

March 14, 2008

Erik Bethel (ebethel@chinavest.com)

Managing Director, ChinaVest, Ltd.

86-21-6323-2255 x818

The Changing Private Equity Landscape in China: The Emergence of the Local RMB Fund

*They sow the wind and reap the whirlwind
-Hosea 8:7*

Introduction

China is quietly creating a home-grown private equity industry. This clearly has repercussions for foreign buyout funds and venture capitalists who have been extremely active over the past few years. In this research piece, we discuss the changing landscape of private equity in China over time, and what the future could bring.

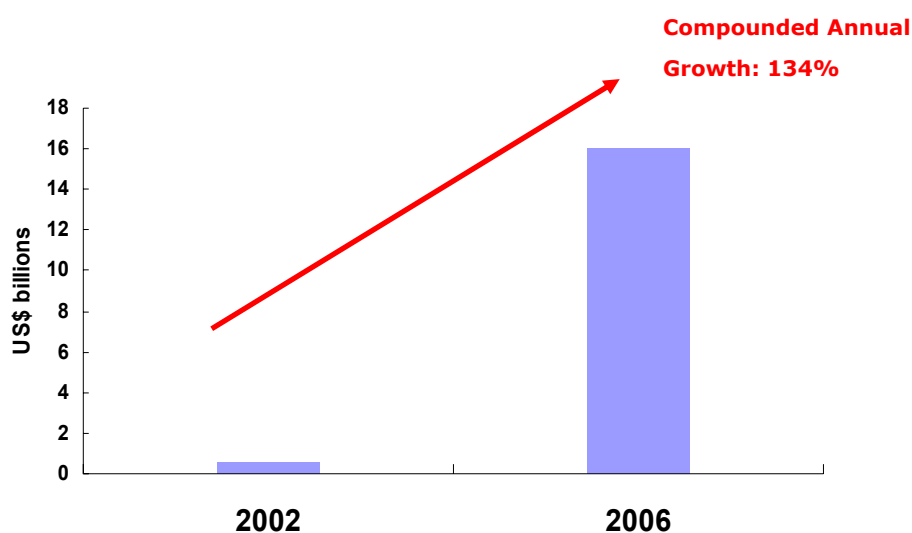
Historical Context

In the not-so-distant past, China could best be described as a “vertical” economy, where all industrial output was controlled from the top down. Throughout this period, Chinese State-Owned-Enterprises (SOEs) enjoyed monopolistic status. In the 1980’s, however, China began to undertake economic reform measures under the direction of Deng Xiaoping. The changes began with the creation of Special Economic Zones adjacent to Hong Kong, permitting a sort of “laboratory of capitalism.” These economic zones were soon reproduced throughout the nation, in a controlled manner, creating an explosion of entrepreneurial activity. In those early years, there was very little private equity activity and only a handful of pioneering private equity/venture capital firms willing to make investments in China. Our firm, ChinaVest, for example, raised its first institutional fund in 1983.

The next important—almost cataclysmic—economic reform event in China took place with China’s accession into the World Trade Organization (WTO) in 2001. For China’s economy, this event had its share of consequences. The most significant was the effective destruction of one of the principal tenants of the communist system—*the separation of ownership from regulation and management*. The WTO, in effect, forced China to sell off assets and create a regulatory system. Though the process has NOT yet been completed, and tensions continue to exist throughout the *entire* apparatus of central government, this new economic system is well underway and its effects are far-reaching.

It was in this post-WTO transitional period that the world's major private equity firms decided to enter China in a significant way. The period also coincided with incredible difficulties at "orphaned" state-owned assets, newly privatized firms, and other enterprises, who realized that they could not turn to Chinese banks for capital. Inefficient SOE's could no longer borrow from equally inefficient banks. Due to new regulations governing bank loans (i.e. loans actually had to get repaid), the tap, for all practical intents and purposes, was turned off. Chinese firms desperately needed capital, and many of the world's leading private equity firms, flush with liquidity, began making investments in China. Within a few years, incredibly large amounts of capital appeared at an alarming rate. The figure below shows the amount of China-specific PE/VC money in 2002 compared to 2006.

Figure 1: PE/VC Money Raised for China (2002 vs. 2006)



Source: Zero2IPO Research Center, Asia Pacific Private Equity Bulletin, ChinaVest

Author's Note: While these numbers seem extremely high, they should be placed in proper context. As one example, Bain Capital's recently-announced global fund (i.e. a single fund) was roughly US\$20 billion.

Foreign PE Funds in China

In China, the advent of large, foreign institutional buyout funds and venture capitalists has inexorably changed the economic landscape. China has clearly benefited from the private equity industry; local firms have received expansion capital, management support and financial/operational best practices. However, Beijing's approach to foreign financial buyers has evolved from a welcoming attitude to one of relative cautiousness.

