Private Equity In China

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A great deal of attention has been paid to the extraordinary rates of growth that the Chinese economy has achieved in recent years. This hype surrounding the Chinese economy is drawing a lot of private equity investors in, but few will make it out. Only those who understand how to navigate the local environment using a combination of western business practices and local knowledge will attain strong risk-adjusted returns.

Before Moving into China

Before investors go into China, they need to engage in self-reflection and answer several questions. Can they commit to China? If they can't, then they will have no chance to compete with the local PE firms and the foreign groups who have gone local. Stanford Management Company's chief representative in Asia, Jason Zhang, said "Silicon Valley guys will tell you that [they] have an operational distance of 50 miles." Can others defy this and obtain extraordinary returns half a world away? Only if they go local.

"All politics is local", but so is PE. Think of PE managers' constituents as the Chinese owners of good companies. These "constituents" will not give these investors their vote of confidence and let them invest in their companies unless they know these investors and trust them to add value to their quality companies. Given the current crowded nature of the PE market on the mainland, PE money is more of a commodity than ever, so investment managers need to distinguish themselves. They need to build up a reputation for success and trust and the only way to achieve this is by spending time in China. Historical events have made the Chinese xenophobic, so foreign investors are already in the red in the trust column. This means investors cannot travel to China once a month and expect to have the relationships or street knowledge to lead them to the best deals. They need to put a lot of time and money into cultivating a strong relationship with a local partner who can "help navigate and source deals"[2] For international investors who lack this willingness, stay out.

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[12] Zhang, Jason (Chief Representative of Asian Investments), Stanford Management Company (July 29th, 2005).

Half measures don't work either. Stanford's Zhang knows of groups who have full-time investors on the mainland or have partnered with local PE firms, but keep final decision-making authority at home. "If you remote control [these local representatives]… I have seen so many relationships like this that don't work" he says. When the China reps' ideas are constantly being shot down, it leads to frustration and they leave. Firms should not let good local representatives leave because they have control issues. They may be irreplaceable. Not because their brains are replaceable, but because their *guanxi* or relationships cannot be duplicated. I'll delve into this topic in depth later, but suffice it to say that many business deals are built on one person's relationships and these could evaporate if he or she quits.

If this is not enough, home base should also realize it has relatively little cultural understanding of what businesses can succeed in China compared to their local reps or partners. "A local [rep] brings you deals but [if] you as home base look at deals with a western perspective" Zhang said continuing "[it] defeats the point of having a local [rep]". Western firms are not easily going to be able to bridge the culture and knowledge gap to understand why their China branch is pushing certain deals. The solution according Zhang: "you hire local partners, but you must come to China so he's learning and you are learning so over time it could work". Foreign PE groups must have intimate relationships with their China partners so they can trust the PRC-based investors to make decisions.

That takes a lot of faith, but that's how it has to work. To make it functional, foreign PE groups should assign their own relatively senior investors to China for a significant amount of time and partner them with a stellar local PE group. Apply this advice from the *Harvard Business Review* to a PE setting: "it is important that a senior person head the China office-someone with good personal ties to the corporate CEO-so that problems with global business division can be addressed with the requisite authority"[4]. This way the PE managers at home can feel comfortable and the local reps can make quick decisions to achieve the highest returns. There is a surplus of PE money in China right now and if some firms can't make speedy decisions, others will.

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[4] Lieberthal, Kenneth and Geoffrey Lieberthal. 2004. "The Great Transition." In Harvard Business Review's <u>Doing Business in China</u> (21) Harvard: Harvard Business School Press.

To make things even smoother, this senior investor should ensure that the local partner embraces a philosophy similar to the main office's. Firms' philosophies are important as they determine the direction of investment. If a group's doesn't jive with having proactive reps, then it should stay out of China.[6]

Moving In

After looking into the mirror and answering yes to the China commitment, a PE firm needs to start building up its relationships and set up an offshore holding vehicle for its investments. If investors have skill and the right relationships, they can make a profit. If they're offshore, they can repatriate it.

