

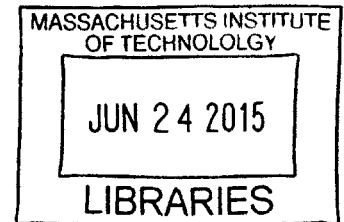
**Analysis of Investment Prospects for Chinese Private Equity Firms
in the U.S. Market**

By

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The Hong Kong Polytechnic University, 2010

ARCHIVES



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ABSTRACT

With the wealth and experience accumulated during the past decade, Chinese private equity (PE) firms have emerged as active investors in cross-border acquisition deals. Ambitious global expansion plans of Chinese companies and a supportive regulatory environment further boost the demand for such deals.

This thesis examines prospects for such firms to invest in the United States (U.S.), the world's best-established PE market. It analyzes the demand of Chinese PE firms to make global investments, competitiveness of these firms, and the feasibility of investing in the U.S. market. This thesis focuses on privately-held firms as opposed to sovereign wealth funds.

Thesis Advisor: Mr. Phil Cooper

Title: Senior Lecturer, Finance

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1. Introduction

As an important channel for cross-boundary capital flow, private equity (PE) investments are widely predicted to be more globalized in the coming five to ten years. In the past, the top players in this industry were mostly based in the U.S. It is highly possible that PE firms from the emerging economies like China will join their top-tier international counterparts given the wealth accumulation and rapid development of PE industries in these countries. Chinese PE firms are becoming more sophisticated investors instead of relying on arbitrage between the primary and secondary market through listing investee companies. They are also making headway in the cross-border PE investment spectrum, hoping to diversify their investments and become top global firms.

The strong demand for Chinese capital to make international investments creates opportunities for these PE firms to expand globally. China's outbound direct investments (ODI), largely driven by the ambitious global investments of Chinese companies, is estimated to surpass the foreign direct investment (FDI) in this country in 2015. Chinese government is also attempting to further increase the ODI portion of its foreign assets through regulatory relaxation and supportive policies. Given the strong will of Chinese companies to invest globally and the pro-ODI regulatory environment in terms of more liberalized exchange rate and capital controls, there are tremendous opportunities for Chinese PE firms to make cross-border investments.

In the face of such demands, Chinese PE firms have shown great potential for success in the global market. Throughout my interviews with Chinese PE practitioners, they expressed concerns mainly about the post-deal value-adding capacity of these firms. The two case studies ease this concern as Chinese PE firms have identified unique ways to enhance their competitiveness by utilizing their

portfolio management expertise in the fast-growing Chinese market, or by co-investing with Chinese strategic investors to take advantage of their industrial experience and consolidation capacities.

The U.S. has been identified as a preferred destination for PE investments, especially as the powerful rebound of its economy has set the U.S. apart from other regions where recent geopolitical, economic, and social uncertainties exposed PE investors to great risks. The U.S. PE market is the best-established one in the world, and it still allows investors to generate superior returns thanks to its quality company repository and its wealth of top PE firms. Chinese PE firms have promising prospects investing in the U.S. because the country and companies are becoming more welcoming to Chinese investments.

Chinese PE firms and the U.S. PE market have, respectively, attracted significant academic scrutiny. However, the investment prospects of Chinese PE firms are rarely discussed in the context of the U.S. market. This thesis bridges the gap by analyzing the demand of Chinese PE firms to make global investments, the competitiveness of these firms, as well as the feasibility of investing and getting high returns in the U.S. market. It concludes with recommendations for these firms to improve their chance of being successful investors in the U.S. market.

2. Analysis

2.1 Demand and Regulatory Environment for Chinese Private Equity Firms to Make Overseas Investments

China has been building up its foreign balance sheet at a high growth rate, but the net income from its foreign balance sheet remains negative due to the large proportion of foreign exchange reserves that generate ultra-low returns. As a solution, the country is trying to allocate more of its foreign assets to ODI through regulatory liberalization and policy support. Chinese companies, at the same time, are boosting China's ODI with increasing overseas acquisitions.

The surging ODI signifies great opportunities for Chinese PE firms. These firms have been growing very fast in the past decade, and the momentum is expected to continue because of the upside potential of the industry and the transformation of these firms into more sophisticated international players. With the wealth, international experience, and talent that they have accumulated, as well as the current friendly environment of regulations and policies, Chinese PE firms are ready to ride the wave of overseas investment.

This section briefly discusses: 1) the evolution and outlook of China's PE industry 2) the demand for private direct investments and associated opportunities for Chinese PE firms and 3) the regulatory environment supporting these opportunities.

2.1.1 Evolution of and Outlook for China's PE Industry

The material development of China's PE industry started in the late 1990s with enhancement in legislation and regulations for foreign PE investments in China. For nearly a decade, China's PE industry was dominated by global PE funds. Newbridge Capital and Carlyle were among the earliest investors that had controlling stakes in Chinese companies during that period. Chinese domestic PE firms started to pick up their pace when Bohai Industrial Investment Fund, the first mainland RMB-denominated industry investment fund, was established in 2006 with CNY20 billion under management (Kim, 2014). Domestic PE funds had a significant regulatory advantage over their foreign opponents, which permitted steady growth of domestic PE firms while the 2008 financial crisis hammered the fundraising, investment and exit of foreign firms. Thirty foreign funds and 20 domestic funds invested US\$61 billion in China's PE market in 2008, a 71.9 percent increase in funds value compared with the previous year.

Starting from this turning point, Chinese PE firms became direct competitors to the globally renowned funds already in the Chinese market. PE investments by Chinese firms surpassed the amount from U.S. and European funds for the first time in 2011. Since then, foreign PE investors have been putting more emphasis on joint ventures with Chinese local PEs. At the same time, Chinese local PE firms were starting to recast their investment thesis towards a long-term focus and value-based investments. Because of the slowing down of the Chinese economy and overcapacity in some sectors, Chinese PE firms became more focused on efficiency and operational improvements to create value for the investees. For the same reason, these firms started to put more resources into their overseas investments. The close of the A-share IPO market also

forced the PE firms to seek other exit channels, such as mergers and acquisitions (M&A) rather than simplistic arbitrage between the private and public markets.

In 2014, China's PE market deployed historic capital value on new investments totaling US\$73 billion, 101 percent higher than 2013. The total number of PE deals increased 51 percent from 2013 and reached a record of 593 (PWC, 2015). The fast-growing trend of Chinese PE industry is likely to continue. PE investments account for 2 percent and 1 percent of the GDP in the U.S. and Europe, but only less than 0.5 percent in China (Liu, 2015). There is still huge potential for PE investments to grow in China, signaling great opportunities and demand for Chinese PE firms to invest and keep the industry expanding.

2.1.2 Demand for Private Overseas Investment and Opportunities for Chinese PE Firms

China has been expanding its foreign assets and liabilities along with the process of developing into the world's second-largest economy. According to Hanemann (2014), the country's global assets have been growing at a 10-15 percent annual rate in the past decade and reached US\$5.94 trillion in 2013, driven mainly by accumulation of reserves and ODI. Reserves have been accumulating due to the "twin surplus" of the current and capital accounts as well as the central bank's capital account controls, while continuous increase in ODI demonstrates the ambition of Chinese firms to expand globally. On the other hand, China's foreign liabilities increased 18.5 percent to US\$3.97 trillion in 2013 as economic growth and expectation of RMB appreciation continued to attract foreign investment into the country (Figure 1).