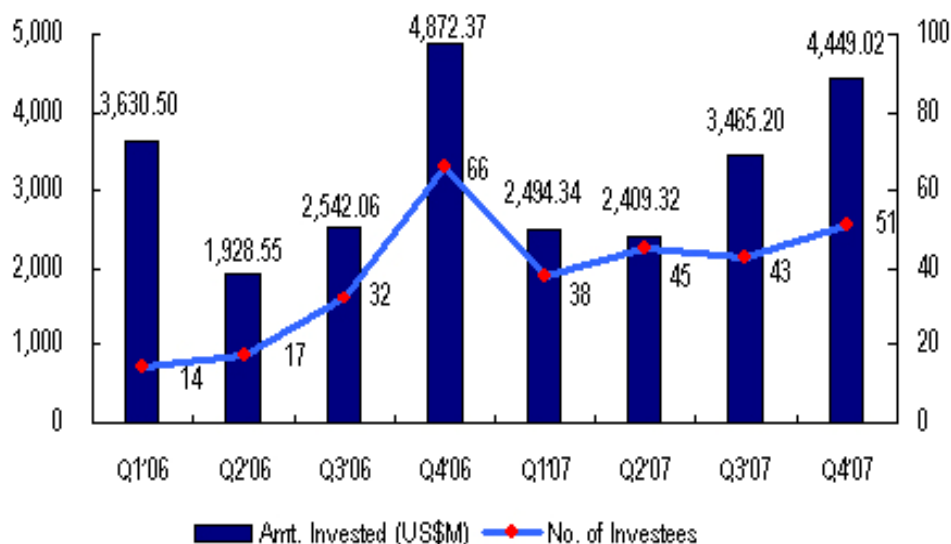
Chinese regulators have become increasingly wary of foreign private equity firms for several reasons. The first is purely nationalistic, a concern that foreigners could own "famous, or well-known Chinese brands." The second is a fear that buyout funds could acquire firms and subsequently lay off workers, thus potentially increasing social instability. The third, and possibly the most important reason, is that China no longer needs foreign capital. With an estimated US\$5 trillion in domestic savings, China may actually have to export capital in coming years.

In response to these concerns, Beijing has created obstacles for foreigners seeking to acquire Chinese companies. One obstacle is a percentage limit set on foreign ownership. Certain industries have pre-defined limits. For example, foreigners can only own 19.9% of banks, or 25% of airlines. Other industries, however, are not so well-defined. In those industries, depending upon the size of the investment, China requires government approval. At the epicenter of the regulatory process is the Ministry of Commerce (MOFCOM). A foreign fund may find itself dealing with (a) MOFCOM's central office in Beijing, (b) MOFCOM's provincial or local branches, or, potentially, (c) both. Adding to these challenges, a foreign fund will also have to gain approval from the relevant industry regulator. The industry regulator can reside at the central government level, the provincial level, or the local level, and often at all three levels simultaneously. In recent years, China's regulators have made it increasingly difficult to get deals done. Notable examples of transactions that have failed due to increased regulatory scrutiny include:

- China Securities Regulatory Commission (CSRC) rejected Goldman Sachs' investment in *Fuyao Glass*. Fuyao, listed on the Shanghai Stock Exchange, announced on November 2, 2007 that the CSRC rejected its application to issue new shares to GS Capital Partners Auto Glass Holdings. The deal was signed on November 20, 2006, at a price of RMB 8 per share. Roughly one year later, after a long period of regulatory delays, Fuyao's share price grew to RMB 31. The application was rejected on the grounds that the share price had risen too high and that the valuation of Goldman's original deal was therefore inadequately low.
- MOFCOM rejected Carlyle Group's purchase of *Xugong Machinery*. This was a high-profile deal in which Carlyle initially proposed to acquire an 85% stake in the construction equipment maker. After a controversial public rejection, Carlyle agreed to acquire a smaller stake in the firm for a higher valuation. The deal is still pending regulatory approval.

High valuations, increased regulatory scrutiny, and increased competition haven't slowed down PE investments at all. In 2007, PE funds invested US\$12.8 billion in 177 deals in China (Zero2IPO). And in 2008, the global credit crisis may actually increase foreign PE activity in China. If banks in developed countries stop lending, or if the cost of capital goes up, buyout deals may dry up in the U.S. and Europe. This, coupled with the fact that China's economy is relatively insulated from global economic turmoil, may spur even further interest in China. Ray Yang, Investment Director at the US\$400 million Orchid Asia Fund, claims that while China might seem to have a lot of liquidity, the percentage of private equity capital to GDP is much lower than in developed economies. "There are some sectors which are overheated, but if you look at the overall picture, there are many more opportunities/deals than money."

