

**DEVELOPING A PRIVATE EQUITY BUSINESS IN CHINA**

**By**

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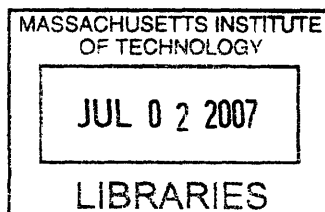
**MIT Sloan School of Management  
May 11, 2007**

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**Zhaoyu (Jeffrey) Gui**

**Submitted to the Sloan School of Management on May 11<sup>th</sup>, 2007  
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## **ABSTRACT**

The private equity business, a good complement to the public equity market and the debt market, has been playing an increasing role in China. However, there is no universal formula for doing this business. As an art rather than a science, it varies from country to country.

After two decades of reform and open-door policy, Chinese enterprises are essentially the same as the ones in developed countries. The major difference lies in the different developmental stages and business environments such as the dominant governmental role in China, the lack of business leaders and the immaturity of financial market.

This different business environment drives a different market structure including more venture investments than buy outs, more late-stage and pre-IPO investments than early stage, and more investment in private sectors than state-owned enterprises. As a result, the excess of investment capital focuses on the small market of late-stage investments with a high potential of IPO.

Given the current business environment, I suggest three key investment strategies. First, bring the value to the companies in a competitive industry by providing business model upgrades, market knowledge, and disruptive technologies. Second, originate deals by helping the government to achieve its public goal of restructuring industry resources and accelerating Chinese enterprise globalization and modernization in regulated industries. Third, seek any possible investment opportunities provided by the immature financial market.

**Thesis Supervisor:** Stewart C. Myers  
Robert C. Merton (1970) Professor of Financial Economics  
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This thesis is ultimately dedicated to Jane and Zilan, and to my parents who always emphasized education and taught me to have an ambitious vision.

Jeffrey Gui

May 2007

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## **Chapter 1: The Background of the Thesis**

### **1.2 Introduction to Private Equity Business**

#### **1.1.1 Overview**

The private equity business (PE) is an important source of funds for start-up firms, private mid-market firms, firms in financial distress and public firms seeking buyout financing. This business started in the 1940s, following a process of boom and bust: rapid increase in fund-raising in the late 1960s, decline in the 1970s, rebound in the mid-1980s, recession in the early 1990s, peak in the late 1990s, down-turn in the early 2000s and rapid growth during the past few years.<sup>1</sup>

In 2006, 684 new funds raised \$432 billion, a 38% increase in the already strong 2005 figure. The private equity investors around the world now have approximately \$1.4 trillion, consisting of \$700 billion of actual investment and a further \$700 billion of uncalled commitment to funds. The growth in private equity is leading to very large fund size. The ten largest funds raised \$100 billion, especially in the buyout segment, which was one quarter of the entire industry.<sup>2</sup> Fund raising in emerging markets accumulated to \$33 billion in 2006, a 29% increase from 2005.<sup>3</sup>

Meanwhile, the investment amount of private equity is ever-growing. Mega-deals became increasingly commonplace: Hospital Chain, HCA, was acquired by KKR and Bain Capital for \$34 billion in 2006; REIT giant, Equity Office Properties Trust, was acquired by Blackstone for \$39 billion in 2007; and Texas Utility, TXU is presently being acquired by KKR and TPG for over \$40 billion. The proven strong long-term return has been the key

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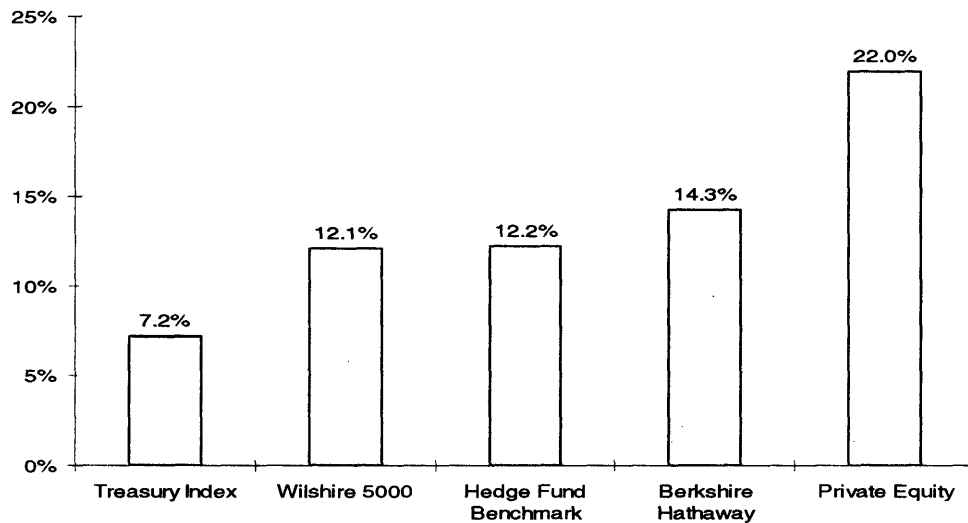
<sup>1</sup> Lerner, J., Hardyman, F., and Leamon, A., 2003, "Private Equity Today and Tomorrow", *Venture Capital and Private Equity*, page 1.

<sup>2</sup> The 2006 Performance Monitor, The 2007 Global Fundraising Review, <http://www.preqin.com>.

<sup>3</sup> Emerging Markets Private Equity Association (EMPEA) Reports, <http://www.eurekahedge.com/news>.

driving factor for investors to allocate more assets to the private equity sector (Figure 1). Private equity has become the most popular business on Wall Street today after investment banking in the 1990s and venture capital in the early 21st century.<sup>4</sup>

**Figure 1: Yale Long-Term Asset Class Performance**



Source: Zogheb, R., 2006, *Private Equity and LBOs*, Citigroup Internal Presentation

This paper investigates the industry of private equity and studies its drivers and impact on society. By comparing and contrasting the business environment in the U.S. and China, this paper presents a business strategy that will foster the growth of private equity businesses in China.

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<sup>4</sup> In the U.S., usually private equity means a buyout business, mainly focusing on buy out of listed companies, while venture capital means the investment from angel to pre-IPO. In China, venture capital means investment at an early stage, while private equity includes late-stage, pre-IPO and buyout. The typical private equity business in China is late-stage, pre-IPO and buyout business.



### **1.1.2 Essentials of Private Equity Business**

Private equity is a highly integrated business.<sup>5</sup> One business cycle includes four phases: fundraising, selecting investments, managing portfolio companies, and exiting. Each phase incorporates many tasks. For instance, selecting investments include deal origination, due diligence, deal structure, legal issues, pricing, negotiation, and syndication. These processes demand different skill sets such as entrepreneurship, operational experience, corporate finance, industry knowledge, communication and negotiation, and sometimes even political influence.

Private equity varies from country to country due to the differences in culture, political environment, and economic development. For instance, private equity business plays an important role in the U.S. both in the venture investment and listed companies buyout sectors; however, the private equity markets are leaning to buyout business in Europe and venture investment in Asia. Furthermore, private equity business is an art rather than a science, and there is no universal formula for it. It all depends on your judgment about the enterprise in which you intend to invest as well as its external environment.

### **1.1.3 Social and Economic Impact of Private Equity Business**

The private equity market is an efficient resource allocation system that provides equity capital to the firms not quoted in the stock market. Private equity plays a critical role in the American economy and increasingly around the globe as well. However, there is no universal agreement on the value that private equity brings to businesses. Franz Müntefering, the German Social Democratic Party chairman, compared private equity firms to a swarm of locusts. He said they "graze" on under-priced businesses, lay off employees and resell for a

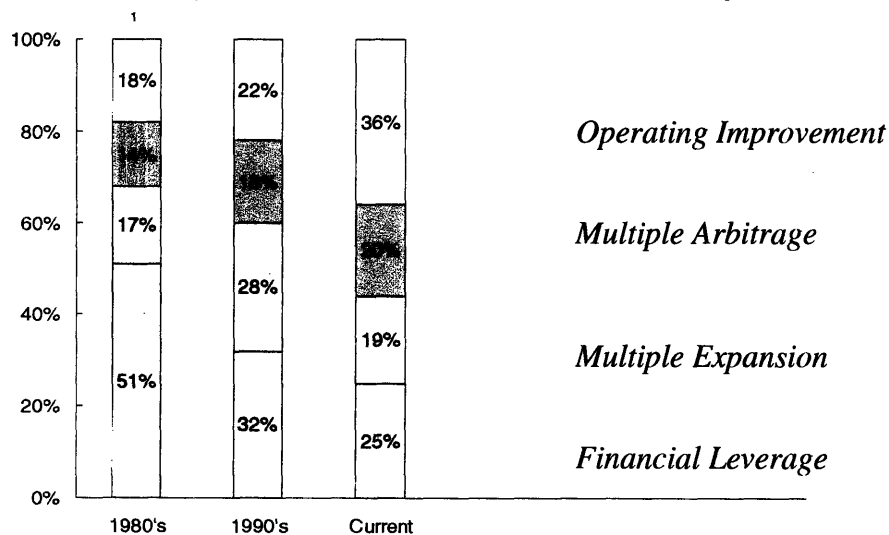
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<sup>5</sup> See definition and mechanism of private equity in Appendix 1.

sweet profit.<sup>6</sup> Moreover, the Financial Times published an article with the title “The “Demonized” private equity industry is set to grow even bigger” on November 9<sup>th</sup>, 2006. In a response, Nigel Doughty, chief executive of Doughty Hanson, defends private equity business saying “we're not locusts. We're nurturers, farmers; we could even be compared with a honey bee.”

Indeed, the goal of private equity business is to maximize profit, while at the same time being a long-term investment which usually exists for 8-10 years. A private equity fund provides a wide range of value added service. For example, in terms of venture investment, the value arises from providing equity capital for growth, building up corporate governance, consulting business strategy, improving its productivity and leveraging other portfolio companies’ networks. In terms of corporate restructuring, the value added both includes business restructuring (M&A, alliance, new strategy), and financial restructuring (reduction of debt). In terms of business buyout, the value added derives from tax benefits, improved productivity and a management team.

**Figure 2: Break Down of Value Added in Buyout Business**



Source: Baek, K., 2004, Economic Modeling of Korean Private Equity Market, page 28

<sup>6</sup>“ Dutch government slams 'locusts'”, 2006, <http://www.financialnews-us.com/index.cfm>.

## **1.2 Organization of the thesis**

### **1.2.1 Issues Facing Chinese Private Equity Business**

The first private equity firm was formed in 1946 by Massachusetts Institute of Technology (MIT) president Karl Compton, Harvard Business School Professor Georges F. Doriot, and Boston business leaders. The activity in the private equity industry increased dramatically in late 1970s and early 1980s. Today, the private equity business is on an unprecedented scale. The investment strategies, products and expertise have been unprecedentedly sophisticated on a grand scale.

Although the private equity business is matured globally and China is ready for this business, there still remain practical problems when doing private equity business in China, including:

- An economy driven by investment but not led by demand;
- Uncertain government policy;
- Frequent amendments in government regulations causing disruptions;
- An immature capital market, going periodically from boom to bust;
- Herd and gold rush mentality creating irrational competition;
- Fast-changing market requiring flexible management;
- Uncertain sustainability depending on exit timing;
- A legal system not yet fully-established;
- A lack of public transparency; and
- A lack of well-trained professionals.

Due to different economic developmental stages and business environments, strategies which are proven to be successful in the U.S. and European markets do not always thrive in the Chinese market, for example:

- The return of investment in high technology and innovation is not necessarily greater than the return of investment in traditional industry;
- It's impossible to buy out a public company; and
- Difficulty of exit forces in choosing an initial legal structure.

Given this situation, my objective is to develop suitable investment strategies which match the current Chinese business environment by practicing international common standards. My experience in the investment banking industry in China will also offer insights to the development of private equity business in China.

### **1.2.2 The Arguments and Method**

**The major arguments follow:**

- Chinese enterprises are essentially the same as the ones in the developed countries. The major difference lies in the different developmental stages and business environments such as the role of government, the lack of business leaders and a well-established system, as well as the immaturity of the financial market.
- The excess of investment capital in relatively small markets reflects the following: a) shortage of exit possibilities; b) lack of investment information and high-cost due diligence effort; c) not yet fully developed legal environment.
- Three investment strategies work in China's market: First, bring value to the companies in a competitive industry by providing business model upgrades, market knowledge, disruptive technologies. Second, originate deals by helping the government achieve its public goal of restructuring industry resources and accelerating Chinese enterprise globalization and modernization in regulated industries. Third, seek any possible investment opportunities provided by the immature financial market.

- Due to the limitation of exit, the deal execution should be driven by exit strategy, i.e., multiple exit strategies and suitable legal structure are the important factors.

**Methodology:**

- Comparing and contrasting business environments in the U.S. and China.
- Selection of information based on a) open information; b) discussion with government officials; c) interview of private equity professionals and d) my personal experience.

## **Chapter 2: Chinese Business Environment Analysis**

### **2.1 Background of Chinese Society and Economics**

#### **2.1.1 China is on the Way to a Market Economy**

During the past two decades, the Chinese government has been pursuing a reform and open-door policy which enables it become one of the fastest growing and largest economies in the world today. The 1992 southern China tour of Mr. Deng Xiaoping, then the supreme leader of China, was the turning point of Chinese economic reform. Mr. Deng had a famous saying: “A cat that can catch mice is a good cat, no matter if it is white or black”, which ended the long term debate over whether a market economy or a central-planned economy was the ‘right’ economic system for a socialistic China and built the consensus to focus on a developing economy rather than debating ideology. Since then, China has pursued a market-orientated economic policy and achieved significant results.