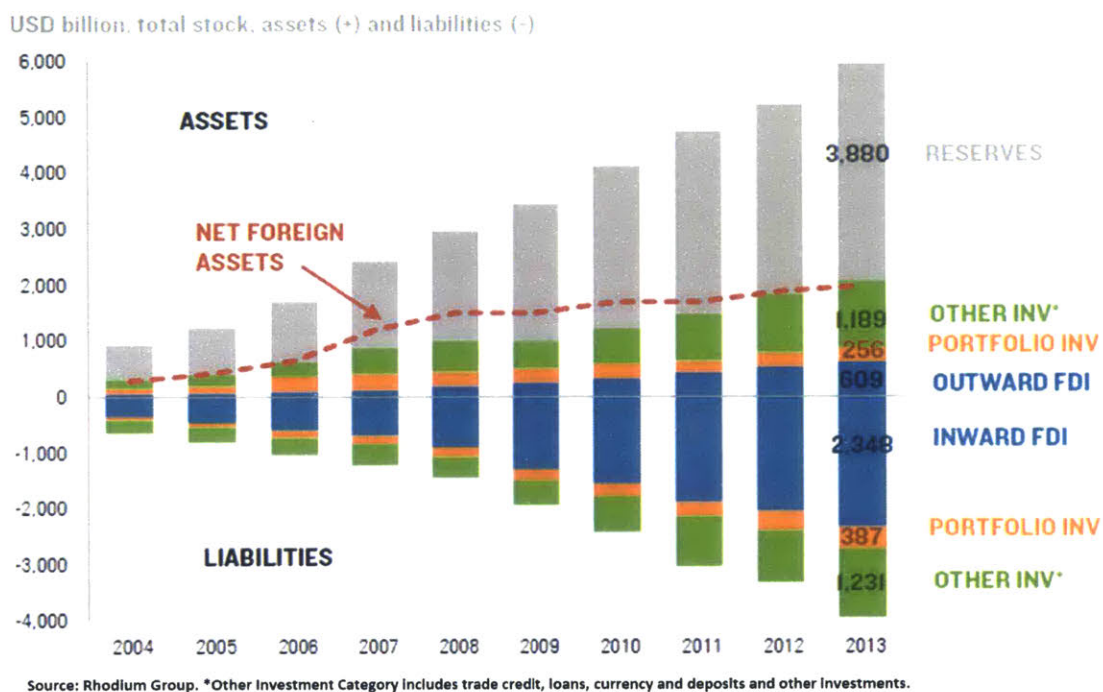


Figure 1: China's International Investment Position, 2004-2013

Despite its rapid expansion, China's total external balance sheet is still very small compared with other advanced economies around the globe. The combined foreign assets and liabilities surged from US\$1.5 trillion in 2004 to US\$10 trillion in 2013 (Figure 2), accounting for only 3 percent of the global foreign balance sheet even though China accounts for 12 percent of the world's GDP¹. In this light, China has massive potential to increase its presence in the global markets through various outward investment channels.

¹ Data from World Bank.

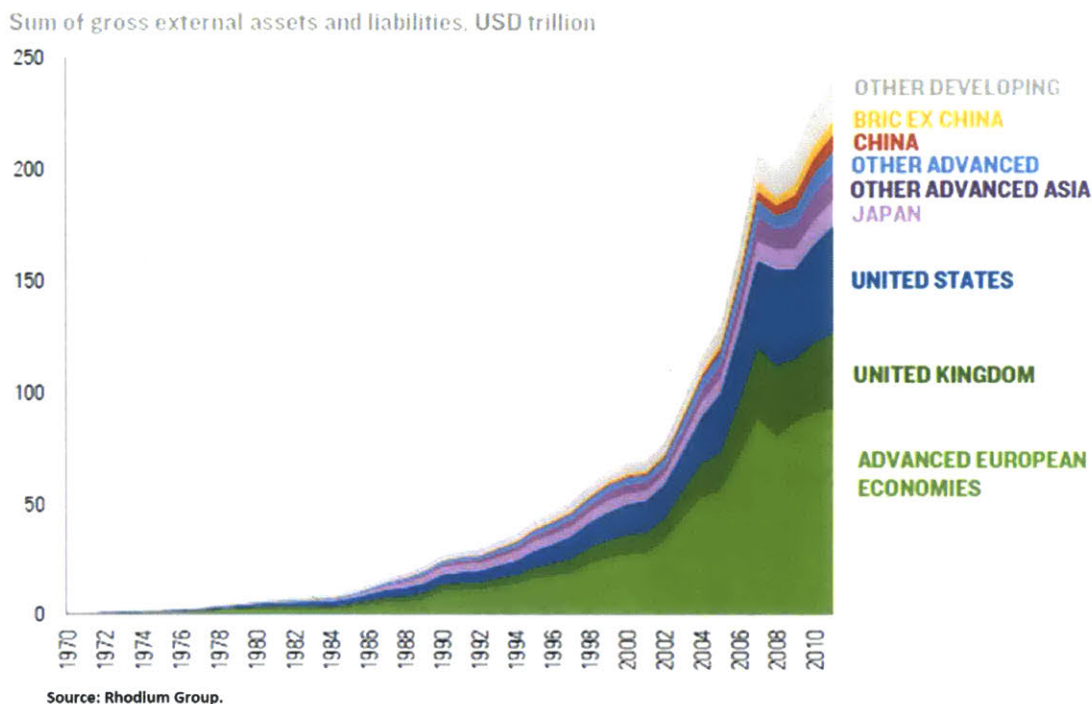


Figure 2: China and Financial Globalization, 1970-2011

In the private sector, Chinese companies have been accumulating vast wealth along with this country's rapid growth since the opening up of its economy in the late 1970s. The investors, including strategic acquirers and PE firms, have switched gears towards overseas markets as Chinese companies have expanded globally. The surging trend of ODI is also a result of decelerated growth in China's domestic economy; investors moved the money overseas for better returns. China's ODI has been chasing its FDI and is poised to surpass its FDI in 2015, according to *The Economist* (Figure 3)². The country's ODI has expanded 100-fold from less than US\$1 billion in 2000 to over US\$116 billion in 2014, while its FDI totaled US\$119.6 billion in 2014 (Qin, 2015). The unprecedented shift reflects the slowdown of FDI into China, and more importantly, the rapid increase of the outbound investment of Chinese companies. According to Qin (2015), Chinese investors invested in 6,128 firms in 156 foreign countries in 2014.

² Graph from the Economist. Available at: <http://www.economist.com/blogs/graphicdetail/2014/06/daily-chart-20>

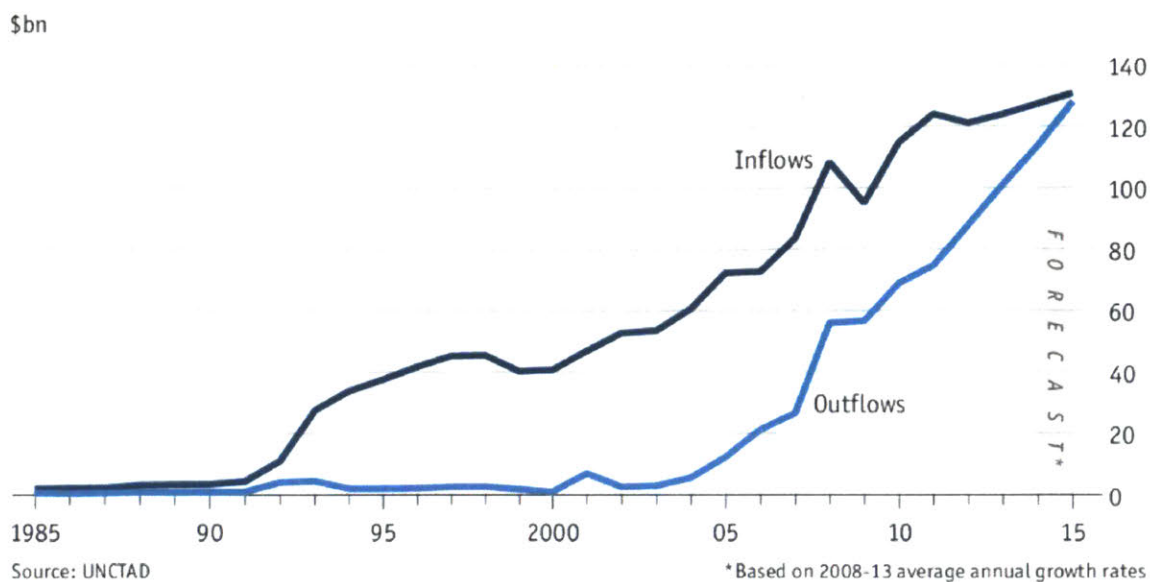


Figure 3: China's ODI vs. FDI

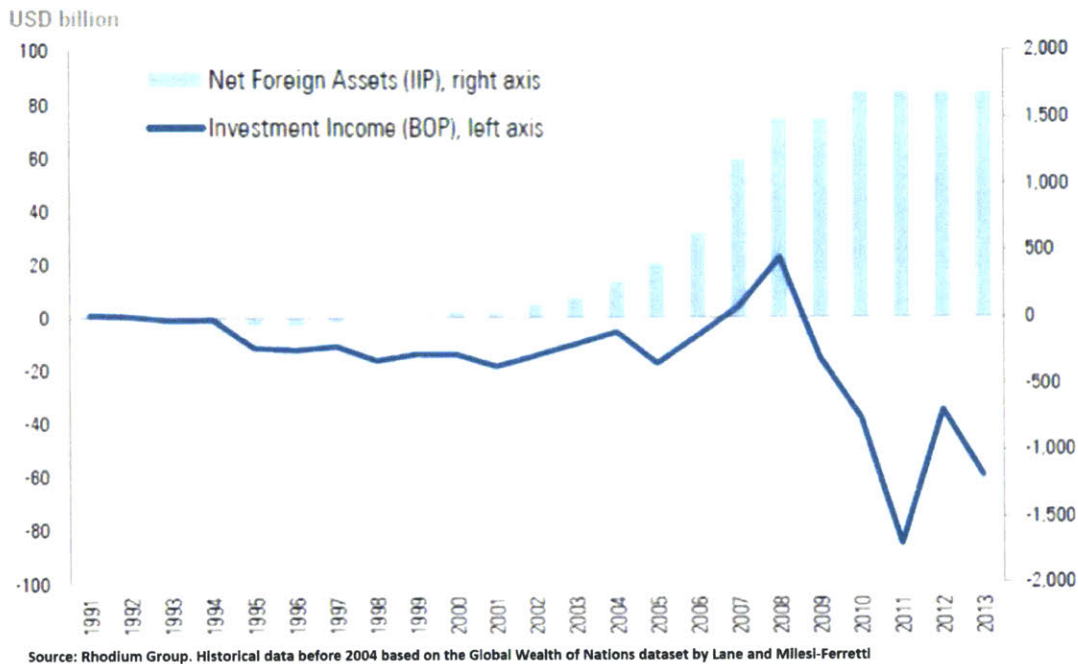
Chinese investors have been shifting their investment focus from the natural resources and energy sector towards “new economy” sectors such as high-tech and cultural industries. This shift is largely a result from the emerging private-sector investors. While growing fast domestically, they have also accumulated abundant experience and international talent through cooperation with their global partners over the past decades. They are more likely to invest in the U.S and in non-traditional industries. Given the continuing slowdown of domestic growth, and the supportive policies for overseas investments in the foreseeable future, Chinese investors have sustainable momentum seeking cross-border opportunities.