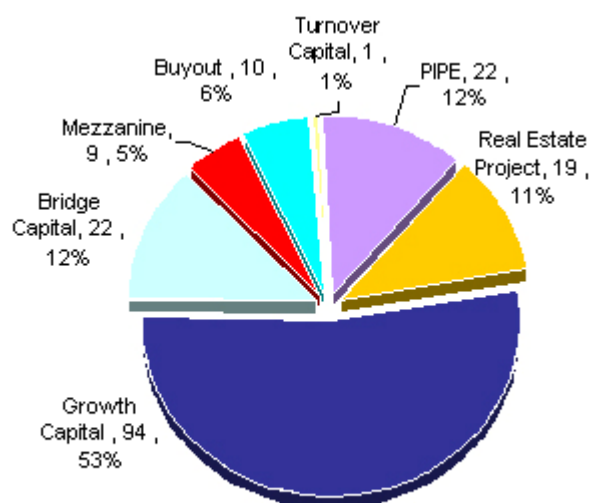
Figure 2: PE Investments in China by Quarter (2006-2007)



Source: Zero2IPO-China VentureDatabase

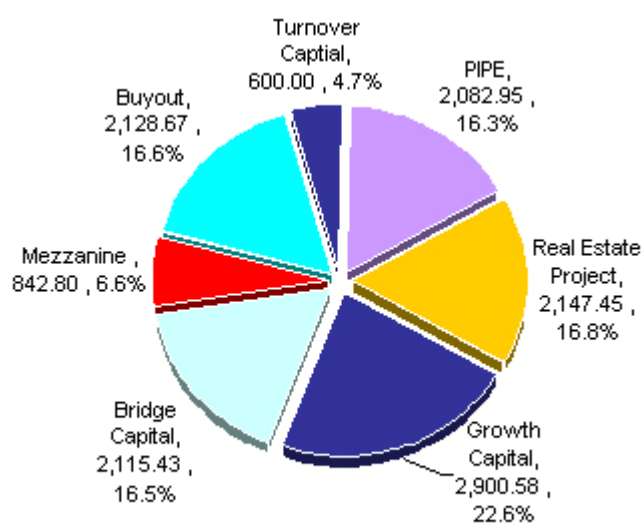
In 2007, international private equity funds, facing ever more intense competition for deals, adopted new investment strategies including bridge loans, PIPE deals (when private equity firms acquire stock in public companies) and mezzanine financing (convertible bonds and other quasi-equity financing). This past year, there were 22 bridge capital transactions. Notable examples include a US\$100 million Carlyle bridge deal in *Kaiyuan*, China's largest hotel management company, and Merrill Lynch's investment in property developer *Guangzhou Hengda*. PIPE investments grew by 16% in 2007. Meanwhile, 9 mezzanine capital deals totaled US\$842.8 million. The figures below highlight the deal volume by number of deals and also by the amount invested.

Figure 3: PE Investments in China by # of Deals (2007)



Source: Zero2IPO-China VentureDatabase

Figure 4: PE Investments in China by \$ Volume (2007)



Source: Zero2IPO-China VentureDatabase

In summary, for much of 2006-2007, the environment for foreign private equity firms in China was marked by: (a) record levels of fundraising and high liquidity, (b) increased regulatory scrutiny, (c) higher valuations, (d) increased "alternative" investments such as PIPE deals and bridge financing, and, most recently (e) the emergence of the domestic PE fund.

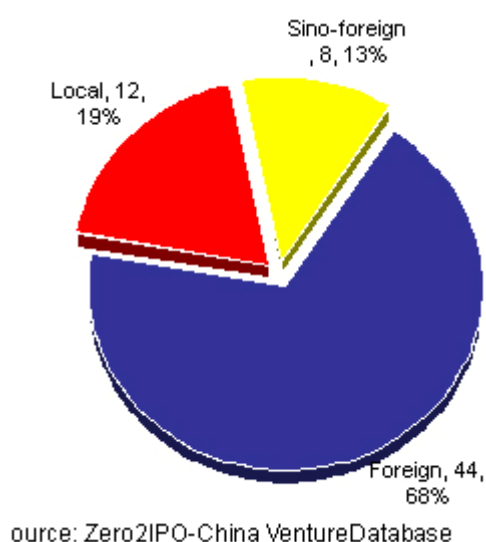
The Emergence of the Local PE Fund

Foreign funds have always competed with each other in China, but they are now facing a new threat—Chinese domestic funds. These local funds have raised money from increasingly wealthy corporate and individual investors. Today, with the support of Chinese government, local PE funds are emerging as viable competitors.