Since 1992, Chinese GDP has grown steadily at a rate close to 10% per year. The GDP has reached \$2.7 trillion and grew at a real annual rate of 10.7% in 2006, which is fastest among all the emerging market countries.<sup>7</sup> Real GDP growth of China will slow from 10.7% in 2006 to 9.5% in 2007 and 9% in 2008.<sup>8</sup> As the government continues its efforts to rebalance the economy, attempting to make growth less dependent on exports and investment, while introducing measures to boost domestic consumption, the current account surplus will narrow from an estimated 7.8% of GDP in 2006 to 6.3% of GDP in 2008.<sup>9</sup> The purpose of current Marco-control is to make Chinese economic growth more sustainable.

Before the reform, many state-owned entities had a dual role. On one hand, they were government agencies which had administrative power. On the other hand, they were

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<sup>7</sup> China National Bureau of Statistics (NBS), 2007, <http://www.chinadaily.com.cn/china>.

<sup>8</sup> According to the forecast from Economist Intelligence Unit (EIU).

<sup>9</sup> <http://www.economist.com/countries/China/profile.cfm?folder=Profile-Forecast>.

companies which conducted business with other companies and the general public. In order to let the market allocate the most resources and to reduce interference from government, the Chinese government took definitive steps to separate the dual-role dilemma in those state-owned entities. This is the so-called “government-enterprise separation reform”. The administrative power of those entities was taken over by other government agencies, which transformed these entities into solely for-profit enterprises that face real market competition. The government, instead of running business itself, now has gradually shifted its focus to public goods provision and public services. Up to 2006, there were only a few industries, such as the railway system and post office system, which had not yet separated the government function from business function. Furthermore, following the policy of “denationalization” (privatization), the presence of state-owned enterprises in competitive industries was much reduced and entry barriers to most sectors by the private enterprises were much alleviated. Privately-held Chinese companies have outpaced the Chinese GDP in terms of growth. In 2003, the private sector accounted for 59.2% of the total GDP, which represents a fivefold rise in output of domestically-owned private companies since 1998 and a threefold rise in output of non-mainland controlled companies in the same period.<sup>10</sup>

### **2.2.2. Chinese Enterprises are Becoming Profit-basis Driven**

The Chinese state-owned enterprise (SOE) restructuring evolved through different stages from a contract system to a shareholding cooperative to an IPO in domestic and foreign capital markets. In 2006, major industries, which include telecommunication, energy, airlines, banking and insurance, etc, have gone through internal restructuring, transformation to shareholding companies and to IPO in a capital market. Meanwhile, new corporate governance and incentive plans were introduced in these sectors. The evaluation criteria for

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<sup>10</sup> Origination for Economic Co-operation and Development (OECD) Economic Survey China, 2005, page 18.

SOE performance are now centered on profitability and other socio-economic goals of SOEs emphasized in the past are much less now. Domestic private company (DPC) and foreign investment enterprise (FIE), on the other hand, have been the fastest growth sectors during the past 20 years. Some big DPCs such as Lenovo Group, Huawei, Haier and TCL represent the fast growing private companies operated on a profit-orientated basis decided by the business nature of DPC.

The external environments including legal, financial market, social and culture are favorable for investment in China. New laws, including a Property Rights Law, have been passed and will be effective soon. Using the capital market for resource allocation, the development of financial market expedites the process of a market economy in China. Meanwhile, the social and culture issues are extremely positive for a Chinese boom, backed by its hard-working and fast-learning people, its focus on education and its family-orientated culture. The majority of individuals have a significant business sense. These are all the advantages that fuel the country's sustainable growth.

### **2.2.3 Sustainable Profit Growth of Chinese enterprises**

Chinese enterprises have had soaring profitability in the recent years, not only thanks to a loose interest rate environment, low labor cost and strong external demand, but also upgrades in the industrial and consumption levels, and increased productivity, which appears sustainable.

Compared to 1995-1999, the period of 2000-2005 saw major profitability jumps across sectors in the Chinese economy. Measures of total profitability, such as total profit margin, return on equity (ROE) and return on asset (ROA), all pointed towards rising profitability. Specifically, total margins rose from 5% in 2001 to 6% in 2006, whereas ROE jumped from 4.8% in 1995-1999 period to 14.4% in 2005 and ROA increased correspondingly from 1.7% to 6.0% in the same period (see Table 1).



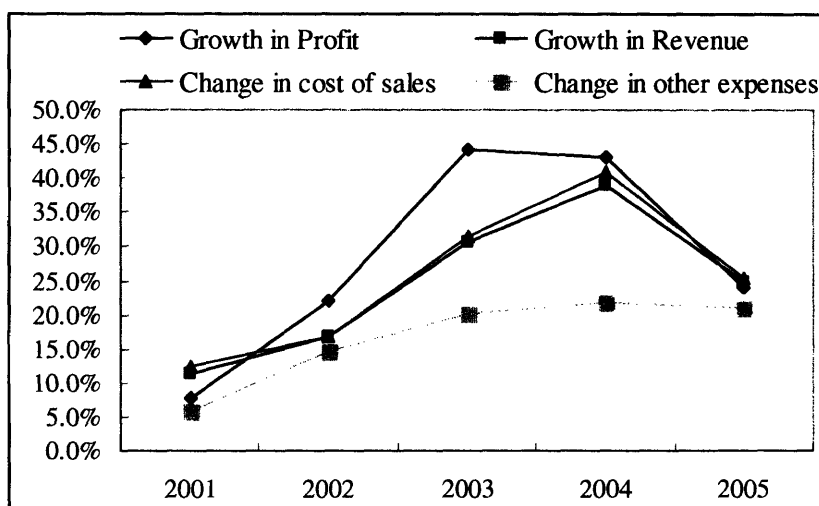
**Table 1: Major Financial Metrics of Chinese Enterprises**

	1995-							
	99	2000	2001	2002	2003	2004	2005	2006E
	Avg.							
ROE	4.8%	8.9%	8.5%	9.6%	12.1%	13.2%	14.4%	
ROA	1.7%	3.5%	3.5%	4.0%	4.9%	5.5%	6.0%	6.6%
Total profit margin	2.8%	5.2%	5.0%	5.3%	5.8%	6.0%	6.0%	6.0%
Gross margin	18.4%	18.4%	17.6%	17.6%	17.1%	15.9%	15.6%	14.8%
Debt/Equity Ratio	178.6%	155.3%	144.1%	142.5%	144.0%	138.3%	137.5%	
Debt/Asset Ratio	64.1%	60.8%	59.0%	58.7%	59.0%	58.0%	57.8%	58.0%
Growth in Profit	7.8%	92.0%	7.7%	22.2%	44.1%	43.1%	24.1%	27.2%
Growth in Revenue	10.8%	20.5%	11.4%	16.8%	30.8%	38.9%	25.0%	25.6%
Change in total cost	11.0%	18.0%	11.6%	16.5%	30.0%	38.7%	25.0%	25.5%
Change in cost of sales	11.5%	19.7%	12.5%	16.8%	31.5%	41.0%	25.5%	26.7%
Change in other expenses	8.4%	8.6%	5.7%	14.6%	20.3%	21.8%	21.0%	15.0%

Source: China Statistical Yearbook 2005, National Bureau of Statistics; and author's calculations

The relatively slow growth of expenses has become the primary source of rising profit margin (see Figure 3).

**Figure 3 : Analysis of Growth in Revenue and Cost of Chinese Enterprises**



Source: China Statistical Yearbook 2005, National Bureau of Statistics; and author's calculations

In conclusion, although China is a transition economy and there might be some back-and-forth in terms of the government's role in the economy, the ultimate direction of a market-orientated basis is clear. Currently, the DPCs and FIEs, as well as the SOEs in competitive industries, are all profit-oriented. The social and legal environments both favor growth of enterprises. Therefore, the necessary conditions of doing private equity business in China are ready.

## **2.2 Systematic Comparisons between China and the U.S.**

The checklist of a private equity business environment usually includes:

- Macro economics and the enterprises fundamentals;
- The regulatory environment ;
- The financial market and exit mechanism; and

- Human resources and the system.

The systematic comparisons of business environments between China and the U.S. are summarized in Appendix 2.

### **2.3 China as a Government-dominated Economy**

The economy of China today is in a unique period of transformation from a long-term centralized economy to a free market economy. Through large scale reform after Deng Xiaoping's southern tour in spring 1992, the Chinese economy today has a far more diverse ownership structure compared to before, when all equity interests were the property of the state. However, while the current Chinese economy has many characteristics of a market economy; it is still in transition, and the government largely remains a dominant force in economic activities.

First, SOEs will play important roles for the long-run. China pursues the market economy under socialism, persists in one party policy, i.e. the China Communist Party, and on public ownership as mainstay policy. Accordingly, the government has the power to allocate resources, mainly through the tax and the dividends from state-owned enterprises. From 2002 to 2006, Chinese tax revenue soared from \$205.6 billion to \$470.5 billion, more than doubled in only 4 years.<sup>11</sup> The annual growth rate of tax revenue is 23%, which is much higher than both the annual growth rate of GDP and of government fiscal expense. Today, the GDP contribution from SOE is reduced to around 30%, and the government encourages the SOEs to withdraw from the competitive industries. SOEs concentrate on up-stream industries including energy, transportation, and raw materials. These strategic industries have an enormous influence on the national economy. SOEs in China are all profitable organizations. The government always tries to improve the efficiency of SOEs by introducing competition.

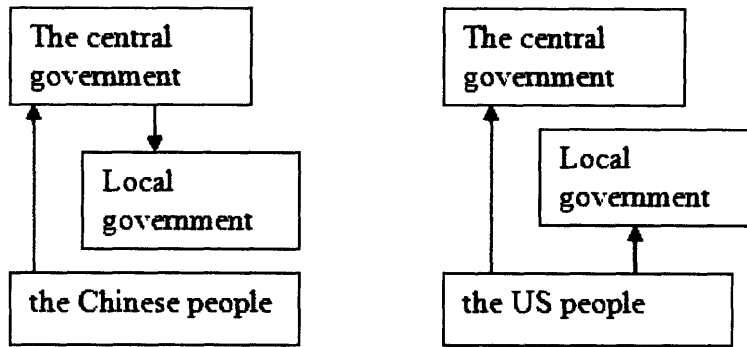
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<sup>11</sup> Mr. Jin Renqing, China's Finance Minister, 2007, <http://www.chinadaily.com.cn/china/2007-01/02/content>

Second, despite the government undertaking a series of reforms to change policies as a guide, it still controls an enormous amount of resources including land and market entry, as well as supervision for investment activities above certain limits. The government ultimately will control the macro-economy through legal and economic means, focusing on public products and social service. China is undergoing a transformation period, since a mature legal system is not well established and proper involvement from the government could improve the efficiency in certain situations. Meanwhile, the competitiveness of private capital is relatively weak, so foreign capital will likely invite imbalanced competition. In the Chinese securities industry, Goldman Sachs and UBS Warburg entered the Chinese market through an “entrance fee”, for example.

Finally, the political structure of the current government, which is a top-down centralized system, has direct influence on economic activities. In comparison with a democratic government such as that in the U.S., the central government of China is similarly elected by popular vote but with little candidate choices. However, unlike the U.S., the central government alone is responsible for appointing the next level in command, such as ministers and bureau chiefs and they in turn appoint their subordinates such as the officials in local government, creating a long chain of command that is not responsive to popular opinion. On the other hand, in the U.S. the local government is not appointed by the central government but by local election, hence they are directly responsible to popular opinion, and not as subjected to the opinion of their superior for promotions and rewards (see Figure 4). The hierarchy of power that is created by the appointment system in China means that the officials will act with self-interest and will not devise and execute policy in a market-oriented manner.

**Figure 4 : Comparison of Chinese and U.S. Political Structure**



The bureaucratic problem created by the long chain of command in the Chinese political system manifests itself in several ways. First, the local bureaucratic officials are learning to be responsible only to their immediate supervisors who are in charge of their promotion and rewards, rather than to represent the local people's interest. Their actions and decisions are focused on making them look good and gaining more power for themselves, instead of acting in a market-oriented, responsible manner. Second, this structure enables the officials not to disclose too much information. Corruption is therefore easier to breed in the emerging economy. Third, the interest conflicts between the central government and the local government represented by the ministries, which usually lack hands-on information, pay more heed to people's interest compared with the lower level local government officials who are at the end of the bureaucratic chain. Gaming between the central government and the local government is always pursued with the central government usually leaning to an overheated market and to macroeconomic control. Finally, the assignment system results in a conflict of interests among different government agencies. The most recent instance of this conflict of interest is the case of Carlyle acquiring XuGong. XuGong announced its intent to look for a foreign investor in order to facilitate its restructuring efforts in 2002, and by 2004, it announced a transaction with the U.S.-based Carlyle Group. However, it was not until 2007 that when the final approval from the Ministry of Commerce (MOC) was received, and with an entirely different package than the initial agreement made in 2004. The delay was due in

part to pressure received from the State Developing and Reform Committee (SDRC), which also has the right to review the sizeable investments and acquisitions. The Carlyle-Xugong deal, due to its complicated negotiation and approval, has become a benchmark for foreign private equity investors seeking to invest in China and understand its regulatory framework.