Think of China as a neighborhood. When you move into a neighborhood, you should make friends so they will watch out for you and help you find business. The more time you spend in the neighborhood, the more friends you make, the deeper the mutual trust becomes, and the more business you get.

These relationships with friends, family, and so forth is called '*guanxi*' in China. It is so important to the Chinese because they have traditionally trusted their friends to protect them and support them because the government and legal system have been consistently unreliable. Good *guanxi* is difficult to gain and if you don't have it, you have little hope of sourcing great local deals.[8] Of course, investors must still perform proper due diligence, but they are less likely to run into losing prospects if they have access to a strong *guanxi* network. Relationships take years to cultivate, so get started. One better is to shortcut this process by using your local partner's *guanxi* as you gradually build up your own.[10]

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[6] Higgins, Robert F. (Managing General Partner, Highland Capital Partners. Harvard Business School Professor) June 2005. [China]

[8] Haemmig, Martin. 2004. "So You're Thinking of Investing in China." Israel Venture Capital Journal (IVCJ). (25) Israel Venture Capital (IVC) Research Center.

[10] Jacobius, Arleen. 2005. "Private Equity: High Prices Could Cast pall on Returns." Crain Communications. (January 10).

Having *guanxi* certainly does not guarantee success. Without business smarts, your firm won't be able to identify future winners. As Kenneth and Geoffrey Lieberthal pointed out in their *Harvard Business Review* essay, "*Guanxi* can be very helpful but are not enough. Officials change position, fall out of favor, or simply promise more than they can deliver. There is no substitute for developing a good understanding of the market".[12] They're right. Deep reserves of *guanxi* lead to doors of opportunity, but business sense is the key that opens the right ones.

Opportunities, especially early stage ones, will be difficult to locate without a broad geographical presence. Brian Chiang of Walden International claims that PE investors "can't do it without Beijing". Not only does this place the investor with connections closer to ever-shifting reformist policies, it also situates the aware close to many investment prospects. Chiang continued by saying that because Beijing has more schools and it's harder to find a job there, it has more entrepreneurs than the financial center of Shanghai. Thus, there are more early stage prospects.

These opportunities will be meaningless to Renminbi (RMB)-denominated funds, though, so they need to set up offshore holding vehicles for their investments. RMB-funds based on the mainland will have difficulty exiting their investments. This is because their options are limited to difficult trade sells[14] or going public on a domestic market where their original shares are locked up as non-floatable shares and dividends are small. Foreign funds that are RMB-denominated will be unable to repatriate their gains due to PRC currency controls. According to Hong Kong based analyst Barbara Mok, another good reason to set up offshore is that "local regulations do not recognize different classes of shares and restricted the sale and public trading of equity held by founding stockholders".[16] Avoid these structures. Offshore holding vehicles

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[12] Lieberthal, Kenneth and Geoffrey Lieberthal. 2004. "The Great Transition." In Harvard Business Review's Doing Business in China (Harvard: Harvard Business School Press): 22.

[14] Wright, Ben. 2004. "Venture Capital Investment in China Isn't All That Scary." The Business. (November 7)

[16] 2005. "New Rules Curb Venture Capital Flow." *Financial Times Global News Wire: Business Daily Update*. (May 12).

incorporated in the Caymans etcetera are the most popular option among the private equity community invested in China and for good reason.