The inevitable trend of cross-border investment signifies tremendous opportunities for Chinese PE firms. According to Tykvová and Schertler (2008), foreign PE funds have invested in over 35 percent of the total of 28,000 international deals in 2000-2006. Outbound investment by Chinese domestic PE firms boomed in 2014, doubling the volume of 2013 with 49 deals and reaching a peak in deal value with US\$14.3 billion (PWC, 2015).

To ride the wave of overseas investments, Chinese PE firms can either actively pursue buyout opportunities or co-invest with Chinese strategic investors where the PE firms can leverage their finance expertise, global network and operational improvement capabilities. In this light, more and more Chinese PE firms are increasing their exposure in the U.S. market. Trustbridge Partners, a Chinese PE firm, has based its U.S. office in Boston, focusing on greenfield opportunities. InnoSpring, a famous startup incubator located in Santa Clara, is backed by Chinese investors and acting as their front office for investing in the U.S.

2.1.3 Regulatory and Policy Support of Chinese Government for Overseas Investments

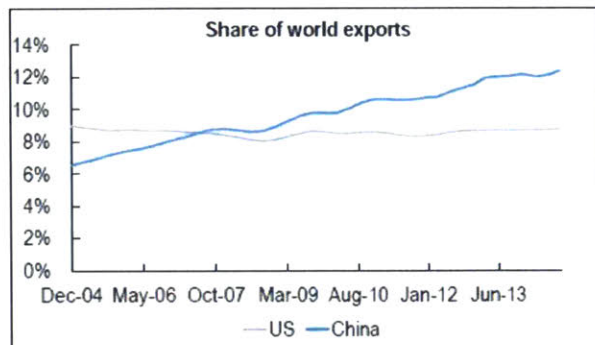
China remains a net interest payer on its foreign balance sheet. Approximately 65 percent of China's foreign assets are exchange reserves, which are invested in low-yield securities such as U.S. treasury bonds. The implied rate of return on foreign assets has been around 3 percent, due to the ultra-low level of interest rates in the U.S in recent years. The rate of return on assets held by foreign investors in China, on the other hand, stayed at 6-8 percent during the time horizon. Due to the composition of China's external balance sheet and the contrasting rates of return on the assets and liabilities, China remains a net interest payer with net investment loss of US\$60 billion on its US\$1.97 trillion of net foreign assets (foreign assets net of liabilities) in 2013 (Figure 4). The loss on the net foreign assets reveals the urgency for China to liberalize its capital account, and reallocate its foreign assets between exchange reserve and better investment opportunities such as ODI.



Source: Rhodium Group. Historical data before 2004 based on the Global Wealth of Nations dataset by Lane and Milesi-Ferretti
 Figure 4: China's Net Foreign Assets and Net Foreign Investment Income Flows, 1991-2012

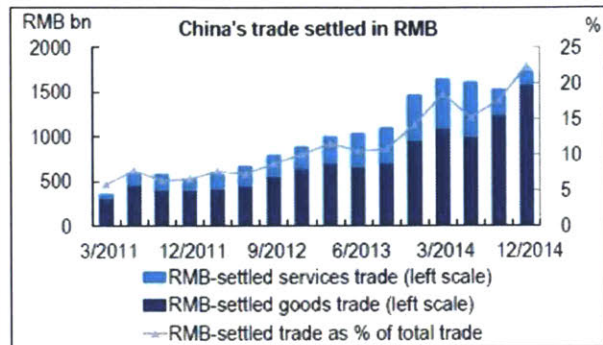
Because of net loss on its foreign balance sheet and increasing manufacturing costs, the Chinese government is encouraging companies to invest overseas as part of the 12th Five Year Plan (2011-2015). PE firms' cross-border investment will largely depend on China's liberalization of both its foreign exchange regime and its capital account. China is pursuing its bold plan of internationalizing the RMB and aims at a fully convertible currency by 2018. China overtook the U.S. as the world's biggest exporter in 2007, and a quarter of the current account transactions are settled by RMB. RMB is also the fifth most used currency by SWIFT payment and second most used currency for trade finance (Figure 5).

China's share of world exports has continued to climb since the IMF's 2010 review of the SDR basket...



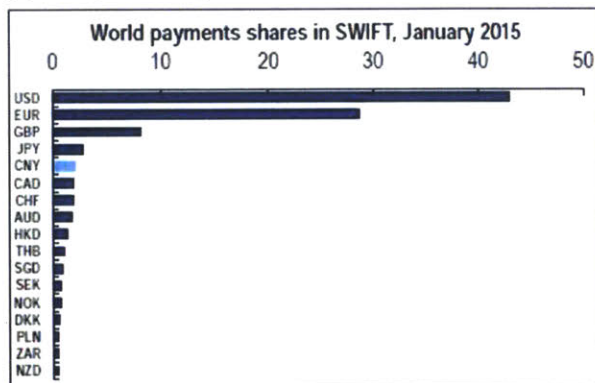
Source: IMF; Citi Research

...and the RMB is now used to settle almost a quarter of China's current account transactions



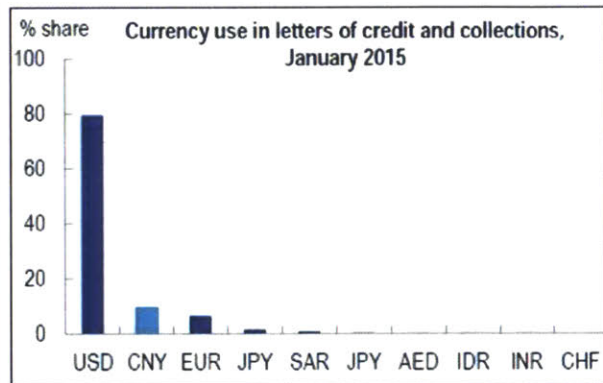
Source: CEIC; PBOC; Citi Research

The RMB is now the world's 5th most used currency in global payments processed by SWIFT...



Source: SWIFT; Citi Research

...and the 2nd most used currency in documentary credits processed by SWIFT



Source: SWIFT; Citi Research

Figure 5: Internationalization of RMB

On top of these strides, IMF will decide in the second half of 2015 whether to include RMB in the Special Drawing Rights (SDRs) as the fifth currency of the international reserve asset (Wheatley, 2015). Wheatley quoted Lubin claiming that the inclusion would be crucial for China to create net RMB liability through capital transactions so as to internationalize the currency. The inclusion is expected to happen within five years (if not this year). In addition to the reform of the exchange rate regime, the Chinese government has been deepening its liberalization of the capital account by relaxing approval requirements on ODI flows. The approval process for ODI has been eased to a registration-based system.

Finally, China has set up the Shanghai Pilot Free Trade Zone (FTZ) with the purpose to simplify investors' access to the foreign exchange and the ODI approval process, which will facilitate the liberalization of cross-border capital flows on a national scale (Cole, 2014). The Chinese PE firm Hony Capital has made its cross-border acquisition through the FTZ, and some Chinese asset managers have formed alliances with U.S. investors in the FTZ to raise a mixture of RMB and U.S. dollars for overseas investments. According to Cole, an investor operating through the FTZ can move a maximum of US\$300 million out of China through a simplified process. In 2014 China created another three FTZs in Guangdong, Fujian, and Tianjin, respectively, to increase the pioneers in its ambitious free market reforms. The policy and regulatory support will spur the Chinese investors to make cross-border investments.

After examining the strong demand and great opportunities for Chinese PE firms to make overseas investments, a natural question is whether Chinese PE firms have the capacity and strength to compete in the global PE markets.

