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Private Equity in China Comes of Age

It's still early days, but the private equity mania sweeping the world's major economies is starting to gain traction in China

by Frederik Balfour and Xiang Ji

The private equity mega-wave that is transforming global finance and business continues apace. Firms such as the Blackstone Group (BX), Carlyle, Goldman Sachs (GS), Kohlberg Kravis Roberts, the Texas Pacific Group, and others spent $737.4 billion in 2006 globally purchasing companies privately or buying stakes in outfits with plans to go public—more than double the level the year before, according to market researcher Dealogic. And there was $630 billion worth of deals done in the first half of 2007.

Yet until recently the dealmaking frenzy has pretty much passed China by. The Chinese government, wary of foreign dealmakers, last September clamped down on allowing Chinese companies to transfer their assets to offshore holding companies, a move regarded as a major blow for foreign private equity firms interested in eventually listing mainland companies overseas and recouping their investment.

The outlook for private equity deals in China, however, is starting to brighten, thanks to the white-hot performance of China's domestic stock exchanges and continuing, robust, economic growth. Share prices at the bourses in Shanghai and Shenzhen are up 58% and 117%, respectively, in 2007, though both markets are highly volatile. And that is generating insatiable appetite for new listings and providing an exit strategy for private equity outfits with a stomach for risk. "I think there is a lot of opportunity for private equity in China," says Chauncey Shey, chief executive officer of Softbank China Venture Capital.

TIED TO LOCAL AUTHORITIES

To be sure, the volume of deals is still very low and so far this year is up only to 24, from 22 for the same period last year, according to Thomson Financial. The value of private equity transactions from Jan. 1 to July 17 actually dropped 84%, to $678 million, compared with $4.2 billion for the same period last year. However these figures are distorted by the $3.8 billion pre-initial public offering investment in Industrial & Commercial Bank of China (ICBAF.PK) by a consortium including Goldman Sachs, Allianz (ALIZF.PK), and American Express (AXP).

Until now, domestic Chinese private equity firms have been tied to single companies or local authorities and jurisdictions. The best known is Hony Capital, the private equity arm of Legend Holdings, the parent company of Lenovo (LNVGF.PK). It has $720 million under management, and investors include Goldman Sachs and Temasek, the investment arm of the Singapore government.

The majority of the roughly 200 private equity firms in China are yuan-denominated funds, typically involved with earlier-stage investments, and are focused on the regions where they are based, giving them an inside edge over truly independent private equity firms. "Many people hope to raise capital from state-owned entities because if your fund has capital from state-owned entities, then your fund has the government's backing and therefore has the government's support," says Walter Huang, who plans to set up a Tianjin-based fund.

CASH-RICH INDIVIDUALS MOVING INTO PRIVATE EQUITY

Huang plans to take advantage of a new partnership enterprise law that took effect on June 1 allowing the formation in China of limited partnerships in private equity funds based on similar principles in the U.S. Though no new funds have yet received the green light, Bloomberg News reported that Fang Fenglei, the current chairman of a joint venture investment bank in China called Goldman Sachs Gao Hua, is considering raising up to $700 million in a local currency fund.

"There are now [cash-rich Chinese] individuals and institutions who have made money through IPOs and investments coming into domestic funds," says Neil Shen, founding managing partner of Sequoia Capital China, which has raised a total of $950 million to invest on the mainland. Shen should know. Ctrip (CTRP), the online travel outfit he helped found in the late 1990s, has been one of the best-performing Chinese companies on Nasdaq (NDAQ) since it listed in 2003, making him a multimillionaire.

While overseas listings have been the principal exit vehicle available to private equity funds, the domestic Chinese stock market is now becoming an increasingly viable alternative. Indeed, the decision by the government last September to disallow Chinese companies from registering offshore was aimed at ensuring more mainland companies would list locally.

FRENZIED COMPETITION FROM NEWBIES

But the booming stock market is a double-edged sword. With the price-earnings ratios for 2007 earnings of listed companies ranging between 30 and 40 times, target companies have an inflated idea of their worth, which is pushing up valuations paid during early stages of funding before companies are taken public. "The A-share [market] is good news for us, it's a bonus," says Kathy Xu, who runs Shanghai-based Capital Today, with $280 million worth of funds to invest. "We are serious about listing some of our portfolio companies in the A-share market."

Also, the expectation that cashing out from Chinese companies is easier than a few years ago has increased the field of competition as many firms with limited experience in China have been focusing on pre-IPO investments. "It's more competitive for sure," says Sequoia's Shen. This is resulting in double-digit price-to-projected earnings ratios today, compared with single-digit valuations a couple of years ago, says Marcus Thompson, chief investment officer at HSBC Private Equity (Asia). "There is always too much money chasing too few deals."

Of course, the potentially biggest factor in the future of the private equity landscape in China is the mammoth State Investment of China fund, which has been set up to manage about $200 billion of the country's $1.3 trillion in foreign currency reserves. Just a couple of months old, the fund made headlines in May when it took a $3 billion stake in private equity firm Blackstone. However the role the fund will play within China has yet to be seen (see BusinessWeek.com, 5/21/07, "China's $3 Billion Bet on Blackstone").

ACTING MORE LIKE VENTURE-CAPITAL FUNDS

Indeed, it's still early days for private equity in China, which ranks just 28th globally in terms of dollars invested. Though growing, the average deal size is still small too, largely because of the near absence of buyouts in the country where the largest companies are still controlled by the state, which finds foreign control over its assets unpalatable. "The headline message is, this is not a buyout market," says Michael Thorneman, who heads up the private equity practice at Bain & Co. in Shanghai. He reckons the average deal size is just $40 million.

As a result, private equity funds find themselves acting more like venture-capital funds in China. The small deal size also reflects the relative immaturity of the private-sector companies with short track records and fast and loose styles. "When we first find these enterprises they can often be in quite a shambolic state of affairs," says Thompson of HSBC.

Even non-controlling stakes by foreigners are subject to substantial approval delays. A deal by Carlyle to take a 45% stake in Xugong Group Construction Machinery for a price not yet disclosed—which was scaled back from an original 80% stake costing $375 million proposed in October, 2005—is still waiting approval by the government. "These things take a long time to come to fruition," Wayne Tsou, managing director of Carlyle Asia Investment Advisers, said in an interview earlier this year. A bid by Carlyle to take an 8% stake in Chongqing Commercial Bank for $43 million was rejected by the Chinese government.

Complicating matters is the pervasive feeling within China that past deals, such as pre-IPO stakes, have allowed foreigners to make windfall profits on state assets. Selling to foreigners is particularly sensitive at the moment, as China gears up for the Communist Party Congress in the fall. "People don't want to be seen politically selling assets too cheaply," says Richard Gibb, head of financial institutions group at Merrill Lynch (MER). "That's not good for their careers."

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