Top-down structure and the government's active role in the economy do not correlate with the market-basis economy. Singapore is successful example for top-down economic structure, and Japan and Korea benefited a lot from the government's involvement during its emerging in the 1960s and the 1980s. In fact, during the past two decades, the Chinese government has played a very positive role in boosting and sustaining Chinese economy growth.

Understanding the government policy and its rules is not only very helpful but also are crucial to figuring out the investment cycle. For example, the current contraction policy is an adjustment of a previously overheated period largely driven by local economy growth. I believe that since the central government has enough confidence, it is likely that the next open policy environment is forth coming.

#### **2.4 Lack of Business Leaders and a Well-established System**

Despite its 1.4 billion population, China currently faces a shortage of professional, managerial and senior executive level talent. This shortage of managers stems from China's high rate of growth, the expansion of Chinese enterprises and large inflows of foreign direct investment (FDI) (\$60 to 70 billion per year), which have increased demand for new business leaders. Because the fast economic growth and large inflows of FDI took place in the early to mid-1990s, 10-15 years are not long enough periods to produce large numbers of business leaders. In a tight labor market competing for managerial talent, employee turnover rates have been high. From 2001 to 2005, average turnover rates rose from 9% to around 14%. Average

salaries increased by 7-9% in first-tier cities such as Beijing, Shanghai, Shenzhen and Guangzhou, and by 7.5-10.6% for second-tier cities such as Chengdu, Sichuan.<sup>12</sup>

However, China does not lack sources of talent. There is an abundant supply of college graduates and Chinese overseas returnees. In 2006, 4.13 million Chinese graduated from higher education institutions but they only qualified for 22% of new jobs.<sup>13</sup> According to McKinsey, China has 15.7 million university graduates between 2003-2008, of which only 1.2 million will qualify for positions in large multi-national corporations (MNCs) due to insufficient leadership skills and experience. Chinese graduates have 'raw talent' which can easily be developed through training, but this needs to be recognized by human resource professionals.<sup>14</sup> The Chinese overseas returnees, also called "Hai Gui", do not fit with the current environment in China. Usually the returned scholars' reputation and prestige are lower when compared to those who remained. In the U.S., 800 to 1,000 Chinese scientists have independent laboratories; these people are not likely to return.<sup>15</sup>

The challenges for returnees who were assigned to be executives usually come from both inside and outside of the company. Internally, they have to face the Chinese companies' culture, which is very different from western companies'. For example, the returnees usually communicate in a very direct manner, which makes the locals, who are usually more indirect, uncomfortable. Externally, the returnees lean toward doing business by law rather than spending time with government officials and not following the unwritten rules, thus the

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<sup>12</sup> Best Practices: Human Resources: Strategies for Recruitment, Retention, and Compensation, 2007, <http://www.uschina.org/info/chops/2006/hr-best-practices.html>.

<sup>13</sup> Private Higher Education's Adverse Effects: Growing Unemployment and Student Protests, 2006, Asia Times.

<sup>14</sup> Thornton, John, Director of Global Leadership at Tsinghua University in Beijing, <http://www.mckinsey.com/ideas/infocus/china/roundtable/stmt1.asp?stmt=2>.

<sup>15</sup> Rao, Yi, Northwestern University scientist, China's Brain Drain and Brain Gain, [http://72.14.209.104/search?q=cache:-arMnfNZumwJ:www.cctr.ust.hk/conference/papers/Cao,Cong\\_paper.pdf+Rao,Yi,+Northwestern+University+scientist+,+China+return&hl=en&ct=clnk&cd=4&gl=us](http://72.14.209.104/search?q=cache:-arMnfNZumwJ:www.cctr.ust.hk/conference/papers/Cao,Cong_paper.pdf+Rao,Yi,+Northwestern+University+scientist+,+China+return&hl=en&ct=clnk&cd=4&gl=us).

companies' short-term interests can be hurt. These examples show that both "Hai Gui" and foreign senior executives face the challenge of a insufficient and inefficient system.

The system is something to regulate people's behavior. The role of the system is to increase the cost of non-compliance and to reduce the probability of default. It includes laws, regulations and business ethics. O. Williamson, the international representative of the New Institutional Economics, developed a four-level system theory in 2000. First, the informal system without express provision or legal protection includes the customs, traditions, religion, culture, and ideology. Second, the formal system includes game rules that are: constitutional, legal, judicial, property rights, government and so on. Third, the management mechanism, game implementation, includes corporate governance, government governance, and governance transactions. Fourth, the market-based allocation of resources includes a high-level system of low-level guidance.<sup>16</sup>

Faults in the system increases the cost of transactions, which can occur only if transaction costs are less than benefits. Usually, the country which is at rule of law is more developed than the country at rule of man. Meanwhile, the transaction cost and system establishment could also explain why Asia has fewer multi-national corporations than western countries.

Unlike the U.S. companies, which are process-driven, in China many companies are funded by strong leaders and are sustained by their charisma. One of the important reasons for China being a rule-of-man society is related to its traditional culture, which neglects human rights. For example, the concept of "San Gang Wu Chang" (three rules and five regulations) requires that a liegeman is absolutely submissive to his monarch, a son is absolutely submissive to his father, and a wife is absolutely submissive to his husband. For example, a common phenomenon in China is that the leader treats the company as his family

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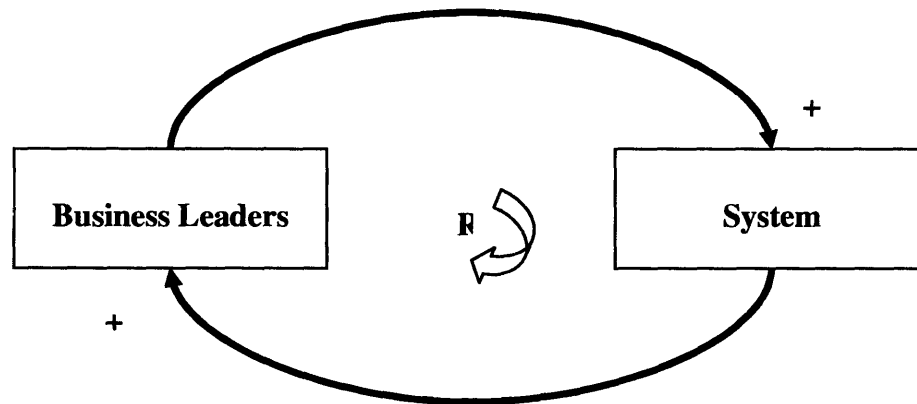
<sup>16</sup> Xu, Xiaonian, 2006, speech notes in Guangzhou, Guangdong province.



and looks at the employees as his children, which restrains the function of system and business scale of the company by losing efficiency fairness in a long run.

Given Chinese society, culture and economic background, the relationship between talent and the system is a reinforced loop (Figure 5). The improvement of the system relies on the talents who not only understand China but also respect a modern system. Meanwhile, a modern system will not only attract more business leaders, but will also retain them in China.

**Figure 5: The System Dynamic between Business Leaders and the System**



Most importantly, this is a gradual improvement process rather than a revolution in China. For example, one of the successful experiences of China International Capital Corporation (CICC), the leading investment bank in China, is to hire local employees at its beginning and to train them in Morgan Stanley, the second largest shareholder of CICC, in New York so that they can understand and follow the company's system. Meanwhile, the open and competitive system attracted more and more talent from both domestic and abroad and these business leaders further enhance the firm's system establishment. Today, CICC could hire talent from top global business schools and Wall Street directly and keeps a big system advantage to its domestic competitors.

## 2.5 The Immature Financial Market in China

While still in its infancy, the Chinese private equity market is poised to take advantage of the currently underdeveloped Chinese financial markets. Despite initial reforms started in 1978, the progress in improving the efficiency in the Chinese financial markets have been very slow, and as a consequence the financial sector has been dominated by bank loans, leaving other financing and exit options for the private equity industry, such as the public equity and corporate bond market, underdeveloped.

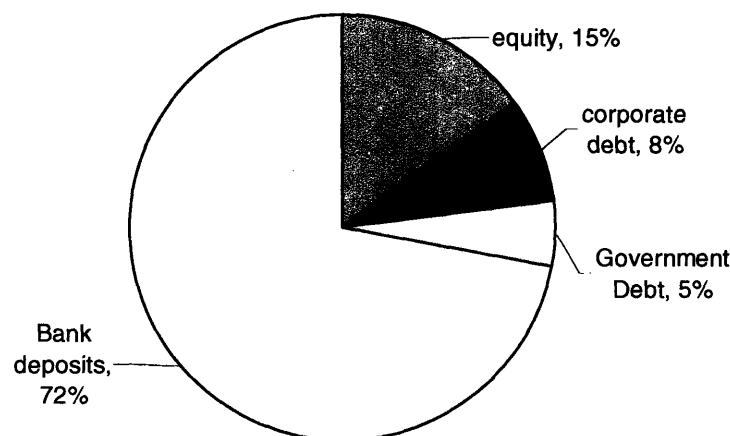
In the Chinese financial market today, bank loans dominate the financing options (See Figure 6). According to McKinsey, the banking sector in China took a majority of the household savings and provided over 95% of corporate funding in 2006. However, the banking sector also remains one of the sectors with highly concentrated state equity holdings. For example, the four largest banks with 53.9% of total bank assets in China were all state-owned and only listed minority stakes through recent initial public offerings (IPOs). Other major banks also include “policy banks” that are mandated to issue government-directed lendings<sup>17</sup>. Because the state is the owner of both the bank and the SOEs, loans were often made to state-owned enterprises (SOEs) as a matter of policy. Often the banks were also pressurized into issuing loans to SOEs by the local government, which only cares about the performance of local SOEs, which affects economic growth and social stability of the region. Finally, absence of the agencies for reporting credit history and financial performance such as a national credit bureau results in difficulty in accessing the creditworthiness of private enterprises, which were thus considered more risky than SOEs. As a consequence, the high-performance private small and medium businesses in China that produced 55% of the GDP in

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<sup>17</sup> McFarlan, F., Jin, L., 2006, “China’s Financial Market: 2006”, HBS Case No. 307-058, page 3.

2005 were largely crowded out of the bank loan market and received only 16% of the bank loans.<sup>18</sup>

**Figure 6 : Component Market of China's Financial System in 2004**



Source: Farrell, D., "The Value of Financial System Reform in China and India", 2007, McKinsey Global Institute, P.4

Raising capital in the public equity or debt market proves equally difficult for a Chinese enterprise. The corporate bond market in China was small and accounts for less than 2% of the total corporate financing, and its participants were exclusively SOE-issued AAA bonds with guarantees from state banks.<sup>19</sup> In addition, the rates on all corporate bonds were required to have either fixed or capped variable rates and were subject to a complex approval process between NDRC and CSRC, making it impossible for leveraged buyout deals to raise capital with junk bonds. The public equity market was somewhat more developed, but liquidity, segmentation and access to the market by both corporations and investors restricted the growth of this market. Since the primary driver of the developing equity market in China was to substitute the banks as the provider of long-term funding for the SOEs, it is relatively difficult for private enterprise to navigate the complicated regulatory process to gain approval

<sup>18</sup> Farrell, Diana, Lund, Susan, Rosenfeld, Jaeson, et. al., 2006, *Putting China's Capital to Work: the Value of Financial System Reform*. McKinsey Global Institute.

<sup>19</sup> McFarlan, F., Jin, L., 2006, "China's Financial Market: 2006", HBS Case No. 307-058.

for listing. Instead, shares of the enterprises that are listed are often illiquid, since most of their market capitalization is due to non-tradable, government-owned “legal persons” shares. Finally the equity market is also segmented into the “A share” market for domestic RMB investors only, the “B shares” market for domestic investors only (but denominated in the U.S. or Hong Kong dollars), and the H shares listed in Hong Kong for foreign investors. The segmentation of the equity market also prevented a flow of capital from foreign institutional investors to A or B share markets. While the recently introduced Qualified Foreign Institutional Investors program allowed some investment by foreign institutions, the selectivity of the program excludes smaller investors from the markets still.<sup>20</sup>

The difficulty for private enterprises and small and medium enterprises in the economy to get sufficient growth capital also translates into extensive informal financing, which was estimated to be around \$120 billion market in China by McKinsey.<sup>21</sup> The informal sources typically range from private “angel” investors, families and informal financial institutions.<sup>22</sup> While the informal sources are able to provide liquidity to a broad range of enterprises at an interest rate that truly reflects demand of capital and some consideration of creditworthiness, it also involves more risks for both the borrower and the lender since the lending agreements often lack legitimacy and are problematic in enforcement.

Given the current inefficiencies in the public market and banking sector in China, enterprises which are excluded from these mainstream markets turn to private equity as a funding solution. The flexibility of funding policy and speedy investment decisions of private equity firms also makes them more attractive financiers than the mainstream lenders. As a

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<sup>20</sup> Wu, Donghuan, 2003, “QFII: China's Gateway to International Capital”, EuroBiz Magazine. European Union Chamber of Commerce in China, Shanghai, China.

<sup>21</sup> Farrell, Diana, Lund, Susan, Rosenfeld, Jaeson, et. al., 2006, *Putting China's Capital to Work: the Value of Financial System Reform*. McKinsey Global Institute.

<sup>22</sup> McFarlan, op.cit.