2.2 Competitiveness of Chinese PE Firms in the Global Markets

Chinese PE firms have demonstrated strong potential to compete in the global market. They have clearly defined success factors for their global expansions, and executed strategies to improve their competitiveness. Many of their overseas investments benefit from China's rapid growth as they help their portfolio companies penetrate or expand in the Chinese market. In addition, co-investing with Chinese strategic investors in cross-border deals is also a superior strategy for the PE firms to enhance post-deal consolidation and operational improvement.

This section introduces some of the major Chinese PE firms, discusses success factors in international markets, and analyzes their competitiveness in the global context. This analysis is conducted through two case studies and interviews with practitioners in Chinese PE firms.

2.2.1 Introduction to Major Chinese PE Firms

Major Chinese domestic PE firms are categorized as follows: 1) financial institution-affiliated PE arms; 2) business group-affiliated PE firms; and 3) spin-outs and funds founded by former bankers. Financial institution-affiliated PE arms are owned by institutions such as banks and securities companies. They are entitled to the unparalleled fund source, project repository and governmental relations provided by the parent group. On the other hand, they are exposed to more layers of regulations and risks. Major financial institution-affiliated PE arms include CITIC Capital Holdings, Bank of China Group Investment, China Development Bank Capital Corporation, and CICC Jia Cheng Investment Management Company. Due to the risk-averse nature and strict regulation for banks, these PE arms primarily take minority stake in the investments instead of positioning themselves as buyout firms.

Business group-affiliated PE firms are those created by successful industrial conglomerates such as Lenovo and Fosun. The business groups have been operating as leading players in their industries and have accumulated significant wealth and knowledge for strategic and financial investments. Prestigious PE firms of this kind include Hony Capital and Fosun capital Group, which are also active investors in overseas market. Internet giants such as Tencent and Alibaba have also set up their own investment funds to seek financial returns in the industry.

The third kind of Chinese PE firms are either PE arms spun out from an investment bank by the management team or founded by former bankers renowned in the industry. The most well-known spin-out PE firm is CDH Investments, a leading Chinese alternative investment company divested from the famous Chinese investment bank China International Capital Corporation (CICC). In addition, Hopu Investment Management Company and Primavera Capital Group are PE firms founded by former Goldman Sachs bankers Fang Fenglei³ and Fred HU.

2.2.2 Post-deal Consolidation Capability and Portfolio Management of Chinese PE Firms

Post-deal portfolio management is widely identified as a critical driver for value creation of PE investments. Operational improvements, solutions to information asymmetry, and human capital provided by mature PE firms are important success factors for cross-border PE investments. Throughout most of my interviews, practitioners in Chinese PE firms expressed concern for on the PE firms' capability and experience to consolidate and improve the business of investees in cross-border deals. Chinese PE firms are still less mature when compared globally, especially in the spectrum of cross-border investments. Successful cross-border buyout cases are very limited. From a portfolio management perspective, however, they have demonstrated potential to become top-class investors. The following case about the acquisition of Pizza Express by Hony Capital provides some evidence about Chinese PE firms' portfolio management capacity.

³ The thesis preserves the Chinese naming pattern, with the family name first, followed by the given name.

Case Study: Hony Capital & Pizza Express

The case traces the 2014 buyout of the British dining chain PizzaExpress, by the Chinese PE firm Hony Capital, and the value creation perspective of the deal. The deal cost Hony nearly GBP 900 million (US\$1.54 billion), among the largest recent European restaurant deals. PizzaExpress has been focusing on its global expansion and depending on the takeover by the Chinese firm to accelerate its penetration in the China's market.

Hony Capital: Hony Capital is a leading Chinese PE firm with assets under management (AUM) of US\$7 billion, sponsored by Legend Holdings Corporation (holding company of Lenovo). Hony has cultivated many companies into leaders in consumer goods, advanced manufacturing as well as healthcare and service sectors. Hony took a great stake in supporting restructurings of Chinese state-owned enterprises (SOEs) and is also a market leader for cross-border investments. In order to enhance the operational and financial performance of portfolio companies, Hony established a consulting arm to exclusively supply front-line operational expertise to its portfolio companies. Legend Holdings was founded in 1984 and has grown from an IT company into a conglomerate, with its revenue reaching US\$39 billion in 2013 on total asset of US\$33.1 billion. The group is managing the entire investment cycle through PE investment (Hony Capital), venture capital (VC) investment (Legend Capital) and the "Legend Star" incubator investment.

PizzaExpress: PizzaExpress is a global premium casual dining chain originating from London. It was established by Peter Boizot 50 years ago in London. The pizza chain was owned by Cinven, a London-based buyout group, prior to the sale. Cinven tried to sell Gondola Group, the parent company that owns PizzaExpress, along with other restaurant assets, including Zizzi. It moved to dispose individual chains separately after realizing the difficulty of selling the whole business

(Chassany and Massoudi, 2014). The China franchise was established in 2000 by Justin Kennedy, a former investment banker at Citigroup in Hong Kong, who introduced the signature ‘Peking Duck’ pizza for Chinese customers. PizzaExpress currently operates over 500 restaurants globally, including 436 in the UK, 26 in China and around 50 in other regions. The Company had a net sales of GBP 374 million in FY 2014 ending on June 29th before Hony made the purchase in July 2014.

Value creation hitherto: Hony has been directly managing the 26 franchised PizzaExpress restaurants in China and intends to open up to 15 more stores every year. According to the first-half financial statements released in March of 2015, the earnings before interest, tax, depreciation and amortization (EBITDA) of PizzaExpress increased 15.8 percent increase to GBP55m on revenues that grew 9.4 percent to GBP231m. Applying a back-of-the-envelope calculation with a constant Equity Value/EBITDA multiple, the value of the investment increased by approximately 16 percent, indicating a simplistic internal rate of return (IRR) of 34 percent. A higher valuation of the business is expected, given the boosted EBITDA margin of 23.8 percent, up by 1.3 percentage points after taking into account the impact of deflationary ingredients prices (Barrett, 2015).

Table 1: Hony's Return on the PizzaExpress Deal

In millions £	EBITDA	Investment	Multiple
Jun-14	47	900	18.95
Jan-15	55	1,042	18.95
Value Increase		16%	
IRR		34%	

International sales for restaurants in Mediterranean region, Middle East and Asia rose 45 percent on a like-for-like basis, which validates the international expansion strategy of PizzaExpress. According to its chief executive Richard Hodgson, the PizzaExpress restaurants in China are typically twice as busy as those in the UK; despite the stunning performance of its international operations, UK restaurants only saw a 6.8 percent increase for the same period.

This takeover deal, though global, resembles deals made in China that benefit from the country's fast growth. Hony utilizes its local operational expertise and network to solve the international information asymmetry, and help PizzaExpress elevate the Chinese market. Nevertheless, evolution of the PizzaExpress deal is a good indicator that top Chinese PE firms have strong potential to provide top-quality post-deal consolidation and operational improvements for multinational businesses.

Another success factor that emerged from my interviews is the importance of co-investing with Chinese strategic investors.

2.2.3 Successful Model of Co-investing with Chinese Strategic Investors

Active strategic investors in the cross-border M&A market are seeking global expansion after years of rapid domestic growth. Their acquisitions are the driving force behind Chinese capital going global. Co-investing with strategic investors in these M&A deals and leveraging their operational expertise in a given industry also improve the post-deal consolidation capacity of the PE investors. Major strategic investors that focus on global expansion are discussed below.

Legend Holding: As the holding company for Hony Capital discussed previously, Legend Holding deploys a full service of asset management through its various funds complemented by

its strategic investment division. Its previous acquisitions of IBM's PC line, Germany's Medion and Brazil's CCE helped grow its international portfolio.

Wanda Group: Wanda was founded by Wang Jianlin, one of the wealthiest men in China, in 1988 as a residential real estate developer, and incorporated in 1992 as one of the first shareholding companies in China. It has grown into a conglomerate with businesses in commercial property, luxury hotels, cinemas, resorts, and department stores. Wanda is ambitiously expanding, globally, through its 2012 record-breaking US\$2.6 billion acquisition of AMC Entertainment, the 2013 purchase of a controlling stake in the British yacht maker Sunseeker International, as well as its recent purchase of 20 percent stake in the Spanish football club Atletico de Madrid for US\$52 million and the Swiss sports marketing firm Infront Sports & Media AG for US\$1.2 billion⁴. AMC was listed on the New York Stock Exchange, and the Wanda group went public in Hong Kong in 2014.

Fosun Capital Group: Fosun Capital was established in 2011 as the asset management platform of the Fosun Group based on its existing PE investment operations. It focus on investment opportunities arising from China's urbanization and industrialization in sectors such as consumer goods, advanced manufacturing, technology, energy and rare resources. As of the end of 2011, Fosun has invested in more than 60 companies and 17 companies have been successfully listed. Fosun Group was founded in 1992 as an IT consulting firm and developed into a conglomerate with operations in insurance, pharmaceutical, real estate, strategic investment and asset management. Considered as the Chinese company most similar to Warren Buffett's Berkshire Hathaway, it has positioned itself as a top-tier investment group leveraging the investment model

⁴ Data from Forbes

of “Combining China’s Growth Momentum with Global Resources”. It recently clinched control of France’s Club Mediterranee for GBP700 million by winning the longest-running bid battle in recent times in France.