A recent hiccup in creating these offshore structures has been causes by two circulars issued by China's State Agency for Foreign Exchange (SAFE) in January and April of 2005. They stated that "No onshore resident (Chinese or resident foreigner) may establish or control an offshore company, either directly or indirectly, without the approval of SAFE".[18] Firms that created such vehicles before January 24, 20005 are not affected, but new holding vehicles will be subject to an as yet unclear approval procedure. The intent was to prevent the selling off of state-owned assets, domestic tax avoidance, and currency speculation.[20] Another, unintended, result was a thirty-one percent drop of funds' first quarter investment because of the fear that the new regulation "may hinder international share sales and capital raising"[22] This is the worry now, but Andy Kung cited an example of a company from Ningbo run by Chinese nationals who received the SAFE license to restructure into an offshore WOFE. He added that shares of the holding company were obtained by the original management team. Other PE investors I interviewed were also optimistic that the PRC government would reissue a clearer circular in the future stating their intention to protect foreign investment within the new regulation because China wants the capital expertise of risk oriented investors.[24] But when will it come?

Some of the Basics

After commitment and moving in details have been dealt with, firms should naturally address the basics of private equity. Exit strategies must be considered early on, quality

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[18] Borrell, Jerry. 2005. "Regulation Bringing China PE to Standstill." *Private Equity Week.* (April 18).

[20] Kung, Andy (Principal), Pacific Venture Partners of Shanghai (June 20th, 2005). [China]

[22] 2005. "New Rules Curb Venture Capital Flow." Financial Times Global News Wire: Business Daily Update. (May 12).

[24] Zhang, Jason (Chief Representative of Asian Investments), Stanford Management Company (July 29th, 2005). [China]

management must be found, and companies with defendable competitive advantages must be identified. None of this is easy.

Exiting may be a priority for a PE investor, but it's not for the Chinese government. IPO's, bankruptcies, and reverse mergers have all been done, but government road blocks and the unsophisticated nature of the capital markets make it slower and give PE firms less options. Things should improve as the government understands how best to support private equity, but here's the situation now:

If you want to exit via IPO, don't even think of listing on a PRC domestic market. One businessman described the Shenzhen and Shanghai stock markets as "a game". The stock markets were constructed to support Chinese State Owned Enterprises SOE's and that's what they continue to do today. Investors cannot purchase controlling shares of SOE's so these bloated companies simply see the stock markets as free money. Good companies are hard to find on the markets because it is very hard for a private company to list on the mainland and increasingly, few want to try. That's partly because on these exchanges "founder shares become nontradable legal-person shares when listed domestically, eliminating this venue as a liquidity source".[26] The bottom line is your firm should not attempt to get involved in domestic exchanges unless significant reform is achieved.

When choosing the markets to list Chinese companies on internationally, most of the interviewed PE managers and VCs chose the New York exchanges first, Hong Kong second, and Singapore and Tokyo as distant thirds. NASDAQ was sited as the most appealing for high tech firms. The Hong Kong market's high liquidity helped rank it at number one in Asia among investors, while Singapore's lower level of liquidity pushed it to third in the eyes of some. There have been some successes with international listings, most notably Semiconductor Manufacturing International Corp. (SMIC), but this is not a common case.[28] Chengwei Ventures Eric Li argued that this should not overly worry investors. "If [investors] have good companies then exits will come; I have listed companies on NASDAQ and have sold companies. If

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[26] Ewing, Richard Daniel. 2004. "The Struggles and Rewards of Private Capital in China". (July 12).

[28] Wright, Ben. 2004. "Venture Capital Investment in China Isn't All That Scary." *The Business.* (November 7).

[investors] have good companies, then don't worry about anything" he said. If a portfolio company fails, then there is quite a bit to worry about for investors, though.

If PE groups find their companies heading the other way from IPO and need to file for bankruptcy, prepare for a long battle. There is little if any legal protection for investors. Not only is it simply a difficult process that according to Andy Kung took Pacific Venture Partners over two years to do once in China, it is incredibly culturally shameful. Unlike the US, where businesspeople declare bankruptcy and then move on to start new companies, it can finish people's careers in China. "If you go through bankruptcy in Asia, then it's basically the end of your life" according to Lotus Capital's Brad Huang. Thus, few entertain the bankruptcy option, so few know how the process works. A difficult process anyway, it may be nearly impossible for foreign investors who are often minority shareholders to convince Chinese owners of its necessity. Don't go bankrupt in China.

