILE	00350.HK	6	2.04	000666.SZ	10.99	0.18	-55.88
SHANGHAI PECHEM	00338.HK	3.23	-4.15	600688.SH	6.32	-0.94	-58.70

HISENSE KELON	00921.HK	3.91	7.71	000921.SZ	8.01	4.98	-60.55
SHANDONG XINHUA	00719.HK	2.29	1.78	000756.SZ	5.09	-0.78	-63.64
CHONGQING IRON	01053.HK	1.23	0.00	601005.SH	3.02	-0.33	-67.09
KUNMING MACHINE	00300.HK	2.32	-2.93	600806.SH	5.99	-0.99	-68.70
NE ELECTRIC	00042.HK	1.03	-0.96	000585.SZ	2.78	1.83	-70.06
NANJING PANDA	00553.HK	2.35	1.29	600775.SH	6.47	-0.92	-70.64
BEIREN PRINTING	00187.HK	2.56	-1.54	600860.SH	7.1	-0.14	-70.86
TIANJIN CAPITAL	01065.HK	3.47	-0.86	600874.SH	9.99	-3.01	-71.93
CMOC	03993.HK	3.56	-0.84	603993.SH	10.26	2.50	-71.96
LUOYANG GLASS	01108.HK	1.74	-1.70	600876.SH	5.61	-1.23	-74.93
YIZHENG CHEM	01033.HK	2.03	-2.87	600871.SH	6.55	-0.30	-74.95
SHANDONG MOLONG	00568.HK	3.57	0.56	002490.SZ	12.45	-1.81	-76.83
ZHEJIANG SHIBAO	01057.HK	2.83	2.17	002703.SZ	15.09	-1.31	-84.84

Last Update: H-shares:2013-03-22 21:10 A-shares:2013 03-22 15:35

(1)Change in local market currency.

(2)Exchange rate: 1 RMB = 1.237320 HKD

Source: AAStocks, http://www.aastocks.com/

Appendix B – Sample Due Diligence Check List[55]

Market

- Market size and trends
- Entry barriers (regulations, licenses required for operation, size, captive customers, etc.)
- Competitive landscape (competitors, size of competitors, commitment to market, strengths and weaknesses, etc.)
- Growth drivers, historical and projected
- Market risks and opportunities

Business

- Business segments/products/branding
- Manufacturing process
- Company's competitive advantage and areas for improvement
- Development plans for the next three to five years
- Market efforts and pricing strategy
- Major customers and key customer performance indicators
- Key suppliers / third party contractors (key terms, number of suppliers/contractors, concentrations, etc.)
- Strategic partners

Financials and accounting

- Capital structure

[55] Recreated by the author based on HSBC PIA Initial Due Diligence List, which is co-developed by Mr. Roger Moh, Ms. Caly Le Xiao, Ms. Karen Yang

- Capital required and use of proceeds
- Financial forecast
- Auditors' reports and opinions, accounting policies and estimates
- Profit and loss statement – key drivers of revenue and profitability, seasonality / cyclicality and taxes; explain significant changes in trends / anomalies
- Balance sheet – working capital (including A/R, inventories and A/P), cash position and indebtedness (including debt maturity), tangible net asset value
- Cash flow statement – working capital changes, depreciation and amortization, capital expenditures (expansion vs. maintenance) and dividends (dividend policy)
- Contingent liabilities, non-recurring items, tax subsidies, tax compliance

Legal

- Corporate structure and shareholding structure
- Licenses and permits
- AOI, Charter, AOA
- Corporate governance
- Intellectual property rights
- Litigations
- Related party transactions
- Major contracts

Production/operation, R&D, and Intellectual Property

- Location and size of manufacturing facilities; discuss possibility for expansion
- Equipment (imported vs. domestic), major fixed assets by category, age, leased/owned

- Manufacturing efficiency (utilization rate / production yield / rework rate, etc.) and quality control process
- R&D efforts (R&D lead time, staff background, product life cycle, etc.) and associated risk factors
- Intellectual properties owned or used

Regulatory

- Regulators, policies and regulations
- Corporate social responsibility
- Approval process
- Evolving trend of laws and regulations
- Politics and government support

HR Management

- Organizational chart and HR policies
- Management (Position, Experience/ CVs, compensation and incentive mechanism)
- Employees (Number break-down by division, benefits)

Appendix C – Sample Term Sheet

Term Sheet [56]

Series __Preferred Stock[57] Financing of [Company Name]

This term sheet (the "Term Sheet") summarizes the principal terms of the proposed investment (the "Investment") in, a company incorporated under the laws of the Cayman Islands (the "Company").