Anbang Insurance Group: The Beijing-based insurer is another adherent of Buffett’s investment philosophy. The development of the young insurance group is phenomenal. Founded in 2004 as a private car insurance company with capital of \$60 million, Anbang has transformed itself into one of the largest insurers in China with 30,000 employees and more than \$114 billion in assets in only one decade. Its revenues from life insurance premiums increased 38-fold and reached RMB53 billion in 2014.

An even more interesting trait of the group is its bold acquisition activities across the globe. Its investment strategy is twofold. Domestically, it is trying to build up a financial conglomerate with full licensing including insurance, banking, securities and fund management. It has established ownership in multiple financial institutions, including its 20 percent controlling stake in Minsheng Bank, China’s largest private bank. Internationally, Anbang is adopting the “Warren Buffett model” where the insurance income fuels its acquisitions and investment income from its portfolio pays off later. The Global Investment Center based in Hong Kong is overseeing all overseas acquisitions. Since 2011, Anbang has invested in four foreign financial institutions: Belgium’s insurance company FIDEA, the Belgian operations of Delta Lloyd Bank, the Dutch insurance company VIVAT, and Korea’s Tongyang Life Insurance. In the real estate sector, Anbang purchased New York’s historic hotel Waldorf Astoria for \$1.95 billion, which is the largest-ever U.S. real estate purchase by a Chinese buyer.

Tencent: Founded in 1998, Tencent Inc. is China's largest and most used Internet service portal. Monthly active users for its mobile social app “WeChat” reached 396 million worldwide by March of 2014. It is building up its empire through a growing international portfolio of early stage investments into promising startups. Tencent completed 25 deals in the U.S. from 2011 to 2014 with a total investment of over US\$700 million. Online gaming has been an important source of Tencent’s revenue and it is trying to focus on mobile gaming to monetize its huge user base on WeChat. Therefore, most of its overseas investments are gaming-related startups, including the gaming software development kit maker Kamcord, game development studio Epic Games and Riot Games. Tencent has been among the most mature and successful investors in the internet startup spectrum. Other investment sectors include artificial intelligence, machine learning, and mobile social apps. Many of the deals are co-invested with globally renowned VCs and angel investors such as Google Ventures and Sequoia.

In addition to the above strategic investors, there are other deals worth mentioning. After its failed US\$18.5 billion bid for Unocal Corporation in the U.S. in 2005, China National Offshore Oil Corporation (CNOOC) staged a comeback in 2013, acquiring Canada’s Nexen for an astonishing US\$15.1 billion. The Chinese automotive company Geely acquired Volvo cars in 2010, followed by the 2013 purchase of Manganese Bronze, maker of London “black cabs”. The strategic investors are usually cash-rich and many of them have their own PE/VC subsidiaries. It is unlikely that PE firms can add value through providing funding for the deals. However, their post-deal consolidation capacity, operational improvement potential, international networks, and ability to provide complicated financial engineering will be invaluable for M&A deals in the U.S. market. The following case is a great example of the successful model of cooperating with Chinese strategic investors in the U.S. market.

Case Study: CDH Investments, WH Group & Smithfield Foods Inc.

The case highlights the 2007 buyout of WH Group, then known as Shuanghui Group, by the consortium led by CDH Investment and Goldman Sachs; WH Group's purchase of the U.S. pork producer Smithfield Food; and the tortuous IPO process of WH Group.

CDH Investments: CDH is one of the largest alternative asset management institutions with over US\$14 billion of AUM as of 2013. CDH was spun out from CICC by the former management team of CICC's private equity group in 2002. It has invested in over 150 companies and more than 30 out of the 50 have been listed on stock exchanges in China, Hong Kong, and the U.S. The investment bank CICC was established in 1995 as a strategic partnership among prestigious Chinese and international financial institutions such as China Jianyin Investment, Government of Singapore Investment Corporation, and Morgan Stanley. As the first joint venture investment bank in China, CICC is a leader in providing comprehensive financial services, including investment banking, capital markets, securities trading, fixed income, asset management, private equity, wealth management and research⁵.

WH Group: WH Group was known as Shuanghui Group at its inception in 1958 by the Luohe municipal government. Wan Long was appointed chairman in 1984 and turned around a struggling company into China's largest food processor in 2007. The Luohe government sold its share to the joint venture of CDH Investments and Goldman Sachs in the same year. Goldman Sachs later realized a large profit by selling most of its shareholdings. Henan Shuanghui Investment &

⁵ Information from Company Website.

Development Company Limited (Shuanghui Development), a subsidiary of Shuanghui Group, was listed on Shenzhen Stock Exchange in 1998.

The Buyout and Subsequent Restructuring: In 2007 CDH and Goldman Sachs led a consortium to acquire 100 percent ownership of Shuanghui Group from the Luohe municipal government for CNY2.01 billion through their joint venture Rotary Vortex Limited, which entitles the joint venture to a 35.715 percent stake of the holding company's listed arm, Shuanghui Development. Rotary Vortex also acquired a 25 percent stake of Shuanghui Development from Luohe Haiyu Investment Co., which increased Rotary Vortex's shareholding of Shuanghui Development up to 60.715 percent (Figure 6). Shuanghui was transformed from an SOE into a private foreign company. CDH then led a convoluted restructuring of Shuanghui, preparing for the IPO. Firstly, CDH, Goldman Sachs, Temasek, and New Horizon Capital set up a BVI joint venture "Shine B" and acquired the IPO platform "WH Group"; the latter acquired all shareholdings of CDH and Goldman Sachs in Rotary Vortex. Goldman Sachs decreased its shareholding from 51 percent to merely 30 percent only one year after the initial takeover.

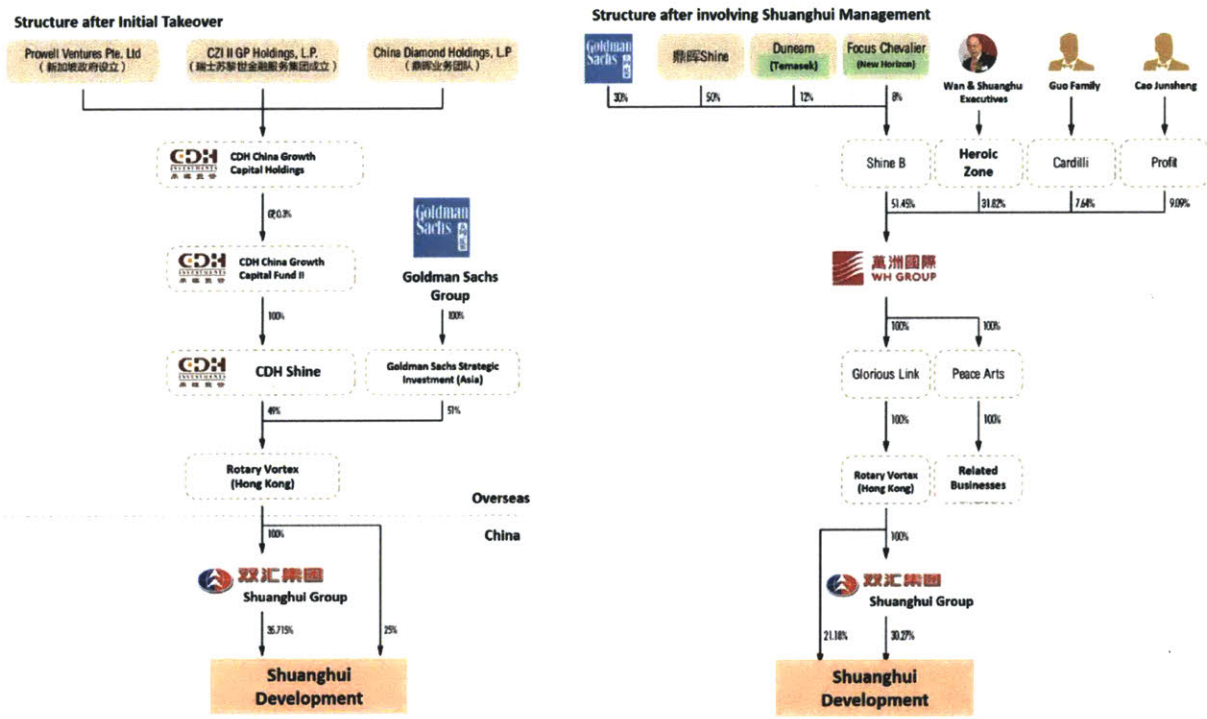


Figure 6: Restructuring Shuanghui

Secondly, management of Shuanghui were involved in the restructuring as Peace Arts, a Shuanghui-related business indirectly controlled by Shuanghui’s executives, led by Wan Long, was folded into WH Group in a the form of a split-off. Previous shareholders of Peace Arts include Heroic Zone, controlled by Shuanghui executives; Cardilli, owned by the renowned Guo Family in Hong Kong; and Profit, owned by Cao Junsheng, who had been a business partner with Shuanghui for a long time. The fact that the deal was a management buyout (MBO) started to surface. In the aftermath of WH Group’s failed attempt to list the related businesses separately, the group continued the restructuring by folding the related business into Shuanghui Development to pacify the minority shareholders, and by further increasing the controlling rights of the management. The final structure of WH Group when it went IPO in 2014 is shown in Figure 7.