Finding quality management to run portfolio companies may be even more problematic. Dr. Martin Haemmig, a consultant to the VC industry, lists it as the major problem for venture investors and this was confirmed in my interviews. He claims that the void is being partially filled by returnees from Silicon Valley.[30] This is true, but be careful of what you wish for. Hugh Wrigley of Duke Management Company (DUMAC) commented that "successful silicon valley managers can come back to China but will take time to learn or relearn local conditions". Others have no top level management experience so unless they bring in their own foreign team, the PE managers must educate and closely monitor their management.[32] Until this new generation of trained managers is ready to take over companies, buyouts in particular will remain heavily exposed. Many opportunities exist for investors, but finding capable managers to help by commercializing research, heading up companies etcetera is what Chengwei's Li called "the bottleneck". PE firms should vet their management closely, ensure compatibility, and then hire. Management will make or break companies.

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[30] Haemmig, Martin. 2004. "So You're Thinking of Investing in China." Israel Venture Capital Journal (IVCJ). Israel Venture Capital (IVC) Research Center.

[32] Kung, Andy (Principal), Pacific Venture Partners of Shanghai (June 20th, 2005). [China]

Bringing in your own trusted managers can be useful too, especially compared to the alternative of dealing with local Chinese management with ownership positions. The latter produces unfavorable situations called 老板问题 (laoban wenti), owner problems. Chinese owners are notoriously reluctant to relinquish control of their companies to outside investors. Thus, gaining majority stake positions are difficult and the challenge of influencing the direction of the company is compounded. Brad Huang, a Chinese born Yale MBA, says he avoids this problem by only looking at companies where he can gain substantial majority control. But. He is a mainland-born Chinese and consequently has better connections and is more trusted by the community there.

If a firm is foreign with no local partner, then its money is its only leverage and as was said PE money is a commodity.[34] Eric Li offered an additional solution, commenting that investors must seek out situations not where they are in control, but where managers they trust control the companies. He said this can provide greater flexibility and sustainability to investors' companies as business models and plans change. First and foremost, however, PE groups will have to gain the trust of the owners of these companies and educate them in order to convince them of the merits of accepting their investments and value-added services.[36]

Not only do you want to hire top-notch management and find owners you can deal with, but the PE manager must also ensure that the company's business is soundly protected. This means there must be high barriers to entry in the field so the company's comparative advantage is protected from China's rampant piracy. Chengwei Ventures Li advises PE managers to find companies that, "build barriers with trade secrets not IP". These barriers can also be created by offering services that can't be copied.

The best people are going to be in these fields too. In *China Inc*, Ted Fishman reported that the graduates of China's top tech school, Qinghua (Tsinghua), aren't developing commercial software etc, but going into industries where "their talents can be rewarded and protected rather

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[34] Zhang, Jason (Chief Representative of Asian Investments), Stanford Management Company (July 29th, 2005). [China]

[36] Wright, Ben. 2004. "Venture Capital Investment in China Isn't All That Scary." *The Business. (*November 7).

than stolen".[38] Look into those subscription services that can't be copied or company specific enterprise software etcetera. An unassailable niche will be the only dependable way to protect the value of investments before exit.

Analyzing Risk

There is money to be made in China, but you have to run the gamut of risks first. After assessing them, your firm must decide whether or not it can be compensated with appropriate risk-adjusted returns. One major risk is that China lacks the formal structure to support a vibrant PE industry. The investment banks and professional VCs that support the smoothly functioning investment machine in Silicon Valley are absent in Shenzhen. As mentioned above, such problems as piracy also plague the unwary investor because the legal system is weak compared to those of developed countries. National IP law will not save ripped off companies because it will not be enforced on the ground locally. Regions will protect local industries that create jobs and will ignore the laws from Beijing. What seems right for the Chinese economy will trump foreign investors' rights in courts, so they have to protect themselves on the front end by buying stakes in companies with other defenses.