Type of Security:	Series __ Preferred Stock
Amount of Financing:	A total of US$____ shall be raised in the financing. Investor shall have the right to invest US$____________ in the financing.
Pre-Money Valuation:	The fully-diluted pre-money valuation is set at US$_________, including all outstanding warrants and options, an unallocated option pool equal to __% of the post-money capitalization.
Warrants:	Any Investor (alone or with its affiliates) investing US$_________ or more shall receive warrants to purchase additional shares of Series __ Preferred Stock equal to __% of the number of Series __ Preferred Shares purchased by the Investor at closing. The warrants shall have a strike price equal to __% of the original purchase price of the Series __ Preferred Stock.
The Founder(s):	

[56] Institute of Asian Private Equity Investment, "Executive Investment Management Workshop", April, 2011
[57] Preferred stock is one of most commonly used financing instruments in growth equity investments in China

Anticipated Closing Date:	

RIGHTS AND PREFERENCES OF SERIES __ PREFERRED STOCK

Dividend Preference:	The holders of Series __ Preferred will be entitled to receive noncumulative dividends at the rate of __% per annum on a *pari passu* basis with the other series of Preferred Stock (including the Series __ Preferred Stock, the "**Preferred Stock**"), when, as and if declared by the Board, from funds legally available prior to any distribution with respect to the Common Stock. No dividend shall be paid on the Common Stock or on any other series of Preferred Stock at a rate greater than the rate at which dividends are paid on the Series __ Preferred Stock (on an as-converted basis).
Liquidation Preference:	In the event of any liquidation or winding up of the Company, the holders of Series __ Preferred will be entitled to receive, *pari passu* with the holders of other outstanding series of Preferred Stock and in preference to holders of Common Stock, an amount equal to the original purchase price plus declared but unpaid dividends. After such payment, proceeds shall be shared pro rata by the holders of Common Stock and Preferred Stock (on an as-converted basis).
Liquidation Event:	Each of the following events shall be considered a liquidation event which shall entitle the holders of the Preferred Stock to payment of the amounts described above: (i) a consolidation or merger of the Company or sale of all or

	substantially all of its assets following which the shareholders of the Company immediately prior to the transaction cease to hold a majority of the surviving or consolidated company; and (ii) any transaction (including secondary sales of stock) pursuant to which any person or group becomes the beneficial owner of a majority of the voting power of the Company's capital stock (a "**Change in Control**").
Redemption Rights:	The Series __ Preferred Stock may be redeemed, in whole or in part, by the holder after ___ years, at cost [**plus __% per year**], payable over three years. Redemption of the Series __ Preferred Stock shall be the holders of the other series of Preferred Stock.
Conversion Rights:	At any time at the option of the holder, each share of Preferred Stock may be converted into such number of shares of Common Stock as is equal to the original purchase price divided by the then applicable conversion price. The conversion price shall initially be equal to the original purchase price. Additionally, each series of Preferred Stock will be automatically converted into Common Stock in the event of (i) an underwritten public offering of the Company's Common Stock with gross proceeds to the Company of at least **[US$__]** and an offering price per share (including underwriting discounts and commissions) of not less than **[US$___]** or (ii) the conversion of more than **[__%]** of the originally issued shares of such series.
Anti-dilution Protection:	The conversion price of the Series __ Preferred Stock (the "**Conversion Price**") will be subject to adjustment for stock splits,

	reverse stock splits, and similar events. The Conversion Price will also be subject to broad-based weighted average anti-dilution protection. These adjustments shall not apply to up to ______ shares of common stock and options to purchase common stock issued to officers, directors, employees and consultants under plans and agreements approved by the Company's Board of Directors.
Performance-Based Adjustment:	The conversion rate of the Series __ Preferred Stock shall also be subject to a special adjustment feature as follows: If following the audit of the Company's financial statements for the Company's fiscal year ending December 31, _____, the net revenue (excluding revenues from acquired companies and businesses) of the Company for such year is less than US$____ million, the conversion price shall be reduced by the same percentage as the percentage by which actual net revenue is less than US$___ million, subject to a maximum adjustment of __%].
Voting Rights:	A holder of Preferred Stock will have the right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of the Preferred Stock held by that holder. The Preferred Stock shall initially be entitled to one vote per share (on an as-if-converted basis). The Board of Directors will have __ members. Holders of the Series __ Preferred Stock, voting as a single class, shall have the right to elect __ member(s) of the board (the "Series __ Director"). The holders of the Preferred Stock shall be entitled to vote

