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Private Equity in China

Challenges and Opportunities

YONG KWEK PING

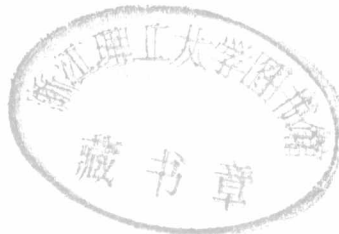


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Preface

Private equity was relatively unknown among the Chinese general public in the 1990s and early 2000s. Even if one were to have heard of private equity in China, they often had a poor understanding of it and often mistook private equity simply as an equity investment firm. Early private equity deals did not attract much media attention. It was not until the mid-2000s when foreign private equity firms started to make inroads into the Chinese market that the media started to pay attention to private equity.

The term *private equity* became more widely known to the general Chinese consciousness only recently, at the height of the economic boom in 2006, when China Investment Corporation (CIC) paid a hefty US\$3 billion for a slightly less than 10 percent stake in Blackstone. This was its first investment deal—even before it was officially incorporated—and the Chinese public started to find out what “a Blackstone” is. Foreign private equity firms were aggressively seeking investments in domestic companies and were looked upon as an important source of capital, as the capital markets in China were not well developed yet. The Chinese bond market was undeveloped or still developing, and the stock market was not easily accessible to domestic companies in order to raise funds. The primary source of capital for domestic companies was through the local banks, namely the state-owned and policy banks, provincial and city commercial banks, and rural cooperatives. To a certain extent, the lack of easy access to capital restricted the expansion of local companies. Furthermore, the mismanagement of the economy prior to the economic reforms had taken its toll on the finances, operational capabilities, human resources, and technological know-how of the local companies. Hence, foreign capital and expertise was greatly valued by the country. To this end, private equity plays a crucial role in the development of the Chinese capital markets with its allure of capital, management expertise, and international networks.

Only a small number of foreign private equity firms had entered the Chinese market, lured by its large domestic market and increasing liberalization of the capital market. Some of the pioneers include The Carlyle Group, KKR, and Blackstone, which have thus far had mixed success in China. Despite being an early mover into the Chinese market, foreign private equity

firms still faced stiff competition from other new foreign private equity firms and domestic private equity firms looking to enter the playing field.

As economic reform gained pace and the domestic populace began to become wealthier and exposed to financial markets, an underlying nationalistic sentiment was being stoked. Foreign private equity firms were charged with buying Chinese assets on the cheap and making very high returns at the expense of Chinese workers who got fired due to the restructuring exercise. The central government became aware of the local sentiment and sought to defend their position that they were not selling Chinese assets on the cheap. It was argued that some of the state-owned enterprises were unprofitable and that the only way to sustain its operations was to sell it to a party that was capable of turning it around. Due to the misrepresentation of the workings of private equity by the Chinese media that labeled private equity firms as corporate raiders, the exact role and functions of a private equity firm is hitherto still a mystery to many in China.

With the preceding as a background, the aim of this book is to demystify the functions of the private equity firm operating in China. As if trying to comprehend private equity alone was not complicated enough, a private equity firm operating in China will likely confound many people who do not have a basic understanding of how business is conducted in China. Needless to say, a private equity firm in China faces many challenges and opportunities. To this end, this book aims to provide a better understanding of private equity in China.

The target audience for this book is investors and professionals who want to gain a better understanding of the operating environment in China and how to carry out investments into Chinese companies. With the constantly evolving economic landscape in China, as well as the myriad of regulatory changes that are taking place, foreign investors are often befuddled by the fluid nature of things in China. Private equity, as an asset class dealing with business, relies heavily on the management expertise of the general partners to deliver on the high rates of returns demanded by limited partners. In addition, due to its illiquid nature, private equity has sparked concerns in the foreign investor community that fear losing their investments due to the high risks that are associated with doing business in China. Readers of this book will find that investing in China certainly poses its own unique set of challenges and opportunities, but this is no different from investing in any foreign market. Indeed, by reading this book, the author hopes to demystify the workings of private equity in China and to dispel any false misconceptions that investors or people have about doing business in China.