Lawsuits are an option, but are often acrimonious affairs and ineffective, especially if the suing party is foreign. Not only may the long process make enemies of the consumers that investors' portfolio companies are wooing, but also of the Chinese politicians. This is because local governments have deep connections to their local businesses. So, taking on these companies, even when they cheat and are in the wrong, may enrage the officials and hurt portfolio companies' abilities to operate in China. Winning a lawsuit could be a pyrrhic victory.

If the government is against your firm, an investor's portfolio businesses are at best severely impeded in everything they do on the mainland and at worse finished forever. On a tour of a company controlled by Chicago's Baird Capital, one of the advantages repeatedly emphasized by management was that it had good relations with the government. This sped up permit approvals and other government processes by many months. That's months that their competitors can't compete if they are not on such good terms with officials. In China, the government controls most everything. Be their friend, especially on the local level.

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[38] Fishman, Ted C. 2005. *China Inc.* (New York: Scribner).

Being their friend does not mean that bribery should be an option. This is a short run strategy that is unnecessary now and will no doubt catch up with guilty firms in the long run in a bad way.

Another unpleasant surprise that might greet a foreign PE manager one day is to find out that Chinese companies are not educated on international business standards. This could mean that a portfolio company could have one accounting book filled out according to GAAP and one book completed according to Chinese standards. And they don't have the same numbers. Ouch. This could also lead to owners refusing to partner with PE firms' chosen managers because of desires to defend their absolute control over their companies. It could also mean that they refuse your value-adding advice once you invest. So, take the time to educate the owners and managers of Chinese companies when you invest. It will pay dividends.

China's structurally-higher risks should lead investors to demand returns on capital in excess of the 15-20% expected in the US. If PE firms are unable to locate opportunities providing such profits, they should not vainly hope for China's current growth and future prospects to somehow work in their favor. The Middle Kingdom has often fascinated the outside world, but rarely delivered on its promise. Be wary.

Don't Be Pessimistic, Be Flexible

As I confronted PE managers in China with the myriad difficulties facing them, some urged an avoidance of pessimism in favor of flexibility. Brushing aside my concerns, they said any investor with sound business practices, smarts, and a willingness to adjust could thrive in the tough investment environment.

The environment is indeed highly challenging and it's probably not getting much better in the near term. In their report to the World Bank on the Venture Capitalism industries of East Asia, Martin Kenney, Kyonghee Han, and Shoko Tanaka argued that "improving the environment for venture capitalism will require rethinking some of the central tenets of the way the Chinese government controls the economic environment."[39] This applies to PE as whole as

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[39] Kenney, Martin, Kyonghee Han, and Shoko Tanaka. 2002. "Scattering Geese: The Venture Capital Industries of East Asia: A Report to the World Bank." Berkeley Roundtable on the International Economy. Paper BRIE Working Paper 146. (September 17).

[42] Li, Eric (Founder, Managing Director), Chengwei Ventures (June 7th, 2005). [China]

well. So investors should not wait for drastic improvements soon, but instead use their savvy to work within the constraints.

Ok. So IP protection standards are not up to those of the developed world. Work around them. For example, VCs in the PRC invest in defendable enterprise software instead of easily pirated commercial software as mentioned above. Granted, the private equity investors I spoke with were almost all Chinese and spoke at least some Mandarin. So, it is a lot easier for them to navigate the local obstacles they face. To this I say once again to foreign groups, get a local partner.