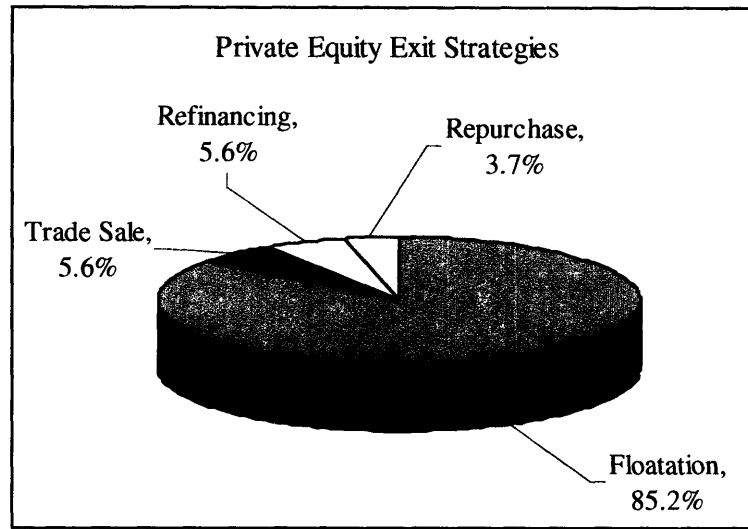
result, there has been significant growth in investment in the private equity markets in China (a 107% increase year-on-year in the first quarter of 2006), accompanied by heavy foreign capital inflow into this sector.<sup>23</sup> However, the private equity sector is still in its infancy, and investments are focused in a few sectors like high-technology projects, energy and infrastructure, and geographically concentrated on the more developed coastal regions. There is much work to be done for the private equity to cover the huge gap between funding needs and the funding capability of the current system.

On the other hand, we have seen the inefficiencies in the Chinese financial market as both an opportunity and deterrence to the development of the private equity industry in China, with the limited exit options provided by the current system being the major problem. Firstly, the nascent private equity industry in China has extensively relied on floatation (IPO) as their exit strategy (see Figure 7), yet the small and highly speculative domestic markets have lead many quality deals to shun domestic market and seek to list abroad for more market discipline and access to greater liquidity from global institutional investors. The absence of small and medium enterprise boards on the exchanges and an over-the-counter (OTC) market in China also lead private investors seeking appropriate valuation for their holdings to list in the foreign alternatives, such as the Growth Enterprise Market (GEM) at the Hong Kong Stock Exchange (Hong Kong Stock Exchange, n.d.) , the Alternative Investments Market (AIM) of London Stock Exchange (London Stock Exchange, n.d.) and Nasdaq OTC market in the U.S.

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<sup>23</sup> McFarlan, op.cit.

**Figure 7: Breakdown of Exit Strategies for Private Equity Investment in China, 2006**



Source: Zero2IPO, *China Private Equity Annual Report 2006*, p.39.

**Table 2: Overseas Listing Distribution of China-headquartered Companies**

Stock Exchange	Number of China-headquartered Company Listings
Hong Kong Stock Exchange	107
Deutsche Börse AG	68
Singapore Stock Exchange	44
Nasdaq	24
NYSE	12
Amex	8
LSE	4

Source: McFarlan, F. Warren, Jin, Li., 2006, "China's Financial Markets: 2006", p. 6.

Compared to floatation, the trade sale is a much less used exit strategy for private equities in China. This is because, compared to the IPO market, the domestic M&A practice

is less developed and faces many regulatory obstacles. Firstly, the non-tradable 'legal person' shares remain a problem during M&A execution despite recent reforms in late 2005 and 2006. Secondly, the M&A market faces the development bottleneck of inadequate intermediation mechanisms. Institutional participants in deal execution, such as investment banks, law firms, appraisal agents, accountants and credit bureaus, are all relatively young and inexperienced in M&A executions. Thirdly, foreign M&As are especially difficult due to protective regulations that cap the investment in protected sectors. As a result, M&A between domestic firms dominates the scene of the M&A market, and foreign-led M&A are often more arduous to complete, as reflected by the recent Carlyle acquisition of stakes in Xugong, a large Chinese enterprise in the heavy machinery sector.<sup>24</sup>

## **2.6 The SWOT Analysis of the Chinese Private Equity Business Environment**

The strengths of the Chinese private equity business environment come from three major areas. First, China is an emerging market, and in particular, both traditional and new industry, private and state-owned sectors have tremendous potential of becoming candidates for private equity business. Second, market economy has gained an unprecedented important status in China, which gives a stage to level up the plays of private equity in China. Third, the market for private equity business is relatively less competitive compared to the ones in developed countries. However, the major weakness lies in the uncertainty of government policy, the lack of investment information, an immature capital market, and an early stage of enterprise development coupled with a shortage of business leaders.

The strength and weaknesses of the external environment in which private equity operates provides an excellent outlook and growth opportunities for private equity business in China. For example, the uncertainty and lack of transparency lift the market entry barrier and

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<sup>24</sup> PriceWaterHouseCoopers, 2007, *People's Republic of China: China's Relentless Growth Continues as the Investor Base Broadens and Investment Volumes Increases*. PriceWaterHouseCoopers.

reduce the competition; the immature capital market extends the business scope of private equity; and the lack of management talents bring the private equity firms the opportunities to add value to Chinese enterprises by leveraging their unique experience and resources globally.



## Chapter 3: The Private Equity Industry in China

### 3.1 Long History, but Currently Young and Early Stage

While private equity (PE) funds are a relative late-comer to the Chinese financial market, private equity types of investments conducted by diversified holding companies and private investors have a much longer history in China. Since the mid-1990s, both domestic and foreign investors have participated in the structural adjustment in the SOE sector with the goal of returning these loss-making enterprises to profits. A M&A- restructuring-exit is the predominant strategy of these early PE-like institutions.

A PE-like firm example that realized superior investment return through M&A and restructuring was Xin Jiang De Long Ltd (De Long). A virtually family-run holding company, De Long amassed capital via speculative investment in equity share purchase permits issued in the A-share market, and took ownership control of three SOEs.<sup>25</sup> Due to the prevalence of legal personal shares and the infantile public equity market, De Long's M&A were executed via acquisition of state-owned illiquid 'legal person' shares in private-placement-like deals from the local Administration of State Property, state-owned commercial banks that owned the legal person shares, and shares that were allocated to employees.<sup>26</sup> As a PE-like firm, De Long was able to discover value via extensive industry research and to create value via restructuring for improved sales and efficiency post-acquisition. Furthermore, De Long also engaged in horizontal and vertical M&A to establish an industry leadership position for their holding companies in their respective sectors to further improve investment return. The stocks of their first three major holdings from these M&As returned 2597%, 1000% and 1000% respectively, over six years in an ultra-bearish

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<sup>25</sup> Li, De Lin, 2004, *De Long Nie Mu*. Retrieved on April 24, 2007 from [http://book.sina.com.cn/nzt/fin/1101384558\\_delong/index.shtml](http://book.sina.com.cn/nzt/fin/1101384558_delong/index.shtml).

<sup>26</sup> Li, op. cit., P.27

market condition where the average return of the stock market was -36%.<sup>27</sup> While some of this staggering performance was due to De Long's ability to borrow cheaply from commercial banks, super-leverage their position and misuse funds in managed investment trust (which ultimately resulted in their downfall), it is undeniable that their strategy was a stellar success. De Long was also one among many that benefited from the macro-policy climate that favored structural adjustments. Driven by the need to save the failing SOEs, the government has gradually opened the market of M&A since 1994 and has encouraged many Hong Kong investors to take equity holding and help restructure SOEs.

Informal funding sources other than investment holding companies like De Long also substitute for private equity firms in China and help meet the funding and leveraging needs of the vast private and small and medium business sectors that were crowded out of the mainstream finance market, where the bank rates can be artificially low due to government control. It is estimated that 75% of the private sector finances were from informal sources such as underground "shadow banks" and rotating credit associations.<sup>28</sup> These informal financing institutions also resemble private equity firms in that the investment or lending decision is autonomous and directed by profit. By lending mostly to small and medium enterprises and private enterprises who does not qualify for bank loans, they also engage in a degree of risk-sharing.

### **3. 2 Current Situation of the Private Equity**

The private equity markets in China are at an early stage of development. The first private equity firms in China began operating in the early 1980s. Local governments

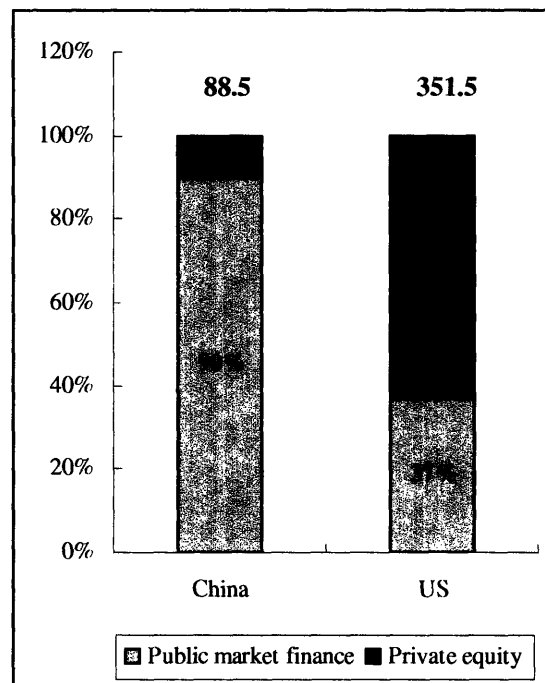
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<sup>27</sup> Li, De Lin, 2004, *De Long Nie Mu*. Retrieved on April 24, 2007 from [http://book.sina.com.cn/nzt/fin/1101384558\\_delong/index.shtml](http://book.sina.com.cn/nzt/fin/1101384558_delong/index.shtml).

<sup>28</sup> Gonzalez, Michael, 2006, "Informal Finance: Encouraging the Entrepreneurial Spirit in Post-Mao China", *2006 Index of Economic Freedom*.

sponsored private equity funds to support new businesses. One of the first was China New Technology Venture Investment Co., founded in November 1985. Foreign firms soon followed. International Data Group (IDG) formed the first foreign venture fund to operate in China in the early 1990s and became an immediate force in the industry. Additional waves of private equity followed over the next decade.<sup>29</sup> Presently this industry is still a minor revenue from which Chinese enterprises raise their equity capital (10% of total financing needs) as compared to the situation in the U.S., where private equity accounts for about a third of the total equity financing (see Figure 8).

**Figure 8: Comparison of Private and Public Equity Financing in China and the U.S. in 2006**

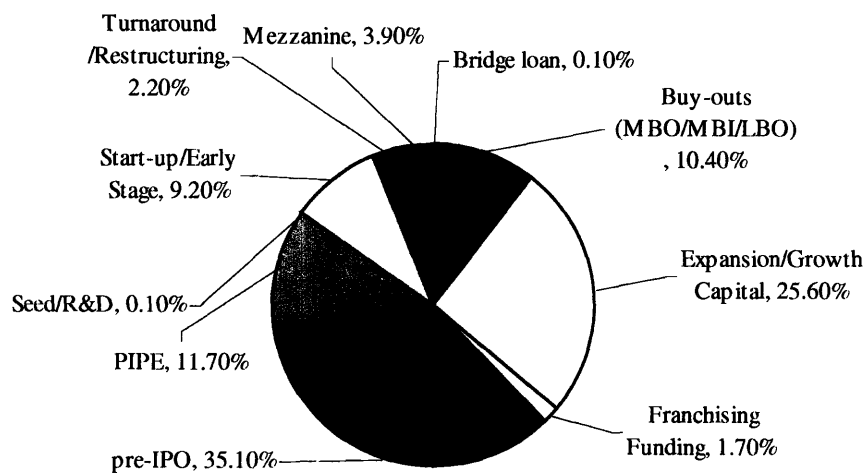


Source: Provided by Chen, Shirley, 2007, "Private Equity Investment in China".

<sup>29</sup> Ewing, Richard D., 2007, "Private Equity in China: Risk for Reward", *China Business Review*.