This book is organized into six chapters. Chapter 1, Private Equity: An Introduction, provides an overview of the private equity industry, its characteristics, and functions. With a basic understanding about private equity, the

readers will be able to appreciate the differences between operating private equity firms in the West compared with those in China. For readers who are familiar with the workings of private equity firms, this section will still be useful insofar as the illustrations and models that are used in this chapter are proprietary models that have been created by the author and implemented in China. The Inventis Private Equity Model will be introduced to assist readers in understanding the dynamics of the private equity cycle from entry to exit and the investment mix that private equity investment could make. This chapter will cover the entire private equity investment cycle starting from the planning, fund-raising, and sourcing stages to the due diligence process, deal structuring, portfolio management, and finally the exit strategy. Readers who are familiar with private equity as an asset class may choose to skip this chapter.

Chapter 2, Overview of the Political, Macroeconomic, and Financial Landscape in China, sets the stage for this book. The political and business environment is intertwined with the private equity industry in China. This is because private equity is fundamentally about investing and growing a business. Without an understanding and appreciation of the diversity and challenges of China's political and business environment, business management will find it difficult to overcome these challenges. This chapter will highlight the centers of power in China and their relevance to the private equity practitioners. In addition, the key macroeconomic trends and developments that are unfolding in China will be highlighted to provide readers with a macroeconomic view and to see how it relates to the development of the private equity industry in China and the opportunities that lie ahead.

In Chapter 3, Private Equity in China, an overview of the private equity industry in China is discussed. This is followed by an analysis of key milestones and developments that have happened in the past decade and their significance to the industry as a whole. The private equity industry in China is constantly adjusting to the evolving regulatory framework in China. The regulatory framework shapes the type and form of private equity funds being developed in China. In addition to the regulatory impacts on funds formation, the exit strategy for private equity funds can also be affected, as the Chinese government is wary of Chinese companies that are avoiding taxes through offshore restructuring. In this regard, a detailed look at the types of investment structure that are permitted and being used is explored. This chapter ends with a look at the challenges and benefits of doing private equity in China.

Chapter 4, Renminbi Private Equity Fund, provides an in-depth discussion on RMB-denominated private equity funds that have increasingly become the investment vehicle of choice when it comes to private equity

investment in China. Indeed, large Western private equity firms have started to make inroads into the RMB private equity funds by setting up and registering funds in cities that have announced preferential policies for fund management companies. The concept of an RMB private equity fund is still relatively new and it is rapidly evolving. There are numerous issues that will need to be resolved, such as the potential conflicts of interest that arise from general partners who run two separate private equity funds (denominated in RMB and USD) and that are backed by different limited partners vying for the same deals. RMB private equity funds pose a different set of opportunities and challenges compared to the USD-denominated private equity funds. This chapter aims to address these issues and to highlight the way forward for RMB private equity funds.

Chapter 5, *Investment Opportunities for Private Equity in China*, discusses the investment opportunities for private equity investment in China and the future direction of the industry. There are enormous investment opportunities in China and this chapter alone will not be able to capture all of the opportunities. Instead, the approach for this chapter is to leverage the 12th Five-Year Plan as announced by the National Party Congress in China in 2011, and to examine the industry sectors that may benefit from favorable policies. In addition, the Chinese government has also announced seven key strategic industries that it is actively encouraging investment into. In this regard, this chapter will cover the industry sectors as identified by the Chinese government as key investment opportunities in the coming decade.

Chapter 6, *Challenges and the Future of Private Equity in China*, looks at the current state of the private equity industry in China and highlights the positive developments and challenges that the industry as a whole may face in the near future. Needless to say, it is impossible to predict the future; however, it is the author's intention to provoke readers to think deeply about the way ahead and how to overcome possible challenges in the future.

This book was written from the point of view of a practitioner to engage the reader. Each chapter will draw on real-life cases in the form of exhibits. The exhibits are intentionally kept brief with sufficient background and analysis. Hence, readers should not expect to see a full-blown case study akin to those used in business schools. The aim of the exhibits in this book is to highlight key lessons that the author wants the readers to take away regarding investing in private equity in China.