There are a number of variations of local funds. One common denominator, however, is currency. The trend in China during 2007 was to raise RMB-denominated funds. The government wants investors to use the RMB as their investment currency. When they exit, investors are encouraged to conduct an IPO on mainland stock markets, rather than on overseas stock exchanges, where Chinese citizens are still not allowed to invest. The problem is that most foreign investors have Limited Partners (LP's) who require U.S. dollar (or other freely convertible currency) returns. This means that foreign investors usually require an offshore holding entity to own the assets of the PRC firm. The offshore entity can then exit in the U.S. market via an IPO or a merger or acquisition, and the PE firm can then provide dollar returns to its LPs. Unfortunately, recent regulations in China have made it increasingly difficult to create offshore entities. This has created further obstacles for foreign PE funds in China.

In 2007, local funds accounted for 19% of the total funds raised. Only a few years ago, there were no local funds. Today there are 12.

Figure 5: Newly Raised Funds by Type



The Chinese government is also behind the creation of “industrial development funds.” The *Bohai Industry Investment Fund* was the first, founded in late 2006. With roughly US\$2.7 billion under management, the fund is aimed at spurring industrial development in Tianjin, a port city located near Beijing. Bank of China owns roughly 50% of Bohai. The National Social Security Fund, with US\$30 billion under management, is also an investor. In September 2007, another five industrial funds, with a combined value of RMB56 billion (roughly US\$7.8 billion), received regulatory approval. These funds include the *Sichuan Mianyang High Technology Fund*, *Guangdong Nuclear Power and New Energy Fund*, *Shanxi Coal Fund*, *Shanghai Financial Fund*, and *Sino-Singapore Hi-tech Industry Investment Fund*.

There are also a handful of local PE funds that raised offshore capital in foreign currencies. These funds are known as “international domestic funds,” but for all practical intents and purposes, they are viewed to be Chinese. One is Legend Hony, the investment arm of the parent company of computer maker Lenovo. Another is CDH Investments, a spin-off of China International Capital Corporation (CICC—China’s first joint venture investment bank). CDH has US\$2 billion under management and has been an extremely active investor. Brian Doyle, a partner at CITIC Capital, another large international domestic fund, is a strong proponent of local funds. “At the end of the day, local funds make decisions where they live, in the markets where they operate, whereas foreign funds have to report back to New York, Connecticut, London, etc. Our investment process is much more streamlined and as a result we have made six investments in 18 months.”

Local funds are here to stay. And while these funds have certain advantages, they still face obstacles. KC Kung, a managing partner at US\$1.5 billion MBK Partners, an offshore buyout fund focused on making investments in China, Japan and Korea, notes that “local funds have two theoretical advantages – less regulatory scrutiny and fewer ownership restrictions, both of which are often issues with foreign funds.” He adds, however, that, local firms face hurdles as well, such as potentially adverse tax implications on exit, “at least 20% or 25% of the capital gains.” Orchid Asia’s Yang adds other concerns: “While local funds may have better access to deals, a potential problem is that their incentive structure is not as sophisticated as the international funds so it’s hard to retain a professional team.” A final concern is that local funds may not have sufficiently developed international networks for exit options. In other words, domestic funds can easily tap into the local capital markets and IPO their portfolio companies on the local Chinese stock markets. But compared to offshore funds, they have limited relationships with foreign strategic buyers, and with the international capital markets.

Conclusion

China's financial system remains flush with liquidity. It is also relatively insulated from the international credit crunch related to the U.S. sub-prime market. As a result, China’s PE market will remain vibrant in 2008. However, the private equity landscape is changing, and foreign funds may find themselves at a disadvantage. Because Beijing is increasingly cautious of turning over control of assets to foreigners, local private equity funds, with few ownership restrictions, strong government support and less regulatory oversight, may represent a key

challenge for foreigners in the future.

Regardless of their advantages, putting too much emphasis on the local private equity industry could be dangerous. In the past, Chinese banks, securities houses, and state-run investment funds came under pressure from local government officials to bankroll pet projects that failed to produce investment returns. Furthermore, Beijing's domestic bank bailout drained the country's coffers by hundreds of billions of dollars. And when Chinese securities firms made unregulated investments in the late 1990s, including a number of VC deals, the government was again forced to clean things up.

The pivotal theme related to understanding the Chinese private equity landscape can best be described with one question—"who owns China?" This will be the overarching issue for years to come. The question will be answered, in part, by national government, local officials, the newly reformed Chinese banks, and the countless millions of entrepreneurs who have created this economic juggernaut, an inertial force unparalleled in modern history. It will also be answered by the many domestic and foreign private equity funds with a vested interest in doing business in China.