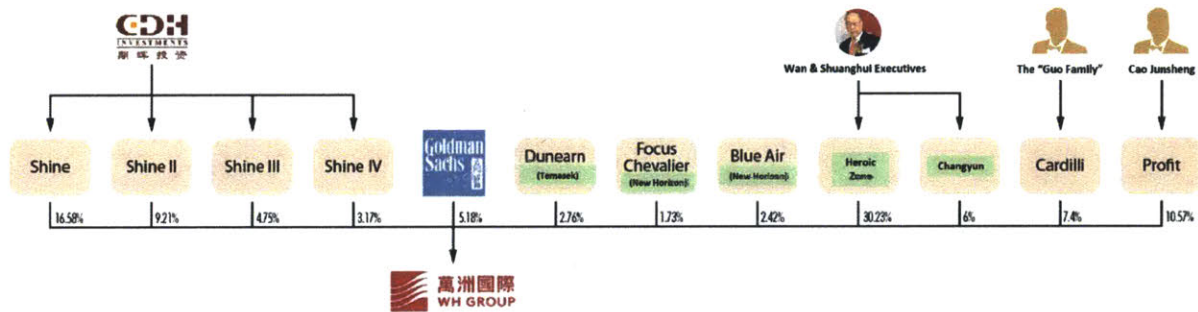


Figure 7: Final Structure of WH Group for IPO

Acquisition of Smithfield Foods and WH Group’s IPO: In 2013, WH Group acquired the Virginia-based Smithfield Foods, America’s biggest pork producer, for US\$4.7 billion. The indicated price for the takeover was US\$34 per share, a 31 percent premium of the market price. Taking into account the debt assumed along with the deal, the total cost for the acquisition reached US\$7.1 billion. It was the largest deal ever in the China-U.S. business history. The acquisition transformed China’s largest pork producer into a global behemoth, selling products under both brand names, and utilizing Smithfield’s advanced methodology for pork rearing and slaughtering.

The Price-Earnings (P/E) ratio of Smithfield was within 10-11 range while Shuanghui Development was traded with a P/E multiple of around 20. Valuations for companies in the same industry diverged greatly in the U.S. and the Chinese/Hong Kong stock markets. WH Group was anchoring its hope on delisting Smithfield from the U.S. market and listing the assets in Hong Kong, as part of WH Group, for a higher market capitalization. The initiative resonated with the Chinese idiom “killing two birds with one stone”, as it would also provide an exit channel for CDH Investments after a lengthy holding period of 7 years.

WH Group was finally listed on the Hong Kong Stock Exchange in August 2014 at HK\$6.2 per share or US\$0.8, raising US\$2.4 billion for the group. The size of the IPO was smaller than an earlier attempt withdrawn in April 2014, which was pegged at about US\$5 billion. The valuation of the company was at an 11.5 forward P/E ratio, lower than the 15-20.8 range implied in the original attempt. The lower valuation was a result of an unfavorable market condition, and the institutional investors' urgent need for an exit channel.

Although the IPO didn't reach WH Group's expectation, the buyout is a classical case in which a Chinese PE firm led the deal combined with MBO and leveraged buyout (LBO) followed by the investee's overseas acquisition and successful IPO. According to the interviews with people familiar with the case, CDH was the only active decision maker among all the institutional investors. Wan Long also commented that CDH and its CEO Jiao Shuge was the actual mastermind behind the scenes. The takeover of Smithfield was considered to be risky due to the large amount of financing required, the antitrust investigation, and the difficult approval process of the Committee on Foreign Investment in the United States (CFIUS). CDH accelerated the takeover by leveraging its connections in the Chinese banking sector and the U.S. co-investors' local network. CDH organized a consortium for a syndicated loan amounting to US\$4 billion months before the takeover, with 2.1 times oversubscription for the syndication by more than 30 banks led by Bank of China. The whole process for the acquisition only lasted 4 months.

Co-investing with a strategic investor is one way to improve the combined consolidation capacity of the acquiring consortium, leveraging the operational experience of the strategic investors in a given industry. The CDH Investments, WH Group & Smithfield Foods case is a good demonstration of this strategy. CDH utilized its investment expertise and network to privatize the

state-owned pork producer, and planned and executed WH Group's cross-border acquisition of Smithfield and subsequent IPO of the group. While keeping a large stake in WH group, CDH restored controlling rights to the Shuanghui management, aiming to leverage the management's operational expertise to enhance the post-acquisition consolidation between Shuanghui and Smithfield.

From the perspective of CDH, the investment in WH Group was very successful in terms of returns. Goldman Sachs had a return of more than 10 times after unloading its shareholding in WH Group in 2009. Although the information is not publicly available, it is widely expected that CDH, with a longer holding period and considerable amount of shareholding, would have a better return on this deal, thanks to its strategy of co-investing with the strategic investor.

In addition to evaluating the competitiveness and growth potential of Chinese PE firms, analyzing the feasibility for them to make successful investments in the U.S. is also necessary for determining their prospects of investing in the U.S. market.

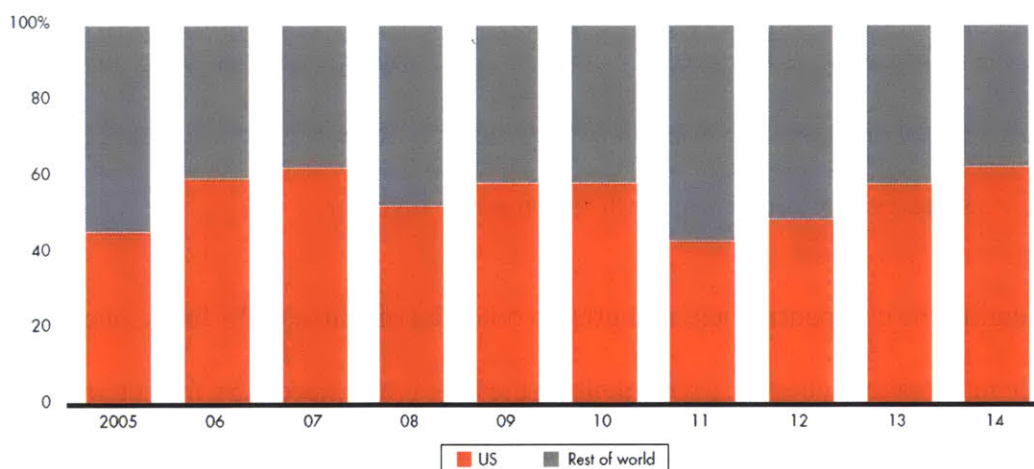
2.3 Feasibility for Chinese PE firms to make successful investments in the U.S.

The U.S. market has been leading the PE deal activities, especially in the past few years when investors have been encouraged by low debt financing costs, record stock prices and improving economic conditions. Despite its mature economy and sophistication of its business community, the U.S. market offers investors premier returns. American regulators and companies are increasingly welcoming Chinese investors, as evidenced by multiple investments across various sectors.

This feasibility analysis reveals reasons for the high investment returns in the American PE market, and U.S. companies' acceptance to Chinese investors.

2.3.1 Attractiveness of the U.S. Private Equity Market

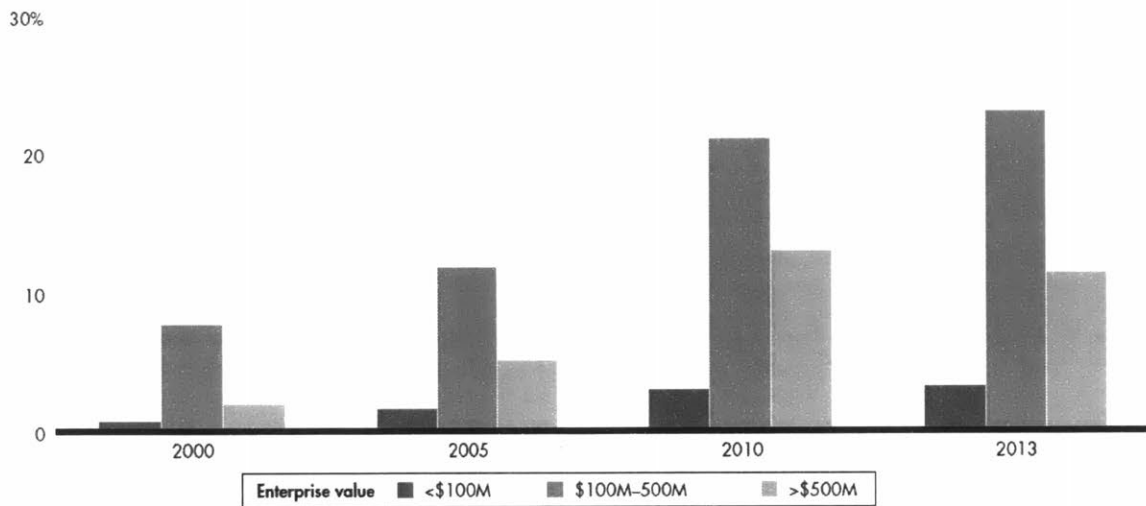
The U.S. has been attracting major PE investment capitals historically. Over the past decade, US-focused buyout funds accounted for over half of the global capital, and reached over 60 percent in 2014 (Figure 8).