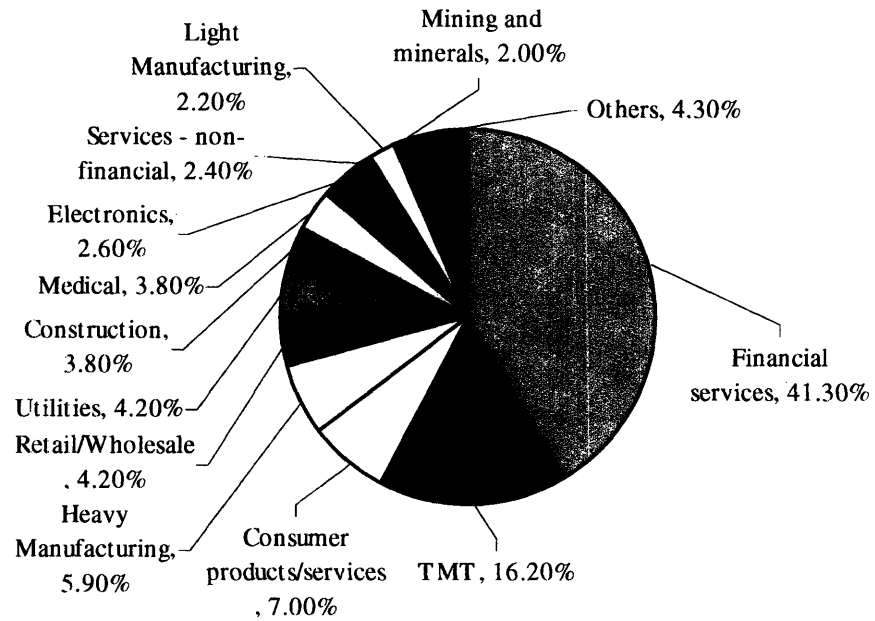
However, the private equity industry has already differentiated itself in terms of types of investment and industry focus. As of 2006, most of the funds were invested either in pre-IPO (35.1%) or Expansion/Growth Capital stages (25.6%) (see Figure 9). Existing PE investment also display a distinct focus on sectors invested in, which are concentrated in financial services (41.30%) and telecommunication, media and technology (TMT) (16.2%) (see Figure 10). Each private equity fund develops its own strategy to go to target firms. For example, the Hong Kong-based investment bank CITIC Capital takes a two-pronged approach, investing in mature businesses or medium-sized enterprises with an eye to bringing them to IPO, while also investing to capitalize on the relocation of manufacturing into China. The CDH has its growth and buyout fund which is independent with its venture capital fund. And the same situation happened with Carlyle, which has a separated growth fund and a buyout fund and exited the early stage market several years ago.

**Figure 9: Breakdown of Private Equity Investment by Investment Stage in 2006**



Source: Provided by Chen, Shirley, 2007, "Private Equity Investment in China".

**Figure 10: Breakdown of PE Investment by Industry in 2006**



Source: Provided by Chen, Shirley, 2007, "Private Equity Investment in China".

In addition, the market is segmented not only by the investment stages but also for the franchise. Among the more than 300 venture capital and private equity firms, we could position most of the funds' position in the following Table 3.

**Table 3: The Segmented Private Equity Market in China (Partial List)**

	VC	PE	Buyout
Top Tier  (Based on reputation and success)	IDG, SAIF, Sequoia  Capital China,  Legend Capital,  Granite Global  Venture, Softbank,  JAFCO Asia, Intel  Capital China, CDH  Venture...	CDH, Goldman  Sachs, the Carlyle  Group, 3i, ...	Hony Capital, KKR,  Carlyle Group...
Middle	NEA, ePlant  Venture, Lightspeed  Venture, Northern  Light, Fidelity  International  Venture, Gobi ...		

Source: Ranking from Zero2IPO Annual Report 2006, and author's interviews.

### 3.3 Characteristics of the Chinese Market

As the Chinese PE market continues to evolve, it increasingly starts to display attributes that were specific to the Chinese market such as the predominance of mid-to-late stage ventures over seed capital or buyouts. These characteristics have their roots in the unique corporate culture, business traditions and regulatory environments of China.

First of all, more venture activities were observed in private equity deals than

buyouts, because of the unique difficulty associated with buyouts in China. While China remains a top destination of private equity deals in Asia, most of the funds were not channeled into buyouts (see Figure 9). In terms of business opportunities, the buyout scene is attractive, since hundreds of SOEs are considering selling, restructuring, or privatizing portions of their assets. Excluding financial assets, the assets under SOEs in need of restructuring totals \$2.5 trillion according to a 2007 estimate by CICC.<sup>30</sup> This attractive category, however, is dominated by insiders and is difficult for foreign firms to penetrate, although the State Asset Supervision and Administration Commission is installing transaction centers and experimenting with opening up the sale of SOE assets and equity.<sup>31</sup> Also, truly gaining control in a corporation can be difficult for investors in China. John Ying, managing director at iVentures, calls this the "head honcho problem" (*dalaoban wenti*). Major PE investors frequently find it difficult to gain board seats and minority shareholder rights are widely disregarded. In protected sectors such as commercial banking, the situation is worse since aggregate foreign ownership is capped at 24.9%.<sup>32</sup>

Secondly, growth and pre-IPO stage investments, which account for more than 50% of all investments, were much preferred to early/seed stage investments, which account for less than 10% of the total (see Figure 9). This bias towards later stage ventures is a direct result of IPO being the predominant exit strategy in the Chinese PE market. In addition, it is observed for the small and medium Chinese enterprises that they use PE investors only as a last-resort financing option, behind informal financing, which they are more familiar with and

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<sup>30</sup> Provided by Chen, Shirley, 2007, CICC.

<sup>31</sup> Ewing, Richard D., 2007, "Private Equity in China: Risk for Reward", *China Business Review*.

<sup>32</sup> Ewing, *op. cit.*

easier to obtain.<sup>33</sup> This also explains the relatively large number of late-stage deals as the informal financing cannot meet their need adequately.

Finally, PE deals in China are focused more on private sector companies rather than SOEs due to different borrowing cost and access to funds faced by the two sectors. Commercial banks which are the key lenders to Chinese enterprises are mostly government controlled, and are used to issue policy loans to support SOEs which are backed by government credit. As a result, the borrowing rates for credit for SOEs are kept so low that they not only pay less than comparable firms in the U.S., despite on average being smaller and operating in a riskier environment, but they sometimes pay even less for average financing cost than the prescribed benchmark rate by Chinese central bank.<sup>34</sup> SOEs also have almost exclusive access to the public equity and debt market. Cheap and adequate access to capital thus makes fundraising from PE firms unattractive for SOEs. In comparison, the private sectors have very little access to bank credits and public market finance. Liquidity obtained from informal financing were at interest rates at least 50% higher than the bank interest rates, making financing from PE deals more attractive to the private sector.<sup>35</sup>

### **3.4 The Performance of Private Equity Funds in China**

#### **3.4.1 Fund Raising**

Fund raising has accelerated during the past few years. In 2006, 40 funds which could invest in China raised US\$14.2 billion (see Table 4). Moreover, 6 of 40 new funds were initiated by Chinese institutions, and the total amount of fund raising was US\$1.517 billion.

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<sup>33</sup> Gonzalez, Michael, 2006, "Informal Finance: Encouraging the Entrepreneurial Spirit in Post-Mao China", *2006 Index of Economic Freedom*.

<sup>34</sup> Farrell, Diana, Lund, Susan, Morin, Fabrice, 2006, *The Promise and Perils of China's Banking System*, McKinsey Global Institute.

<sup>35</sup> McFarlan, F., Jin, L., 2006, "China's Financial Market: 2006", HBS Case No. 307-058.



Accompanied by the improvement of the regulatory environment, the investment professionals and institutions have matured, and more and more investors recognize this asset class. Domestic funds play more important roles in the Chinese private equity market.

**Table 4: China-related Fund Raising in 2006**

Quarter	Fund Number	Capital Raised (US\$M)
Q1' 06	8	1768.00
Q2' 06	9	2863.00
Q3' 06	10	5130.27
Q4' 06	13	4435.00
Total	40	14196.27

Source: Zero2IPO, 2006 annual report, p.19.

**Table 5: Top Ten New Funds in Asia in 2006**

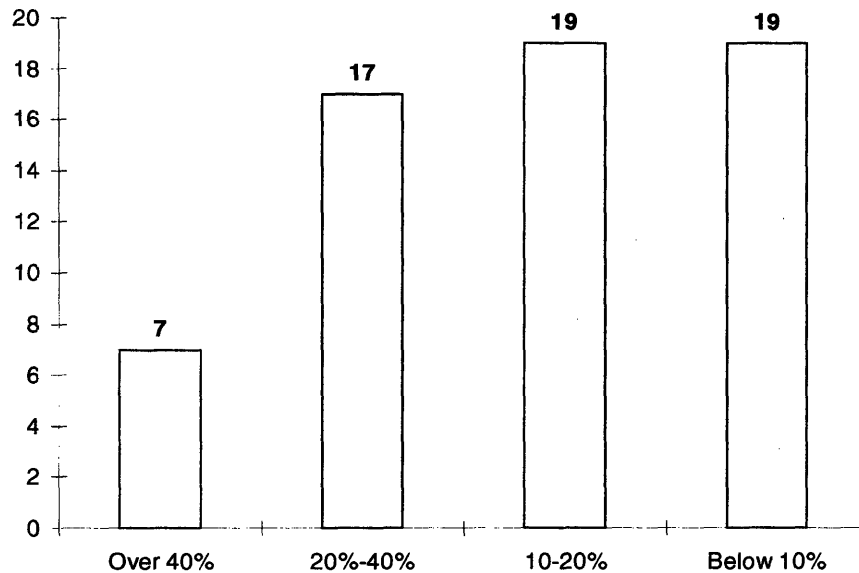
Date	Fund Name	GP	Capital (US \$M)	Investment Sector
Jun-2006	Carlyle Asia Partners II	The Carlyle Group	1,800	TMT, consumer products, retail, manufacturing and financial service
Jul-2006	North Asia Buyout Fund	MBK Partners	1,560	TMT, financial service, industrials, consumer products /retail, commercial service
Dec-2006	Bohai Industrial Investment Fund	Bohai Industrial Investment Management Corporation	765.30	Financial and commercial service, airport and seaport logistic, chemical industry and leisure
May-2006	Avenue Asia Special Situation Fund IV, LP	Avenue Capital	700.00	Distress companies
Jun-2006	Carlyle Asia Growth Partners III	The Carlyle Group	680.00	No limit
Apr-2006	Singular Guff BRIC Opportunities Fund	Singular Guff	600.00	Diversified
Feb-2006	AXA Private Equity Asia	AXA Private Equity	550.00	Diversified
Dec-2005	Asia Pacific Mezzanine Fund 2005	Intermediate Capital Group	500.00	MBO and growth capital
Sep-2006	Baring Asia Fund III	Baring Investment Asia Ltd.	490.00	Diversified
Apr-2006	Partners Group Asia Pacific 2005	Partners Group	375.00	Growth and late-stage

Source: Zero2IPO, Annual Report 2006.

### 3.4.2 Fund Return

China has provided spectacular private-equity returns in recent years. The following figure is the distribution of the return of partial private equity firms in 2005.

**Figure 15: The IRR of Private Equity Funds in China**



Source: Zero2IPO China Venture Capital Research Center 2006.

It is very hard to get the comparable investment returns elsewhere. A story from James Hahn, CEO of Global Venture Network and managing partner of China Private Equity Partners with operations in Hong Kong, may illuminate this market. Many U.S. investors are happy to find a 5% return. In China, today, the average investment is \$5 million for a 30% stake in a Chinese growth company grossing \$10 million with net income of \$3 million and a pre-money valuation of \$15 million, or five times the net income. Comparable U.S. public companies in the same high-growth sectors such as healthcare, media, and education are trading at price-to-earnings ratios of 25 times that. Buying low and selling high has delivered a minimum return of 100% a year for a five-year, \$100 millions size fund in China.<sup>36</sup>

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<sup>36</sup> China or India: Which Is the Better Long-term Investment for Private Equity Firms? <http://knowledge.wharton.upenn.edu>, April 26, 2006

### **3.5 Forecast of the Private Equity Industry in China**

Going forward, we see that a Chinese economy being gradually put in place to prepare for a private equity market as the necessary condition for developing PE business. This entails an infrastructure such as the legal framework and accounting standard necessary to ensure deal execution, as well as the receptiveness of the government and the financial market to private equity deals that are novelties to the Chinese market.

China has made tremendous progress in establishing an investor-friendly legal framework. Recent reforms in the legal sector have included consolidating the regulations on investment in key areas and laying down clear standard practice guidelines to ease the investment process. Some critical changes have included amendments to company and securities law which legalize the ownership of private property and give corporations an infinite life, along with a bankruptcy law that establishes a unified framework for bankruptcy in private or state-owned enterprises and clear procedures for insolvent enterprises to restructure or exit the market. Even the heavily regulated sale and purchase of state-owned assets are becoming more transparent and executable with changes in the regulations.

The format improvement of accounting standards adopted by Chinese companies has driven the quality improvement. In January 2007, the Chinese Accounting Standards (CAS) has officially converged with International Financial Reporting Standards (IFRS). The commitment of China to adopt and consistent apply accounting standards based on IFRS principles have been widely applauded by investors, analysts and institutions as an important development towards transparent financial reporting by Chinese enterprises.

However, compared to the infrastructure preparedness, the Chinese government itself still holds a relatively cautious stance towards pure market-driven investment activities. For historical reasons, China's leaders are more inclined to retain control on economic activities and to exclude foreign influence. This conservative approach can be observed from recent behavior of some Chinese government officials, who allegedly dominate whole sectors by

foreign investors and call for "severe measures to curb and punish hostile takeovers aiming to monopolize the Chinese market". Faced with increasingly active investments, additional screening procedures for cross-border mergers were also introduced in part to protect national security.<sup>37</sup> However, there is also demonstration of increased savvy by the government, as the recently-issued lists of industries over which the Chinese government will retain control reflect a more selective approach to foreign investments. On the other hand, as an increasingly important international capital provider, it is in China's interest, today more than ever, to maintaining an open international market for investment. The commitment of the Chinese government to transparency in the financial markets during accession to WTO means further positive change will be observed in opening the Chinese market for investments.