Acknowledgments

Private equity is an exciting and fulfilling career that takes general partners around the world. Writing this book has been an enriching and interesting journey. Private equity itself is sometimes mysterious and the same goes for China. It has been a challenging journey to attempt to put these two elephants together and to be able to articulate and organize my thoughts on these two topics into a book.

My sincere gratitude runs deep to the many outstanding individuals who have been involved in the production of this book. I am most thankful to Kelvin, Josh, and Yuan Ye, for their indefatigable support and research into the subjects. They have painstakingly gone through all my drafts and provided many invaluable comments. Their intelligence is ubiquitous throughout the book. I would like to dedicate this book to all three of them. During the initial planning of this book, Chai Ming Jie, Wong Qing Yuan, Kenny Ng, Yeo Zhi Aik, Ryan Li, and Daryl Poon provided me with excellent suggestions on the structure and contents of this book. I am grateful to these young friends of mine. They are all the most important people in my life.

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毛主席万岁！

毛泽东

两个凡是

华国锋

改革开放

邓小平

三个代表

江泽民

科学发展

胡锦涛


Long Live Chairman Mao!
Mao Ze Dong

Listen to Mao's Instructions. Follow Mao's Decisions.
Hua Guofeng

Open and Reform
Deng Xiaoping

Three Representatives
Jiang Zeming

Scientific Development
Hu Jintao



Private Equity in China

Contents

Preface	xiii
Acknowledgments	xvii
CHAPTER 1	
Private Equity: An Introduction	1
Overview	1
<i>Stages of Development of a Company</i>	2
<i>Differences between Private Equity and Venture Capital</i>	5
<i>Differences between Private Equity Investments and</i> <i>Corporate Mergers and Acquisitions</i>	6
Inventis Private Equity Model	8
Structure of a Private Equity Fund	11
General Partners	11
Limited Partners	12
Investment Committee/Advisors	12
Professionals	12
Private Equity Investment Process	13
<i>Planning, Fund-Raising, and Deal Sourcing</i>	14
Due Diligence	16
Deal Structuring	18
Portfolio Management	21
Exit Strategies	24
CHAPTER 2	
Overview of the Political, Macroeconomic, and Financial Landscape in China	33
Overview	33
Regulatory Environment	35
Chinese Government Agencies and Their	
Relevance to Private Equity	37
China's Macroeconomic Conditions and Trends	45
Macroeconomic Condition 1: Inflation	48
Macroeconomic Condition 2: Widening Income Disparity	49

<i>Macroeconomic Condition 3: Accelerated Aging</i>	
<i>Population Structure</i>	50
<i>Macroeconomic Trend 1: Increasing Urbanization</i>	51
<i>Macroeconomic Trend 2: Westward Shift in</i>	
<i>Industrialization and Development</i>	53
<i>Macroeconomic Trend 3: Strong Growth in</i>	
<i>Domestic Consumption</i>	54
<i>Macroeconomic Trend 4: Shift Toward</i>	
<i>Value-Added Industries</i>	56
China's Financial Markets	57
<i>Key Phases of Developments in</i>	
<i>China's Capital Markets</i>	58
<i>China's Equity Markets</i>	62
<i>Foreign Listings on Chinese Exchanges</i>	65
<i>China's Credit Market</i>	67
Trust Financing	72
China's Futures Markets: Commodity	
<i>Exchanges and Derivatives Exchanges</i>	73
Summary	75

CHAPTER 3

Private Equity in China	77
Overview	77
Key Market Trends and Developments	79
<i>Private Minority Placement Quadrant</i>	81
<i>Private Majority Placement Quadrant</i>	82
<i>PIPE Minority Deals Quadrant</i>	83
Private Equity Funds in China	97
<i>Foreign-Owned Private Equity Funds (FOPE)</i>	97
<i>Chinese-Owned Private Equity Funds (COPE)</i>	99
<i>State-Owned Industrial Private Equity Funds (SOPE)</i>	100
<i>Hybrid Foreign/Chinese USD and RMB</i>	
<i>Private Equity Fund (HOPE)</i>	101
Private Equity Investment Structures in China	102
<i>Red Chip Structure or Round-Trip Investment</i>	102
<i>Onshore Structures</i>	108
Leveraged Buyouts	112
Valuation Adjustment Mechanism	114
<i>VAM in China's Private Equity Industry</i>	114
<i>Financial Measures</i>	116
<i>Non-Financial Redemption Measures and Stock Offerings</i>	117
<i>Stock Offering: Expiration of VAM Agreement</i>	119
<i>Challenges of VAM</i>	121