Notes: Includes buyout funds with a final close; represents year funds held their final close
Source: Preqin

Figure 8: Global Buyout Capital Raised by Primary Geographic Focus

A similar trend has been discovered from the angle of companies held by PE firms. PE firms have been steadily gaining ownership of U.S. companies since 2000. Bain & Company (2015) reported that PE-backed middle-market (US\$100-500 million) companies increased from 8 percent of all companies in 2000 to nearly a quarter in 2013 (Figure 9).



Notes: All values are estimated; calculations are based on data only for companies with more than \$10 million in revenues
 Sources: PitchBook; Internal Revenue Service; Bain analysis

Figure 9: PE-backed Companies as percentage of all U.S. Companies, by Enterprise Value

PE investors pick the U.S. as their primary investment geography for a reason. The U.S. has the world's most mature and best established PE market, where information asymmetry and exponential growth is minimal, compared with emerging markets such as China and India. However, investors still recognize great opportunities and returns in this sophisticated market. The U.S. market has nurtured the majority of top-performing buyout funds (with IRR of 15 percent or more), notwithstanding the volatility observed in the past two decades (Figure 10).

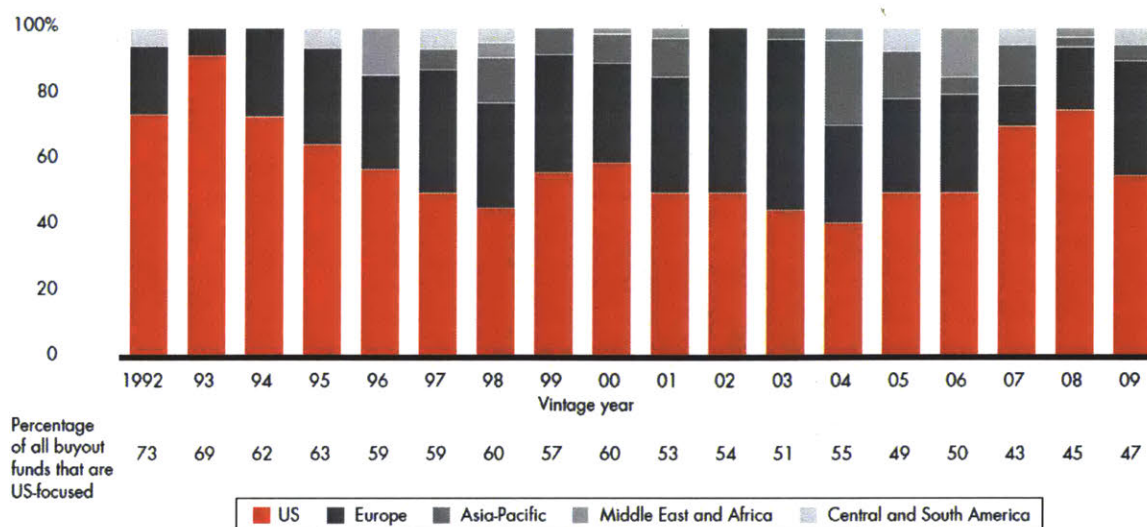


Figure 10: Count of Buyout Fund with net IRR>15%, by Geographic Focus

The preferential returns for PE investments in the U.S. market stem from the economic superiority, investment environment and the advanced business ecosystem of this country. The Global Venture Capital and Private Equity Country Attractiveness Index ranked the U.S. as the No. 1 attractive destination for VC/PE investments for five consecutive years (Groh *et al.*, 2014). The detailed indicators include economic activity, capital market, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial opportunities. In 2014 the U.S. fell in Quartile 1 in every indicator but the taxation category (Figure 11).

	Rank 2010	Rank 2012	Rank 2014	Score 2014	Quartile 2014
VC & PE Index	1	1	1	100.0	Q1
1. Economic Activity	9	10	2	100.0	Q1
2. Capital Market	1	1	1	100.0	Q1
3. Taxation	51	52	49	100.0	Q2
4. Investor Protection and Corporate Governance	11	10	10	100.0	Q1
5. Human and Social Environment	8	9	10	100.0	Q1
6. Entrepreneurial Opportunities	1	1	1	100.0	Q1

Figure 11: Key Indicators for VC&PE Index

In comparison with developing countries such as China (ranked 22nd in the index), the U.S. is trailing in terms of economic growth and taxation (Figure 12). However, the U.S. has better entrepreneurial opportunities, investors protection and corporate governance, depth of financial markets, and human and social environment.

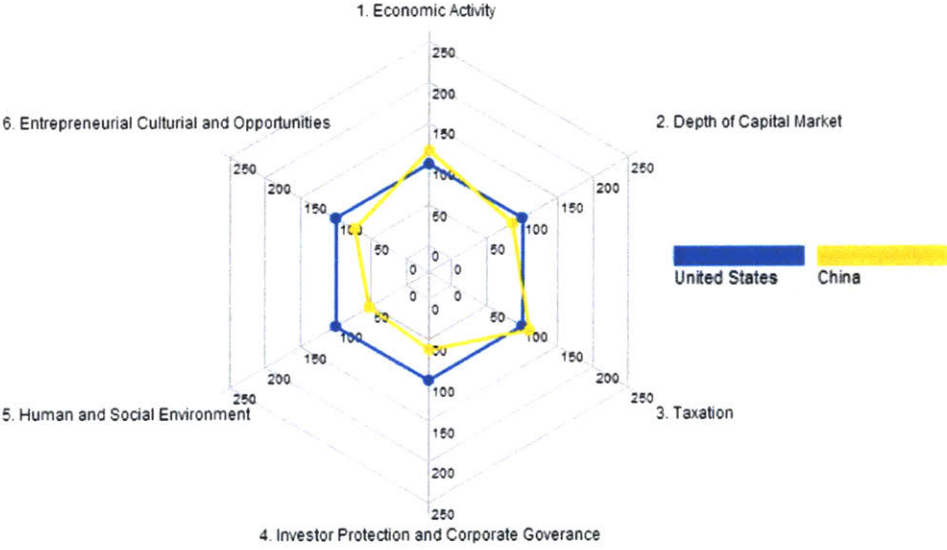


Figure 12: Peer Comparison, the U.S. and China

In terms of the capital market, the U.S. has bigger size and liquidity of the stock and debt market, a more active IPO and M&A industry, as well as better financial market sophistication. Higher quality of corporate governance, better protection of property rights, and more effective quality of legal enforcement give the U.S. better ranking for investor protection and corporate governance. From a human and social environment perspective, the U.S. has better educated human capital, stricter labor regulations and lower tolerance for bribing and corruption. The U.S. has outperformed its major opponents and ranked No.1 in labor productivity among key countries and regions globally since 2007 (Figure 13). The U.S. labor productivity has increased by an annual average rate of 1.2 percent, compared with 0.3 percent in the Eurozone and 0.5 in Japan over the

same period (Goldman Sachs, 2015). On another note, productivity growth is also a key economic indicator of innovation, another important aspect on the country attractiveness list.