One obstacle in developing Chinese private equity is that the exit options remain limited in China. In 2006, most the private equity investments in China have chosen an IPO as their exit strategy. According to CDH investments, IPO that target foreign stock exchange listing is the "proven strategy" to successful exit and return of value.<sup>38</sup> However, according to 2006 report by Zero2IPO, the average return multiple for IPO is 2.98, lower than both M&A (3.45x) and MBOs (3.26x).<sup>39</sup> However, compared to typical holding period of three or more years for deals with MBO and buyout exit, deals with IPO-exits typically have a much shorter holding period since pre-IPO investments dominate the Chinese PE market. Thus combining holding period and average return, IPO exits are still favored over M&As.

Fundamentally, we believe that the following drivers in the economy will propel the continued rapid expansion and development of Chinese private equity industry:

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<sup>37</sup> OECD (2006) *Ask the Economists: Made in China. Is The Game Changing?* Retrieved April 25, 2007 from [http://www.oecd.org/document/21/0,2340,en\\_2649\\_201185\\_37892757\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/21/0,2340,en_2649_201185_37892757_1_1_1_1,00.html).

<sup>38</sup> CDH Investment, 2005, *Proven Exit Strategy for China Private Equity IPO on International Stock Markets*.

<sup>39</sup> Liu, Qi, 2007, *Return Analysis on Chinese Private Equity Investment in 2006: Return Multiple from IPO Exits Lower than Buyout and MBO exits. Zero2IPO esWeekly*.

- ✧ Macroeconomic: the sustained 10% GDP growing forward and robust profit growth of secondary industries with pre-tax 5 year compound average growth rate (CAGR) of 31.8%<sup>40</sup> will attract much more private equity investment and will justify the expected superior return.
- ✧ Legal: Development in regulations governing investment deals and standard practices will streamline deal execution.
- ✧ Accounting: financial records and reporting will improve due to convergence to IFRS, improving transparency of company financials and decreasing cost of investment due to asymmetric information.
- ✧ Capital: Continued banking sector reform and continued diversification of capital provider will improve capital allocation and allow private equity business to take on greater roles in the market for funding enterprises.
- ✧ Human Resources: Return of Chinese trained in overseas developed markets brings expertise and know-how to the domestic industry.
- ✧ Institutions: Continued evolvement of domestic PE market that has China-specific features.

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<sup>40</sup> Chen, op. cit.

## **Chapter 4: Developing a Private Equity Business in China**

An integrated cycle of private equity business includes fundraising, investing, portfolio managing and exiting. In the fundraising phase, one of the most important things is to build good relations with limited partners (LPs), and to help them understand the current market. A clear investment strategy and a workable execution plan are the keys to getting involved in the booming Chinese market. Since exit is always a big difficulty in developing countries, particularly in government-dominated economies, execution process is driven by exit strategy.

### **4.1 The Limited Partner's Perspective**

#### **4.1.1 Why Invest in China?**

Two major principles drive the growth of private equity business in China. First, radical economic reform over the past two decades brings substantial investment opportunities, both internal and external. Second, due to the slower growth, often 3 to 5%, the attractiveness of investing in developed nations is decreasing compared with some emerging markets. Consequently, there are several factors influencing the investment. First, increase in size of many private equity funds has altered in the incentive structure of these funds. Since capital per partner has increased dramatically, the management fee becomes a significant source of income. Many LPs fear that the incentive provided by the share of the profits become less effective. Second, many private equity organizations have encountered strong demand when they seek to raise new funds, which enhances their negotiation power on partnership agreement terms negotiation. Also, the leading buyout funds such as KKR and

Blackstone recently initiated the trend of raising money from public markets. Third, many LPs worry the market as “tons of money is chasing a few deals”.<sup>41</sup>

Although many companies are concerned about the big uncertainties (including substantial information asymmetries) and difficult-to-evaluate investment in China, the investments still yield attractive returns. The U.S. private equity industry data shows that performances of good private equity firms versus bad firms are vastly different compared to other asset classes. Consequently, it makes sense for LPs take a conservative approach to investing in developing countries without enough information about the market and an investment team. Harvard Management Company, the largest university endowment in the world, plans to adopt multiple strategies to approach the Chinese market: First, invest in a global or Pan-Asia fund. For example, of the \$16 billion fund of KKR, \$4B will be invested in Asia, while about \$500 million to \$1 billion will be allotted to China. Second, invest in the regional funds of already-established funds, such as the Sequoia China Fund and the India Fund. Third, once the LPs have a thorough understanding of the market, they will seek opportunities to invest in local funds directly.<sup>42</sup>

#### **4.1.2 The market size of Chinese private equity business**

Because of the fast capital injection and unpredictable government policy, another major concern of limited partners is whether the Chinese market is typified by an imbalance between the supply of capital and attractive investments. I here develop the following chart to address this issue.

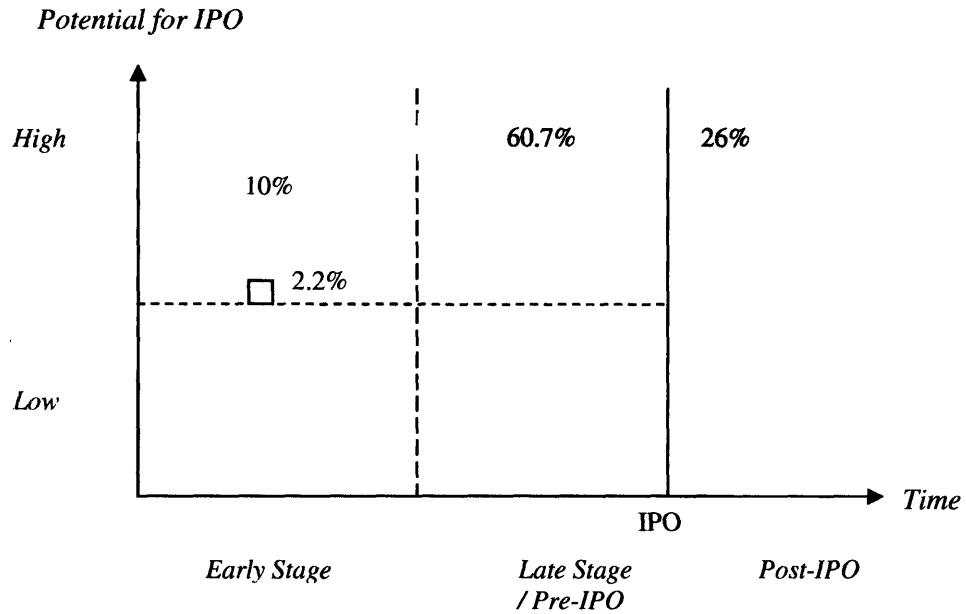
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<sup>41</sup> Lerner, J., Hardyman, F., and Leamon, A., 2003, “A Note on Private Equity in Developing Countries”, *Venture Capital and Private Equity*, p. 1.

<sup>42</sup> John Shue, manager of the private equity investment for Asia, provided this information during the interview with author.



**Figure 12: The Whole Picture of Private Equity Investment in China**



The X-axis represents most companies' developing stages, including early stage, late stage, pre-IPO and post-IPO. The corresponding businesses roughly are venture capital, private equity and buyout. The Y-axis represents the potential of the portfolio company to go public. In 2006, 60.7% of private equity proceeds were invested in late stage and pre-IPO, and 26% of proceeds were invested in buyout, PIPE and mezzanine business. Meanwhile, only 10% of proceeds were invested on the early stage ventures, and 2.2% in turnaround business.<sup>43</sup>

The situation of most capital invested in a limited market with a high potential of IPO companies in late or the pre-IPO stage misleads the LPs about the market breadth and depth of Chinese private equity business. I believe the Chinese market was constrained by three bottlenecks.

<sup>43</sup> The Year-in-Review Asia Private Equity and Venture Capital, 2006, *Asian Venture Capital Journal*.

First, the exit mechanism is a big problem because of immature capital market and lack of institutional investors. Even though IPO is the best choice for exit strategy because of high valuation, and the IPOs dominate the exit strategies as 85.2% share, the relatively small number of PE-backed IPOs (46 companies) compare to the investment transactions over the past few years, reflects the immaturity of Chinese capital market. On the other hand, trade sale has a small proportion as 5.6%, because there are few institutional investors who can invest in the private equity class of assets in China.

**Table 6: The Exit Strategy of Private Equity Investment in 2006**

Exit Strategies	No. of Transactions	Percentage
IPO	46	85.2%
Trade Sale	3	5.6%
M&A	3	5.6%
Repurchase	2	3.7%
<b>TOTAL</b>	<b>54</b>	<b>100%</b>

Source: Zero2IPO, 2006 Annual report, p.39

Second, the lack of investment information and the high cost of due diligence constrain the searching of high IPO potential companies. The big funds, which generate investment information by leveraging their brand name, have to invest above a certain amount of capital per deal. In contrast, the small funds can not afford high cost of deal origination and getting information for evaluation and negotiation. Moreover, the lack of corporate transparency makes the investors difficult to measure the corporations' quality as

well as true value. These problems result in a large number of investors needing to safely stick with high quality deals with a limited geography area.

Third, a lack of constitutional and worldwide-recognized fair legal protection results in the high risk of early stage investment. The lack of protection of intellectual property (IP) and little incentive for innovation both stem the growth of media and small enterprises and discourage investment in ventures at early stages. For example, when the You-tube model was proven to be a success, more than 200 similar companies were established within several months. The competitors easily acquire other business ideas even for the management team, which is not good for the growth of companies in general.

Nevertheless, some positive trends in China could extend the private equity market in the near future for the following three changes. First, the emerging and formation of a multi-layer capital market, namely, the rapid growth enterprises market in Shenzhen and the OTC market in Tianjin, along with the maturing of institutional investors, will provide more exit strategy opportunities. Second, more and more experienced investment professionals and the improvement of corporate transparency could bring more valuable investment candidates to the table. Third, the improved legal system could enhance the confidence to invest in early stage companies.

## **4.2 General Partners' Entry Points**

### **4.2.1 Investment Philosophy**

Just as in the U.S., the investment philosophy in China market includes:

- a proven management team;
- significant growth potential;
- a strong market position; and
- multiple exit opportunities

Most importantly, because of Chinese top-down economy, the Rule of Man culture and the current nationalistic tendency, the key of getting involved into the Chinese booming market is to bring the value to the stakeholders and leverage your good reputation in the market. The stakeholders mainly include regulator, management, clients and vendors, public and investor.

#### **4.2.2 Investment Strategy in a Competitive Industry**

Private equity funds in a competitive industry, which encompasses most middle-and-down stream industries, undertake a diverse array of potential transactions, particularly in the growth enterprises' upgrades and some private companies' buy outs. Because of the different development stage, the economic growth of the U.S. is driven by high technology, innovation and mature-business restructuring. In contrast, China, the largest emerging market country in the world, easily maintains its continuous annual growth rate close to 10% for over more than a decade and will likely continue for another decade, since its starting point was rather low in the 1980s. Therefore, the venture capitalists in the U.S. usually targets high technology sectors of the economy, and buyout firms focus on more mature companies in a variety of industries that need to restructure or combine. By way of contrast, funds in China targeted already-established firms in traditional industries, particularly the industries with internationally comparable advantages as well as with the concept of industrial upgrade or consumptive upgrade.

After two decades of growth in the manufacturing and service industries, the market enters a new phase, which shifts from growth in volume to growth in quality. Over-investment, over-supply and a segmented industry structure is not sustainable, while the inexpensive labor supply will peak on 2008 before reducing gradually.<sup>44</sup> Therefore, this is the

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<sup>44</sup> Labor Shortage: Opportunity or Crisis?, 2006, China Labor Watch, <http://www.chinalaborwatch.org/2006%20Editorials/07-07-2006%20labor%20shortage.htm>

best timing for private equity firms to bring the value to growth enterprises by advising business model upgrades, market knowledge, disruptive technologies and exploring high quality companies. The following examples could further address these investment strategies.

In terms of advising Chinese company business model upgrades, the antibiotic production of a famous pharmaceutical company in Shijiazhuang, near Beijing, is ranked in the top three in the world based on its advanced technologies of fermentation and velum filtrate. It started to produce the product from the 1990s and the industry is getting commoditized. If they could leverage their market position, their research and development expertise to enter the patent medicine market, they will sustain their business by entering public market.

Secondly, as for bringing information of market knowledge to the companies, many examples simply bridge the information gap, thereby helping the company generate profit through new products. For example, the best selling model of crane is a removable model in the global market, while the Chinese manufacturers focus on a fixed model. If private equity firms bring market knowledge as well as capital to the Chinese company, which has competitive advantage in machinery industry, they could gain a profitable market.

Third, the disruptive technology and business model could enhance the competitive advantages by lifting the entry barrier. For example, Mengniu Dairy, with the help of CDH and Morgan Stanley's private equity arm, heavily invested in the UHT milk technology and won a significant market share successfully. In contrast, Yili Dairy and Guangming Dairy lost big market shares due to their different technology approach.

Fourth, exploring for high quality companies can generate huge value for private equity firms. Goldman Sachs and CDH discovered that the account receivable turnover of Yurun Food is only 60 days, which is far less than its comparables, usually at three months. This means Yurun has pricing power over its retailers. So, the two private equity firms brought Yurun Food into public trading last year.

Another business opportunity in the competitive industry is to buy out private enterprise. The first generation entrepreneurs who still manage private enterprises are challenged by losing control and other daunting management problems. Some of the enterprise owners, particularly in the Zhejiang and Jiangsu provinces, want to transfer the family business to the professional management team and only want to keep a small proportion of shares. Thus, this is an excellent opportunity to buy out these fast-growing and competitive businesses. Private equity firms not only bring capital and management teams to sellers, but also accelerate the enterprise modernization. On the other hand, customer resources and government relationships are usually maintained by the first generation entrepreneurs, so a very negative influence will be generated when they leave the company. Accordingly, it is a good strategy if the private equity firm teams up with an industry strategic investor.