	together with the holders of the Common Stock on an as-converted basis on the election of the remainder of the Board of Directors. Except as otherwise provided by law or set forth below, the Series __ Preferred Stock and the Common Stock shall vote together on all other matters.
Protective Covenants:	Consent of the holders of **[__%]** of the Series __ Preferred Stock, voting as a separate class, will be required for: (i) creation of any new class or series of shares having preference to the existing Preferred Stock with respect to dividends, voting, liquidation preferences, or conversion rights or the issuance of any debt instrument convertible into, or debt issued with warrants exerciseable for, any equity securities of the Company, (ii) any increase in the authorized number of shares of Preferred Stock, (iii) any amendment to the **[Articles of Incorporation]** materially and adversely affecting the Series A Preferred Stock, (iv) a merger or acquisition of the Company or a sale of all or substantially all its assets or any other transaction involving a Change in Control, (v) any redemption or repurchase of shares of Common Stock (other than from employees, directors and consultants as approved by the Board of Directors) or Preferred Stock (other than as contemplated above), (vi) declaration of dividends on Common Stock, (vii) incur indebtedness for borrowed money in excess of US$______, (viii) issuance of any equity securities by any subsidiaries or the entrance into any partnership, joint venture or profit-sharing agreement or similar arrangement, or (ix) change in the authorized size of the Board of Directors.

OTHER RIGHTS OF INVESTORS

Indemnification:	The Company will indemnify Board members to the greatest extent permitted under applicable law.
Financial Information and Inspections:	The Company will deliver to each holder of more than _____ shares of Preferred Stock: (i) within 90 days after the close of the fiscal year, statements of operations and cash flows for the fiscal year then ended and a balance sheet as of the date of such year-end that have been audited by an accounting firm of international stature; (ii) within 45 days after the close of a fiscal quarter, unaudited statements of operations and cash flows for the quarter ended and a balance sheet as of such quarter end; (iii) within 10 days following the end of each calendar month, a profit and loss statement and balance sheet for such month which also discloses the variance of each item from budget;12 and (iv) not less than 60 days prior to the end of each fiscal year, management's proposed budget for the coming year. These obligations will terminate upon a public offering of Common Stock. The Company shall permit each holder of more than _____ shares of Series __ Preferred Stock Investor, upon reasonable notice and at such Investor's expense, to visit and inspect the Company's properties, to examine its books of account and records (and make copies thereof and take extracts therefrom) and to discuss the Company's affairs, finances and accounts with its officers, all at such reasonable times during ordinary business hours as may be requested in writing by the Investor. The information and inspection rights shall not be in

	limitation of any rights that any Investor may have with respect to the books and records of the Company, or to inspect their properties or discuss their affairs, finances and accounts, under the laws of the jurisdiction in which it is incorporated.
Registration Rights:	For the purpose of this Term Sheet, an IPO is an initial public offer of shares or securities of the Company, or an entity that incorporates substantially all of the businesses of the Company, on a stock exchange. In the event of an IPO in which the disposal of securities is subject to registration with securities regulatory authorities or the availability of an exemption from such registration, the Investors shall be entitled to the customary registration rights.
Right of Participation:	Each holder of at least ____ shares of Preferred Stock shall have a pro rata right (based on its percentage ownership of the Preferred Stock) to participate in future equity financings of the Company (except for options to purchase up to ___________ shares of Common Stock reserved under the employee reserve pool and except for acquisitions, license and joint venture agreements and other customary exclusions). Any securities not subscribed for by any holder of Preferred Stock shall be reallocated among the participating holders. This right will not apply to, and will terminate immediately prior to, an IPO.
Right of First Refusal:	Each holder of at least ______ shares of Preferred Stock shall have a secondary right of first refusal to purchase their pro rata portion of any shares of Common Stock that a Founder may seek to sell (other than customary sales to family members and family trusts and