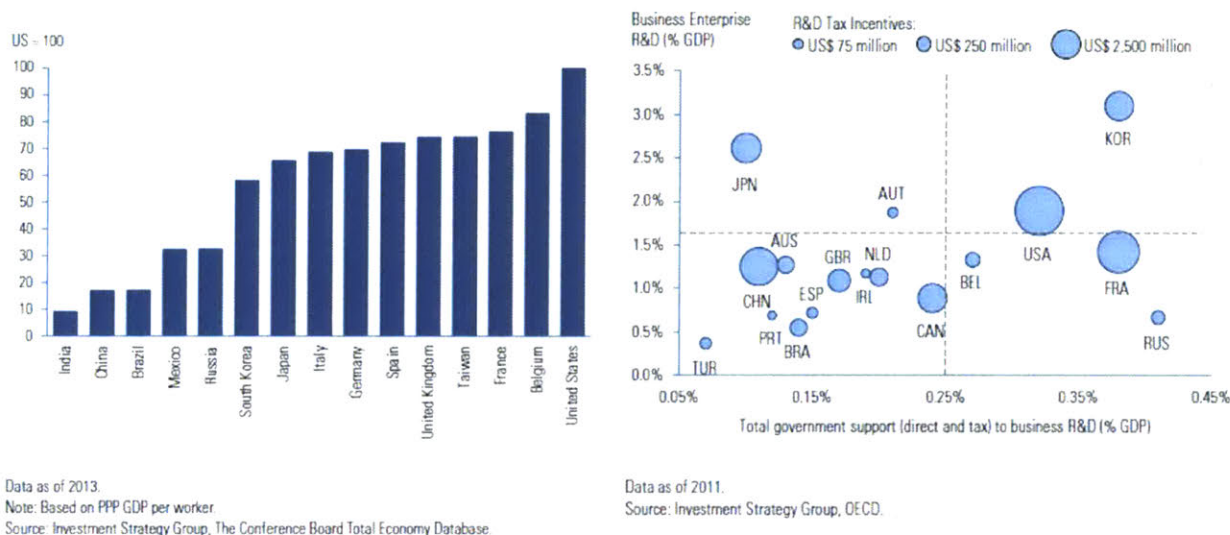
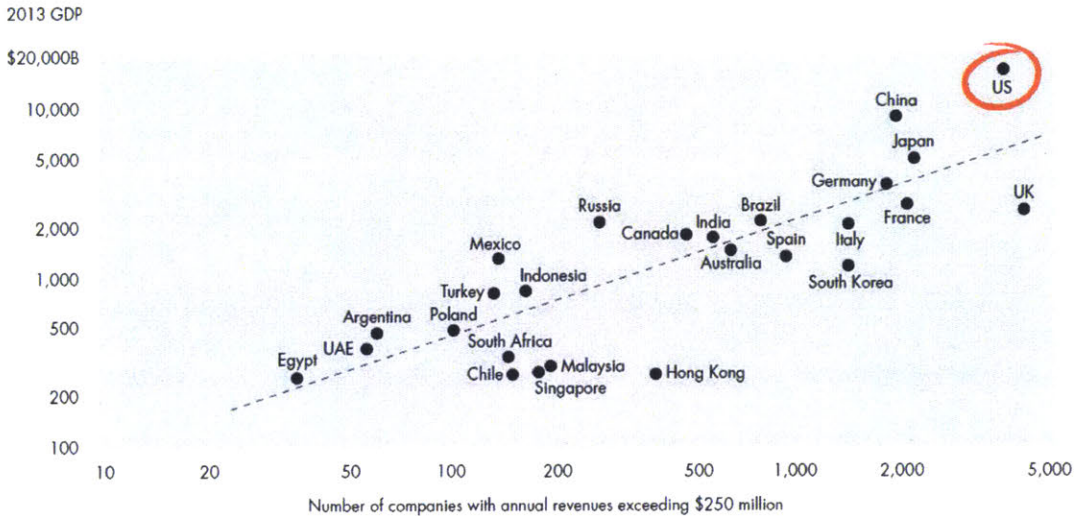


Figure 13: Labor Productivity and Innovation Environment

China has been catching up on innovation and entrepreneurial activities, but the U.S. is still leading the scientific innovation, simplicity of starting and closing a business, and research and development (R&D). The U.S. spent nearly US\$400 billion in 2012, accounting for 30 percent of global R&D expenditure and exceeding the second highest spender, China, by 55 percent (Figure 13). The U.S. technology companies currently account for 65 percent of the market capitalization of global technology companies, while the country's overall share of global market capitalization is only 52 percent. The U.S. has also fostered over two-thirds of the global innovation-dedicated VC funds since 2007 (Goldman Sachs, 2015).

In addition to the strengths of the U.S. listed in the country attractiveness index, another factor that enables the global PE investors to consistently generate high returns is the massive pool of companies in the world's largest economy (Figure 14). The U.S. has nearly 5,000 companies with

revenues of over US\$250 million each; the numbers for China, Japan and Germany are all around 2,000. The wealth of quality companies in this country allow investors to better select investment opportunities, and improve the businesses of investees.



Notes: Based on FY '13 revenues; includes public companies and private companies for which revenue data is available
Sources: IMF; Capital IQ; Bain analysis

Figure 14: Company Pool in the U.S.

In summary, the U.S. is a preferred destination for PE investments given its advantages in attracting PE capital. The leading and expanding PE industry, quality company pool and rich base of top PE funds allow investors to generate superior returns in the world’s most sophisticated PE market. It is then valuable to know whether such a great market welcomes the Chinese investors.

2.3.2 Acceptance by U.S. Companies of Chinese Investments

In the past some of the proposed investments by Chinese investors faced difficulties from the American regulators. For instance, China's state-owned CNOOC intended to purchase the petroleum company Unocal Corp in 2005 but the deal was barred by the U.S. government due to sensitivity of the oil and gas industry. Although these investments faced difficulties from the U.S.

regulators, they are very rare cases and most of the investments in the U.S. do not require regulatory approval. President Obama and Vice President Biden clearly stated that they welcome and encourage Chinese investments as they are important for the job creation and economic recovery. In 2012, the same company CNOOC acquired minority stakes in the Eagle Ford Shale and Niobrara Shale in Texas, Wyoming and Colorado without any problems.

At the corporate level, the U.S. companies generally welcome Chinese investors. Chinese investment in the U.S. increased from US\$3 billion in 2011 to US\$12 billion in 2014⁶. These investments have grown in both frequency and diversity across different sectors. In 2012 another Chinese oil and gas giant Sinopec acquired a one-third stake in oil and gas fields developed by the U.S. firm Devon Energy for US\$2.2 billion. In the same year, Wanda Group acquired the cinema chain AMC Entertainment for US\$2.6 billion. In the real estate sector, Chinese investors have been particularly active in recent years, especially in New York. Beijing real estate tycoon, Zhang Xin, paid US\$1.4 billion in 2013 for a 40 percent stake in the Midtown Manhattan landmark General Motors Building; Fosun International paid JP Morgan Chase US\$725 million for One Chase Manhattan Plaza, the tower built by David Rockefeller.

U.S. companies welcome Chinese investments for not only economic benefits but also strategic reasons. Many of them hope to penetrate or expand in the Chinese market with the help of their Chinese investors in terms of local operational expertise, cultural proficiency and business network. They also supply the same toolkit to help their Chinese partners navigate regulatory and cultural backlash in the U.S. For example, IBM shepherded its Chinese buyer Lenovo through the regulatory and political process associated with the sale of its PC business unit in 2005.

⁶ Data from Rhodium.

3 Conclusions

To conclude, investment prospects in the U.S. are promising for Chinese PE firms. There are strong demands for these firms to make international investments thanks to ambitious globalization plans of Chinese companies and the strong will of the Chinese government to facilitate ODI. The aggressive plan of the Chinese government to internationalize its RMB and liberalize its capital account set up a better groundwork for companies in this country to make outbound investments.

Facing such opportunities, these firms are ready to compete in the U.S. market with the wealth, experiences, human capital and consolidation capability accumulated in the past decade. The two case studies demonstrate their strong potential to provide top-quality portfolio management, and the successful practice of co-investing with strategic investors.

The U.S., as the most preferred destination for PE investments, enables investors to generate superior returns powered by its multiple strengths in economic and business environment aspects. It has more sophisticated financial markets, more advanced investor protection and corporate governance, more profound human and social capital, larger repository of quality companies, as well as better environment for innovation and entrepreneurship. On top of all these favorable features, it is feasible for Chinese PE firms to invest in such an attractive market as the U.S. companies generally accept and welcome Chinese investments.

Although the analysis in this thesis shows positive investment prospects for Chinese PE firms in the U.S. market, recommendations are made in order to further increase the possibility of success for these firms to invest in the U.S.

4 Recommendations

Firstly, Chinese PE firms should partner or syndicate with top global funds in investments in the U.S. Over the past decade, the Chinese PE firms have been successfully cooperating with top global PE firms, such as Carlyle, in the Chinese market. Syndications are also common in cross-border deals in which Chinese PE firms hope to help the investees accelerate the penetration and expansion in China's market, as shown in the Hony & PizzaExpress case. Working with the leading players enhances the local network and operational expertise for international portfolio management, and helps Chinese PE firms gradually become more professional and mature in cross-border markets.

Secondly, Chinese PE firms are recommended to develop in-house consulting arms that focus on post-deal operational improvements and consolidation of investees' businesses. In-house consulting arms reduce the cost of hiring third-party operational management consultants, and improve the efficiency and effectiveness through a better communication and a consistent investment philosophy. They are particularly invaluable in cross-border deals given the information asymmetry, and differences in regulations and cultures.

Finally, Chinese PE firms should keep close partnership with Chinese strategic investors in the international M&A market. The strategic investors, as the major force of Chinese capital investing overseas, will provide not only investment opportunities but also consolidation expertise in their respective industries.

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