#### **4.2.3 Investment Strategy in a Regulated Industry**

Given that the government dominates the business sector in China, the major upstream industries are heavily regulated and controlled, including energy, materials, transportation, telecommunication, banking and insurance. Recently, due to the fast GDP growth and commodities price surging, the companies in the regulated industry usually have faster growth rates and higher profit margins than the industrial average. Accordingly, they take the most investment value and are very difficult to approach. Most SOEs are in these industries with a sizable assets and profits.

**Table 7: The Scale of SOEs in China**

	Central Government	Local Government
Asset	US\$1.5 trillion	US \$ 1 trillion
Sales	US\$ 1 trillion	US\$ 500 billion
Net Income	US\$ 100 billion	US\$ 25 billion

Source: Provided by Chen, Shirley, 2006, CICC.

It is obvious that maintaining a good relationship with the government and bringing value is the key to entering these industries. The relationship between government and private equity funds is not in opposition with the government's stated public goal to enable the two synergic parties to achieve a win-win situation.

For that reason, it is important to satisfy the public goal before investment. That could mean if the government's short-term goal is to develop the economy, the private equity funds try to contribute GDP; if the government is seeking for social target, the private equity funds try to involve public investment and charity events; if the government wants to target a political goal, such as reform of SOEs, the private equity funds try to leverage the management expertise and global network to seek the opportunities in this sector. Correspondingly, once the investment institution helps the government achieve its goal, the government can help the private equity firms enter the market with favorable terms through tax benefits, land or market resource allocation to ensure a positive investment return. Goldman Sachs helped the government solve the problem of non-performance loan (NPL) from commercial banks and spent RMB 501 million (US\$60 million) on the turnaround of Hainan Security Firm. Eventually Goldman Sachs was rewarded by the security firm license and a large number of investment deals.

Bringing value to the industry and enterprise is another pre-condition of entering this market. Currently, the regulated industries encounter the challenges of industry consolidation, globalization and modernization. In terms of industry consolidation, due to the over-investment and administration intervention, over-supply and over-competition are common in some of the industries, particularly for steel, cements, electrolyte aluminum and airlines. For example, the state-owned Air China, China Eastern Airlines and China Southern Airlines (Big 3) run the international routes from their own hub Beijing, Shanghai and Guangzhou separately, without global network links multiple of gateways, thus reducing the competitive advantages on international routes. At the political level, with the increasing political strength and consolidation of current Hu Jintao and Wen Jiabo's government, the State Assets Supervision and Administration Committee (SASAC) plan to further consolidate the central government controlled corporations from 156 to 80 to 100 within three to five years and will eventually consolidate further to just 50. Thus, the SOEs have incentive to expend their business and to involve M&A actively.

In terms of globalization, the Chinese economy heavily relies on global markets, while some enterprises have to be involved in global competition and to acquire the market and resources when they are over a certain business scale. Furthermore, due to pressure from the imbalance of foreign capital inflow and outflow, the Chinese government encourages the Chinese enterprises' outbound merger and acquisition. Nevertheless, Chinese enterprises still lack sound as well as well-planned and well-executed strategies of globalization, necessary integration skills, and an appropriate approach.

With the company's growth, globalization and industry consolidation, the existing human resources and system could not support any further development of the corporation very well. Hence, modernization is the crucially necessary process of Chinese enterprises at a certain stage. This modernization involved corporate governance, organizational structure and



the managerial system to further develop the core business and spin-off of the non-core businesses.

These trends provide the private equity that could leverage international resources for a great advantage. The proposed approach is to leverage the private equity firms' advantages of capital, international network and management know-how to help the Chinese enterprises' globalization in order to accelerate the industry consolidation and corporate modernization while the private equity fund generate investment opportunities during the whole process.

In terms of investment strategy, due to the fast growing fundamentals of the enterprises in regulated industry, the private equity fund could generate attractive returns without being the controlling shareholder. The proposed strategy is to buy-in rather than buy-out, and to find the investment opportunity to carve out valuable assets.

#### **4.2.4 Invest in the Immature Financial Markets**

Compared to the situation in the U.S. and other developed countries, the immature Chinese financial market provides private equity firms abundant deal flows. The banking sector, alone represents 72% of financial stock in China in 2004 and mainly supports the development of SOEs and provides short-term working capital loans. The market scope and depth of corporate bonds and stocks are limited, and thus the entry barrier is too high to finance the middle and small sized companies. Given this situation, the proposed investment strategies include the following two examples:

First, private owned enterprises have to raise money by selling part of their shares. Limited by credit and collateral, private enterprises find it difficult to obtain bank loans from commercial banks, while these companies also have difficulty raising money from the public market, both because of lack of government backing and weak corporate governance. Although the informal financing market provided capital of about 5% of total loans or about US\$119 billion in 2005, the number is still less than the gap between financing need and bank

lending at 7.7% of total loans.<sup>45</sup> The information of these firms could be searched and obtained from commercial banks and other financial service entities.

Second, most companies which consider back door listing could be replaced by private equity investment.<sup>46</sup> Since the domestic public market is not well developed, and access to international markets is limited to the largest firms, some of the growing enterprises plan to be listed on the main board through back door listing. According to incomplete statistics in 2004 and 2005, there were 107 Chinese companies listed in the U.S. stock market; 86 of 107 are back door listing (most of them use OTCBB)<sup>47</sup>. Even if about 46% of these companies eventually raised money in this market and 14 of them converted to the main board, this way is still much less efficient than first generating capital and management know-how from private equity and then going public and listing on the main board directly when qualified.<sup>48</sup>

### **4.3 Legal Structure and the Exit-driven Approach**

The Chinese immature financial market has difficulty providing exit strategy, while it provides many investment opportunities. First, the A-share domestic market could support limited companies raising money and mainly serve SOEs. Second, the overseas market usually has higher expense requirements, which does not favor middle and small sized enterprises. Third, the shortage of institutional investors and weak or not fully developed legal system increase the difficulty of trade sales. Usually, the natural working flow of private

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<sup>45</sup> Provided by Chen, Shirley, 2007, CICC.

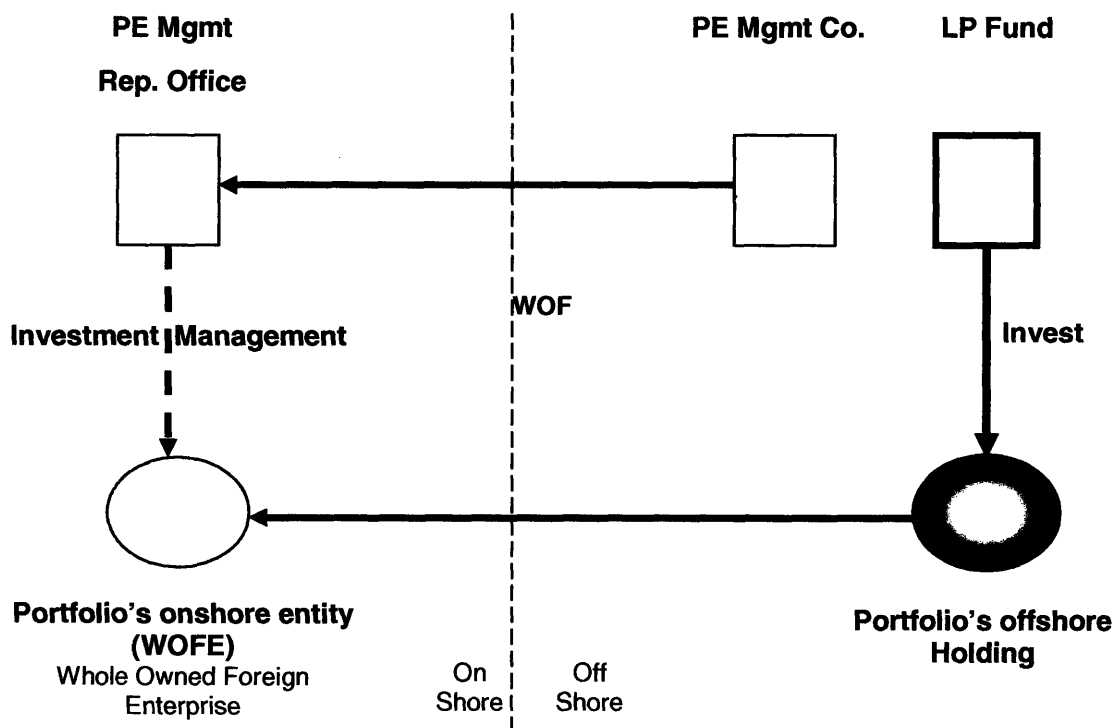
<sup>46</sup> A strategy of going public used by a company that fails to meet the criteria for listing on a stock exchange. To get onto the exchange, the company desiring to go public acquires an already listed company, <http://www.investopedia.com/terms/b/backdoorlisting.asp>.

<sup>47</sup> The OTC Bulletin Board (OTCBB) is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many over-the-counter securities that are not listed on The Nasdaq Stock Market or a national securities exchange, <http://www.sec.gov/answers/otcbb.htm>.

<sup>48</sup> China A M C, 2007, <http://fund.jrj.com.cn/news/2007-01-06/000001901333.html>.

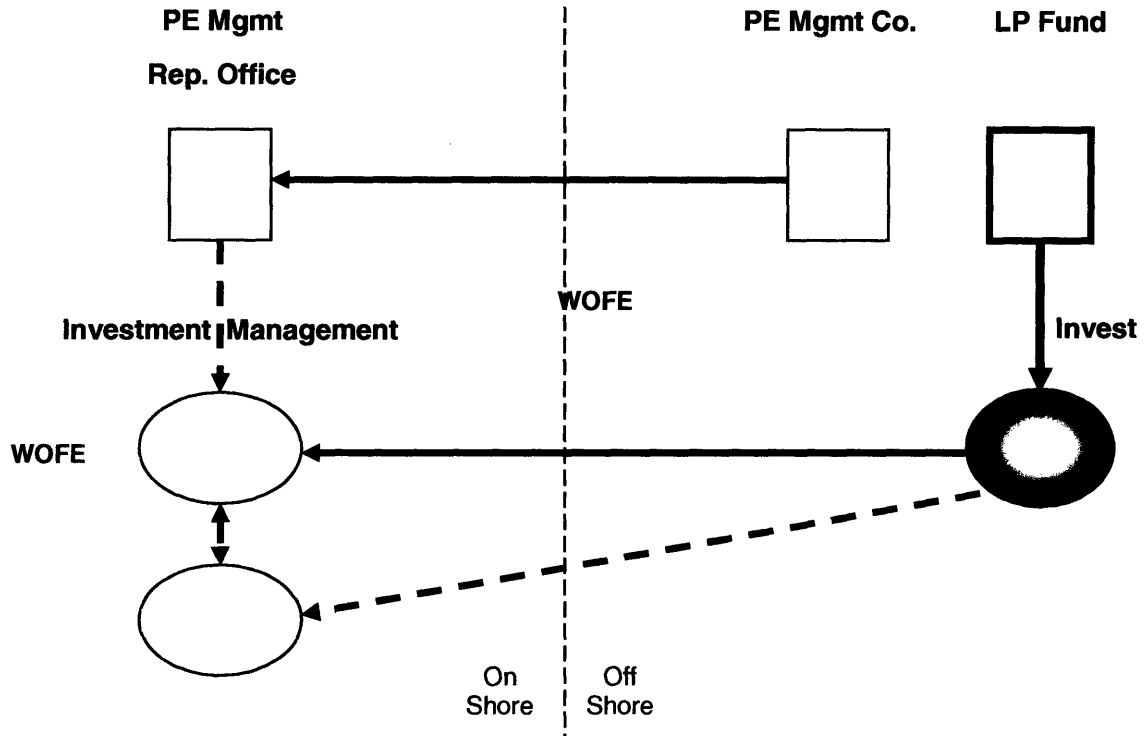
equity business is from deal searching to due diligence, valuation, deal structure, legal structure and then investment. In China, most of the private equity investments failed in the 1990s, mainly due to the wrong execution process results in the exit problem, particularly for legal structure. CDH Investment, the top tier private equity firm in China, avoided the wrong legal structure and exited its investment successfully with the information from its then-parent company, CICC. In conclusion, due to exit issues, the execution of private equity business in China should be driven by exit strategy, i.e., when you make the investment decision, you should make sure the investment has multiple exit strategies with a suitable legal structure. During the past few years, the foreign private equity firms have two legal structures of investing in a non-restricted Chinese company and investing in a restricted Chinese company.

**Figure 13: Foreign PE Firm's Investment in a Non-restricted Chinese Company**



Source: Hardyman, F., 2007, "Gobi Partners: Raising Fund II", HBS case 807-093, p.15.

**Figure 14: Foreign PE Firm's Investment in a Restricted Chinese Company**



Source: Hardymon, F., 2007, "Gobi Partners: Raising Fund II", HBS case 807-093, p.16.