	distributions to partners and similar beneficial owners, all of whom shall be similarly bound ("Exempt Transfers")) and which the Company opts not to purchase. This right does not apply to, and will terminate immediately prior to the consummation of an IPO.
Right of Co-Sale:	To the extent that shares of Common Stock offered by a Founder are not purchased through the exercise of rights of first refusal described above, the holders of the Preferred Stock shall have a right of co-sale (based on their ownership of the Company's outstanding capital stock) in the event that a Founder wishes to sell any of his shares to a third party (other than Exempt Transfers). This right will terminate immediately prior to an IPO or change of control. The holders of the Preferred Stock and the Founders shall have a right of co-sale with respect to proposed sales of shares of Preferred Stock (other than Exempt Transfers) that a holder wishes to sell. No Founder or holder of Preferred Stock shall make any sale of shares in any transaction or series of transactions constituting a Change in Control unless the acquirer offers to purchase all shares held by such persons and the price paid to the holders of the Preferred Stock is at least as great as what the holders of the Preferred Stock would receive upon liquidation of the Company.
Sale of the Company:	If, after _________, 200__, an unaffiliated third party makes a bona fide offer to purchase all of the capital stock of the Company or substantially all of the Company's assets and the holders of **[____%]** of the Series ___ Preferred Stock elect to sell, the Founders shall have 30 days to match the offer (and obtain a firm

	commitment for the financing, if applicable), and failing their ability to do so, they shall sell their shares or vote to sell the Company's assets to the third party on the same terms.

OTHER TERMS

Vesting of Founders' Shares:	Each of the Founders shall enter into a Restricted Stock Agreement with the Company providing the Company with (and, if the Company does not exercise this right, the holders of the Preferred Stock on a pro rata basis among them) the right to repurchase from the Founder all of his shares of Common Stock of the Company should his employment with the Company cease, for any reason, prior to ___________, 200__. Shares shall "vest" monthly on a straight-line basis. The purchase price shall be the Founder's cost.
Stock Option Plan:	The Company shall establish a stock option program covering 20% of the issued capital of the Company from time to time (subject to the cap of 20% of the issued capital at the closing of the Second Investment) for participation by selected employees of the Company from time to time.
Market Standoff:	Each purchaser of the Series __ Preferred Stock shall enter into an agreement whereby if requested by the Company or the lead managing underwriter of the Company's IPO, such person will not sell, assign, pledge or otherwise transfer (or take any short equivalent position with respect to) his shares until the expiration of 180 days following the effectiveness of the Company's registration statement, provided that this obligation shall only apply if each of the Company's officers, directors and holders of 1% or more of the fully-

	diluted capital stock is also subject to such obligation.
Confidential Information and Inventions Agreement:	Each officer and employee of the Company has entered, and each person serving in any such capacity in the future will enter, into the Company's standard Employee Confidential Information and Inventions Agreement.
Use of Proceeds:	The Company shall use the proceeds from the sale of the Series __ Preferred Stock for business expansion, capital expenditures and general working capital and for any other purpose approved by the holders of at least a majority of the Series __ Preferred Stock.
Expenses:	The Company will pay at the Closing the reasonable legal fees and expenses incurred by a single counsel to all Investors.
Exclusivity:	From the date of acceptance of this Term Sheet until the earlier of (i) ___________, 2001 and (ii) the date this transaction is abandoned by the Investor (the "Exclusivity Termination Date"), the Company, the Founders and each of its officers and directors (1) shall deal exclusively with the Investor in connection with the issuance and sale of capital stock of the Company; (2) shall not solicit, or engage others to solicit, offers for the purchase or acquisition of any capital stock of the Company or all or any substantial part of the assets or for any merger or consolidation; and (3) shall not negotiate, entertain discussions or enter into any agreements or understandings with any other person with respect to any such transaction. During such exclusivity period, the Company will cooperate in good faith to facilitate the due diligence investigations by the Investors and their counsel and other

	representatives. The Exclusivity Termination Date shall be automatically extended to ____________, 2001, if on or prior to _____________, 2001, Investor shall have made a capital call to its limited partners for funds necessary to pay the purchase price of the Series __ Preferred Stock.
Confidentiality:	Upon acceptance of this Term Sheet, the Company will not solicit other potential investors nor disclose the terms of this Term Sheet to other persons (other than in connection with consummation of the transactions contemplated in this Term Sheet) prior to termination of this Term Sheet and shall use their best endeavor to procure their respective representatives to observe this obligation.

This term sheet is only a framework upon which the Investors and the Company may discuss a proposed equity investment by the Investors in the Company, is not intended to constitute a binding agreement or an offer that is capable of acceptance and shall not be deemed to create any legally enforceable rights in favor of any of the Investors or the Company. Without limiting the foregoing, until such time as the Investors and the Company have executed definitive binding documentation, any Investor may terminate negotiations in its sole discretion without liability therefor.

INVESTOR

By: ___________________________

Name: _________________________

Title: __________________________

THE FOUNDER(S) and THE COMPANY:

For the Company and, where applicable, for themselves:

______________________________	______________________________
Printed Name: __________________	Printed Name: __________________
Title :_________________________	Title :_________________________

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