Conclusion

As is obvious now, it is no easy thing to profit in China, but it is possible. Understanding China's capital market and how to locate specific outstanding investment opportunities can help PE firms succeed. First, PE investors should be aware that China's capital efficiency might affect their strategy. Walden's Brian Chiang noted, "China is more capital efficient than US companies so Walden can invest in more companies with less money than [in the US]". This does not necessarily bode well for investors. "Businesses are so capital-efficient that they don't need our money. Capital efficiency is a double-edged sword for investors, as entrepreneurs are in a better bargaining position where their need for capital is less and those that do need capital may be of lower quality" Duke Management's Hugh Wrigley added. In the past, Chinese owners could not access outside sources to fund their businesses, so they relied on their own family and friends for money. PE managers most difficult challenge, says Brad Huang, are to prove to these owners that they can add value via strategic alliances etcetera so their investment and guidance will be accepted. The PE field is growing ever more crowded in the PRC so investor groups will have to ensure that they can differentiate themselves in this way in good companies' eyes or they will be left with second best.

All investors know that China is a developing country. But what's really developing? Stanford's Zhang noted that "not every US company can come to China and be successful like if you are in early stage biotech". Opportunities obviously still exist in some technology fields, but China cannot match the developed world's innovative research or its commercialization of it, yet. Some PE types advised me that IT has done well on the mainland, but not to neglect the bread and butter industries that are supporting the basic infrastructure development of the massive country. Don't neglect consumer-focused companies either. Chengwei's Li commented that Chinese PE is different from the US in that there is not as much a focus on solely advanced technology and few are focused solely on specific niches within sectors. Bottom line: Think broad and be opportunistic.[42]

As firms seek out opportunities in China, they should be aware that local PE investors are predicting a bursting bubble in their arena soon. The majority of the victims will be foreigners they say, especially those without local partners. Andy Kung noted that, "those familiar with China VC won't invest as before because [the valuations are] too high". Why? Too many big, international firms with too little sense of the local environment are pushing them up to unsustainable levels. Newcomers miss out on smaller, less public deals and instead compete over widely available deals. Duke Management's Wrigley called this combination of competition and high valuations, "a pretty nasty cocktail".[44] A lack of awareness of China's different investor culture may be a cause. As Kung noted:

"US VCs put more emphasis on funding innovation; China VCs…always try to cut cost; when a US VC does deal then this VC gives a higher valuation and more capital to companies, but in Asia the VCs bargain with the management team to lower fundraising capital". Don't be a lemming. The best strategy for foreign PE firms right now may be to move into China, get their feet wet, and keep a tight fist on their wallets.

The Word on the Street: Advice and Strategies from the Experts.

Pacific Venture Partner's Andy Kung on where to look to invest: "In Asia there are not a lot of innovative products so one must figure out how to make products cheaper and cheaper and control cost because doing innovation is hard". Venture TDF Shanghai's David Su: "way too much capital [coming into China], so look more to early story…Only 2 or 3 firms do early stage investments in China". Article on Lip Bu-Tan: " 'bad habits' are too entrenched in older companies, so he avoids expansion-stage deals".[46] Walden's Brian Chiang: "US guys when they come in just want to find pre-IPO companies". Stanford's Jason Zhang: "Even if China grows to

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[44] Wrigley, Hugh. Private Investments, Duke Management Company (DUMAC). (September 26, 2005). [US]

[46] Stein, Tom. 2005. "Globe Trotters." *Venture Capital Journal*. (May 1).

half of US, this presents huge growth potential. [Investors] can wait until China is ready, but then all the potential is gone. Still, [Stanford] is not going to invest in China because China is somehow growing…only invest if a company can make money. Be patient and wait".

Martin Currie's Chris Ruffle Comment on Finding Managers: "Chinese managers you meet are hard men now; managers are former truck drivers etc. A number will end up in jail and a number on Time magazine".

These additional sources are anonymous to protect their identities:

Anonymous Source I: On legal protection for the private sphere: "Government officials have connections and corruption makes things better in China because government officials now have property and connections to investments and they want to protect their own investments".

Anonymous Source II: "[Governments like China's] are fine until they're not fine; then they are very not fine. You must never forget [about political risk]".

Anonymous Source III: "The government is smart enough to create a few successful private firms, but that doesn't mean that foreign firms can make a profit. The government just creates good images by making a few private equity firms successful by helping SOEs, but SOEs will be wiped out soon".