Exit Strategies for Private Equity Investment in China	121
<i>Initial Public Offerings</i>	122
<i>Initial Public Offerings in Domestic Markets</i>	125
<i>Initial Public Offerings in Overseas Markets</i>	129
<i>Trade Sales</i>	130
<i>Secondary Sales</i>	130
<i>Leveraged Recapitalization/Distribution of Dividend</i>	131
Benefits of Private Equity for China	132
<i>The Case for Demutualization of Chinese Stock</i>	
<i>Exchanges through Private Equity Investments</i>	136

CHAPTER 4

Renminbi Private Equity Fund	137
Overview	137
Setting Up and Fund-Raising in China	138
Investing in China	142
<i>Exit Options for the RMB Fund</i>	143
The Renminbi Private Equity Fund	144
<i>Types of RMB Funds</i>	145
<i>Domestic Limited Partners</i>	149
<i>Private Equity Regulations and Incentives</i>	159
<i>RMB Funds' Edge in Investing in China</i>	160
Challenges and Opportunities for FOPE-RMB Funds	161
<i>The Future of Domestic Limited Partners</i>	162
<i>Qualified Foreign Limited Partnership Pilot Program</i>	163
<i>Management of Hybrid Funds</i>	166
<i>Onshore Legal Structures of RMB Funds</i>	171
<i>Restrictions for Foreign-Invested Partnerships (FIPs)</i>	175
<i>Treatment of FOPE-RMB Funds: Domestic or Foreign?</i>	176
<i>Exit Options for RMB Funds</i>	177
<i>Domestic Listings on Chinese Stock Exchanges</i>	178
<i>Private Equity Secondary Markets in China</i>	179
<i>China's Domestic Limited Partners</i>	180
Impacts of RMB Convertibility on RMB Private Equity Funds	181
<i>RMB Private Equity Outbound Investments</i>	182

CHAPTER 5

Investment Opportunities for Private Equity in China	187
Overview	187
Foreign Acquisition and National Security Review	189
China's Five-Year Plan for National Economic and Social Development	191

China's Seven Emerging Strategic Industries	195
<i>Energy Saving and Environmental Protection</i>	199
<i>Renewable Energy</i>	205
<i>Alternative Energy Vehicles</i>	210
<i>Next Generation Information Technology</i>	213
<i>High-End Equipment Manufacturing</i>	215
<i>Biotechnology</i>	217
<i>New Materials</i>	221
Investment Opportunities in China's Energy Sector	224
<i>Key Energy Security Concerns</i>	224
<i>Strategies to Tackle China's Energy Challenges</i>	227
<i>Trends in the Oil and Gas Sector in China</i>	230
<i>Relationship between the Energy</i>	
<i>Firms and the Government</i>	233

CHAPTER 6

Challenges and the Future of Private Equity in China	235
Overview	235
Fund-Raising	236
Deal Sourcing	238
<i>Good Deals Are Getting Scarce, Valuations Becoming Too High</i>	239
<i>FOPE Funds Are Competing with COPE Funds in Deal Sourcing</i>	239
<i>Moving West</i>	240
<i>Consolidation Opportunities</i>	240
<i>Seeking Uniqueness from Other Funding Sources</i>	241
Due Diligence	242
<i>Reliability of Financial Statements</i>	243
<i>Intellectual Property Rights</i>	245
Deal Structuring	247
Portfolio Management	250
<i>Change from Boss Culture to Management Culture</i>	251
<i>Communication and Timely Information</i>	251
<i>Resistance to Change</i>	252
<i>Fighting for Control</i>	253
Exit	255
<i>Valuation Obstacles</i>	256
<i>China's Private Equity Secondary Sales Market Is in the Nascent Stage</i>	257