Before April 2005, two-thirds of Chinese domestic stock market shares were non-tradable and held by the state or legal entities. Following satisfactory results from the conversion of non-tradable shares into free float ones, CSRC gave the green light to IPOs again in May, 2006. Accumulative financing on the A-share market hit a new historic high, totaling \$33 billion. Local exit doors are again open now. The pros of exit by the A-share market include high valuation, a short approval process, permission in certain regulated industry and favorable government subsidies. The cons include that applying Chinese law reduces some investor rights and increases risk. In the meantime, the legal structure is totally the same as establishing a Joint Venture Company.

#### **4.4 Chinese Private Equity Today and Tomorrow**

In the short-run, the Chinese private equity market is segmented, and most of its capital is limited to a small market which has high potential of IPO and is in the late-stage. Lack of exit strategies, investment information, business leaders and a favorable regulatory environment are all important reasons for stemming the growth of private equity business in China. Therefore, the Chinese government announced a buildup of multi-level capital market, in order to: 1) accelerate the developments of the Shanghai main board market and the Shenzhen middle and small enterprises (MSE) board, and benefit the Hong Kong Stock Exchange as the bridge of mainland and the world; 2) set up a growth enterprises board in Shenzhen, and lower the entrance barrier to support the finance of startups; 3) establish the OTC market for the shares trade of new startups, non-performing companies and the business unable to go public, to release the pressure of exit avenue. Meanwhile, the government fosters the local private equity firms, such as selecting several securities firms to practice direct investment business. I believe that the regulatory sentiment will be positive for private equity business when the local funds have a reasonable competitiveness for foreign funds.

In the long-run, with about 10% rate of Chinese GDP growth, the assets volume will be double in the next five years. It's impossible for the Chinese banking system, debt market and public equity market to support that much financing, so private equity will close the gap and play an active role to fuel economic growth. Innovation, supply of management, the change of regulatory environment and exit avenues are all the other drivers of Chinese private equity business. There is no reason to expect too many private equity firms in the next 10 years.

Today, although the Chinese finance market is immature, its big market potential and stable political environment drive more and more international capital allocate to this market. The investment opportunities are concentrated in the opportunities which generated from the immature financial market, particularly in the private companies sector, and for the middle

and small enterprises. First, China has the largest number of engineers in the world. Thus, all the Chinese industrials for which leveraging the knowledge is very important have competitive advantages in the world. The machinery industry is a good example because of the trends of producing small amount and big types, which need many engineers to redesign and test. Second, the growth of the middle class in China brings a huge consumer market, the consumer upgrade in recent years benefits many industries such as retail, consumer products, and financial services. Third, helping the SOEs' outbound M&A, consolidation, restructuring and modernization is the best approaches to share the profit in the regulated business.

Tomorrow, with government reform and the maturity of market-basis economics under socialism, the government will be more confident in its economy and will tax revenue which results in further privatization and buyouts. Meanwhile, healthy care and energy will be a big challenge to society and will need heavy investment. In addition, the matured capital market and friendly business environment will propel the private equity industry to a new level. In conclusion, a long time commitment, suitable investment strategy, and sophisticated approach, as well as an on-the-ground execution team are the keys to winning the Chinese market both today and tomorrow.

## **Appendix 1: The Definition and Mechanism of Private Equity Business<sup>49</sup>**

Private equity is a broad term that commonly refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. More accurately, private equity refers to the manner in which funds have been raised, namely on the private markets, as opposed to the public markets. The private equity market has become an important source of funds for start-up firms, private middle-market firms, firms in financial distress, and public firms seeking buyout financing.

In the private equity industry, choice of investment has been undertaken by professional private equity managers on behalf of institutional investors. The vehicle for organizing this activity is the limited partnership, with the institutional investors serving as limited partners and investment managers as general partners. Partnerships use organizational and contractual mechanisms to align the interests of the general and limited partners. The specific advantages of limited partnerships are rooted in the ways in which they address agency and information problems. General partners specialize in finding, structuring, and managing equity investments in closely held private companies, while limited partners specialize in searching, evaluating and structuring investment in general partners.

General partners are typically compensated with a combination of a management fee (defined as a percentage of the fund's total equity capital) and monitoring fees (fees paid to the general partner by portfolio companies for services), as well as transaction fees (fees paid to the general partner in their M&A advisory capacity). In addition, the general partner usually is entitled to "carried interest", effectively a performance fee, based on the profits generated by the fund. Typically, the general partner will receive an annual management fee of 1% to 2% of committed capital and carried interest of 20% of profits above some target

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<sup>49</sup> Cite from [http://en.wikipedia.org/wiki/Private\\_equity](http://en.wikipedia.org/wiki/Private_equity) and Prowse, S., 1996, The Economics of Private Equity Market, <http://www.econ.upenn.edu/~rafaels/doc/foundation.pdf>

rate of return, which is typically 8% to 10% (called the "hurdle rate"). Gross private equity returns may be in excess of 20% per year, which in the case of leveraged buyout firms is primarily due to increasing levels of leverage in the portfolio companies, and otherwise due to the high level of risk associated with early stage investments. Although there is a limited market for limited partnership interests, such interests are not as freely tradable like mutual fund interests.

Private equity firms generally receive a return on their investment through one of three ways: an IPO, a sale or merger of the company they control, or a recapitalization. Unlisted securities may be sold directly to investors by the company (called a private offering) or to a private equity fund, which pools contributions from smaller investors to create a capital pool.

The organized private equity market has three major players and an assortment of minor players. The major players are private equity issuers, intermediaries, and investors. Since private equity is one of the most expensive forms of finance, issuers generally are firms that cannot raise financing in the debt market or the public equity market. Many of these companies use the private equity market to finance expansion—through new capital expenditures and acquisitions—and to finance changes in capital structure and in ownership (the latter increasingly the result of owners of private businesses reaching retirement age). Intermediaries, mainly limited partnerships, manage an estimated 80 percent of private equity investments. Under the partnership arrangement, institutional investors are the limited partners and professional private equity managers, working as a team, serve as the general partners. Investors include a variety of groups investing in the private equity market: public and private pension fund (40%-50% of committed capital), bank holding company, endowment, foundations and wealthier families as well as investment banks and insurance companies.



## Appendix 2

### 1. Macro Economy and Enterprise Fundamentals

	China	U.S.
Macro Economy	<p><u>Overview</u></p> <ul style="list-style-type: none"> <li>• Forth largest economic entity</li> <li>• Fastest GDP growth rate</li> </ul> <p><u>Sustainable</u></p> <ul style="list-style-type: none"> <li>• Continued opening-up of the economy</li> <li>• Export advantages, strong investment and upgrading consumption with thriving GDP</li> <li>• Industrial profits come from productivities improvement</li> <li>• Ascendance of RMB</li> </ul> <p><u>Issues</u></p> <ul style="list-style-type: none"> <li>• High export and saving rate cause imbalance</li> <li>• Disparity between coastal and western region</li> </ul>	<p><u>Overview</u></p> <ul style="list-style-type: none"> <li>• The largest economic entity with moderate growth rate</li> <li>• Capital inflow and outflow</li> <li>• Low interest environment</li> </ul> <p><u>Issues</u></p> <ul style="list-style-type: none"> <li>• Widen trade deficit</li> <li>• Soft dollar</li> <li>• Low saving rate</li> </ul>
Enterprise Fundamentals	<p><u>Industry Profitability</u></p> <ul style="list-style-type: none"> <li>• Margin expansion driven by productivity improvement</li> <li>• Industry profitability profile</li> <li>• Over-investment, over-supply and segmentation in some industries</li> </ul> <p><u>Enterprise profile</u></p> <ul style="list-style-type: none"> <li>• Globalization</li> </ul>	<p><u>Industry profile</u></p> <ul style="list-style-type: none"> <li>• Service, high technology and new business sectors drive the growth</li> <li>• Financial, transportation and IT industry contribute big portion of corporate profit</li> </ul> <p><u>Evolution of US company</u></p> <ul style="list-style-type: none"> <li>• Listed company managements face market pressure and are hard to</li> </ul>

	<ul style="list-style-type: none"> <li>• Modernization</li> <li>• Innovation</li> <li>• Corporate governance</li> <li>• Corporate structure</li> <li>• Corporate culture</li> </ul> <p><u>Private company versus SOE</u></p> <ul style="list-style-type: none"> <li>• Private sector grows faster than SOE in the past decade</li> <li>• SOE has largest fixed asset scale</li> <li>• DPE and FIE have higher turnover and ROA</li> <li>• Inefficiency of SOE</li> </ul>	<p>balance short-term interest and long-term interest</p> <ul style="list-style-type: none"> <li>• Chinese enterprises are similar to the U.S. situation in the 1980s</li> </ul> <p><u>Corporate Governance</u></p> <ul style="list-style-type: none"> <li>• Sarbanes-Oxley Act of 2002 (SOX) drives up the cost of going public</li> </ul>
Comparisons	<ul style="list-style-type: none"> <li>• China is an emerging market, the organic growth rate is much higher than developed countries</li> <li>• Both China and the U.S. have external imbalance issues</li> <li>• The GDP growth in China is sustainable because the economy is healthy and corporate profit is driven by productivity improvement</li> <li>• Being a developing country, Chinese industrial profiles and growth patterns are different from developed countries</li> <li>• Investment opportunities: continues to be the most attractive investment destination</li> </ul>	

## 2. Regulatory environment

	China	U.S.
Legal framework	<p><u>Legal framework in China</u></p> <ul style="list-style-type: none"> <li>• Not fully-established framework</li> <li>• Law related to private equity industry in China</li> <li>•</li> </ul> <p><u>Trends</u></p> <ul style="list-style-type: none"> <li>• Amendments to company law and securities law</li> <li>• More transparent and supportive codes for SOE-related and cross-border activities</li> <li>• Some related laws are in legislation process. For example, anti-trust etc.</li> </ul>	<p><u>Legal Framework in the U.S.</u></p> <ul style="list-style-type: none"> <li>• Well established legal framework</li> <li>• Anti-trust</li> <li>• SOX</li> </ul>
Government Policy	<p><u>Big issue in China</u></p> <ul style="list-style-type: none"> <li>• Uncertainty</li> <li>• Top-down structure</li> <li>• Control market resources</li> <li>• SOEs</li> </ul>	<p><u>The role of government</u></p> <ul style="list-style-type: none"> <li>• Market oriented, more discipline than other countries</li> <li>• Unique impact to business, such as Federal Trade Committee</li> <li>• Transparency</li> </ul>
Comparisons and implications	<ul style="list-style-type: none"> <li>• U.S. legal framework favors investors</li> <li>• Non-fully developed legal framework in China is negative to the growth of early stage enterprises</li> <li>• The development of local fund enables the improvement of the current regulatory environment</li> </ul>	

### 3. Financial Market and Exit Mechanism

	China	U.S.
Capital Market	<p><u>Banking system and bond market</u></p> <ul style="list-style-type: none"> <li>• Informal market</li> <li>• The impact of Banking reform</li> <li>• Current bank loan policy: by industry, ownership and geography</li> </ul> <p><u>Capital market</u></p> <ul style="list-style-type: none"> <li>• Shanghai, Shenzhen, HKEX, NASDAQ...</li> </ul> <p><u>M&amp;A market:</u></p> <ul style="list-style-type: none"> <li>• Fast growing market (especially from 2002-2006) in terms of deal number, total value and average</li> <li>• Clear industry focus</li> <li>• Large deals are increasing</li> <li>• Most active player: MNC and SOE</li> </ul> <p><u>Foreign exchange reserve</u></p> <ul style="list-style-type: none"> <li>• Imbalanced capital flow</li> </ul> <p><u>Exit Mechanism analysis</u></p> <ul style="list-style-type: none"> <li>• Challenge to private equity business</li> </ul>	<ul style="list-style-type: none"> <li>• Capital market</li> <li>• PE backed M&amp;A</li> <li>• Capital flow</li> <li>• Exit mechanism</li> </ul>
Comparisons and Implication	<ul style="list-style-type: none"> <li>• Banking system is the dominating funding channel in China right now, but is inefficiency.</li> <li>• The Chinese public market recovered, and will be the major financing channel for the high quality companies</li> <li>• M&amp;A activities are booming</li> <li>• Imbalanced capital flow and huge amounts of foreign-exchange reserve drive outbound M&amp;A</li> <li>• An immature market brings investment opportunities as well</li> </ul>	

#### 4. Human resource and System

	China	U.S.
Human Resource	<p><u>Entrepreneur and Management team</u></p> <ul style="list-style-type: none"> <li>• Lack of managerial, executive management</li> <li>• Talents: high quantity, low quality</li> <li>• Large number of entrepreneurs</li> </ul> <p><u>Investment professionals</u></p> <ul style="list-style-type: none"> <li>• Investment professionals</li> <li>• Local talent with international practice is the best choice</li> </ul>	<ul style="list-style-type: none"> <li>• Entrepreneur culture and team</li> <li>• U.S. top private equity firms investment professional profile analysis</li> </ul>
System	<ul style="list-style-type: none"> <li>• Under-developed</li> <li>• Match with Chinese culture</li> </ul>	<ul style="list-style-type: none"> <li>• Well established</li> <li>• Driver of MNC</li> </ul>
Comparisons	<ul style="list-style-type: none"> <li>• Human resources are remains a hurdle to Chinese enterprises</li> <li>• Private equity firm could bring the management experience to the firm which is different than the role of the bank</li> <li>• Localization and on-the-ground are the keys for investment teams</li> <li>• The best solution is to improve gradually both talent introduction and system establishment</li> </ul>	

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