Private equity roundup China

Building a better working world

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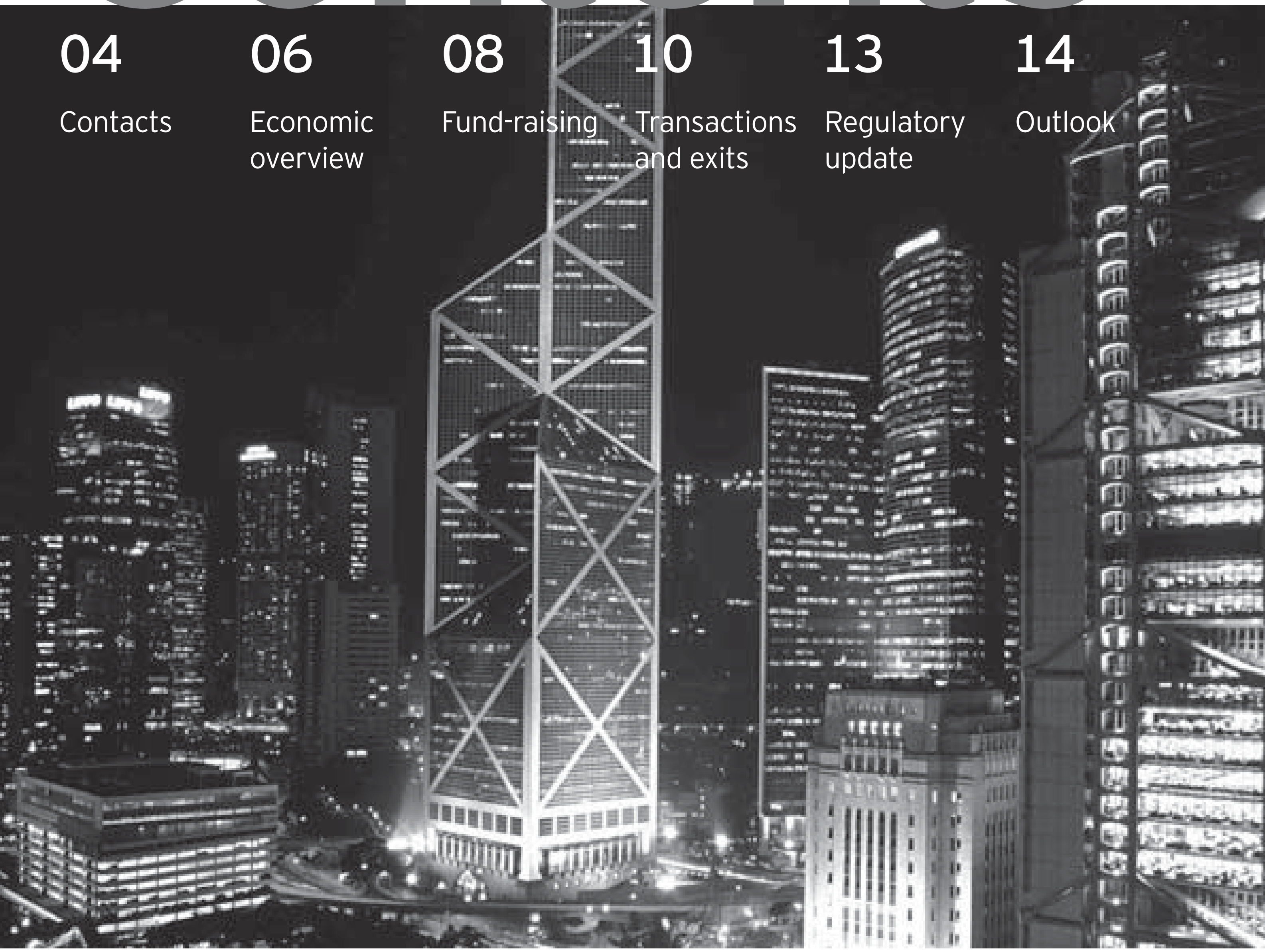

About

Over the last several years, the emerging markets have evolved into a critical pillar of global investors' strategies. With growth rates declining across most of the developed world, private equity (PE) firms have turned to emerging markets as an engine of growth. Just five years ago, the emerging markets represented approximately 12% of total PE fund-raising. Now, they account for more than 20%.

EY's *Private equity roundup* series delves into the drivers of fund-raising, investment activity and exits across a range of developing economies, including Latin America, China, India and Africa. Our quarterly, semiannual and annual reports deliver fresh insight into the forces shaping activity, including macroeconomic trends, regulatory developments and capital markets activity.

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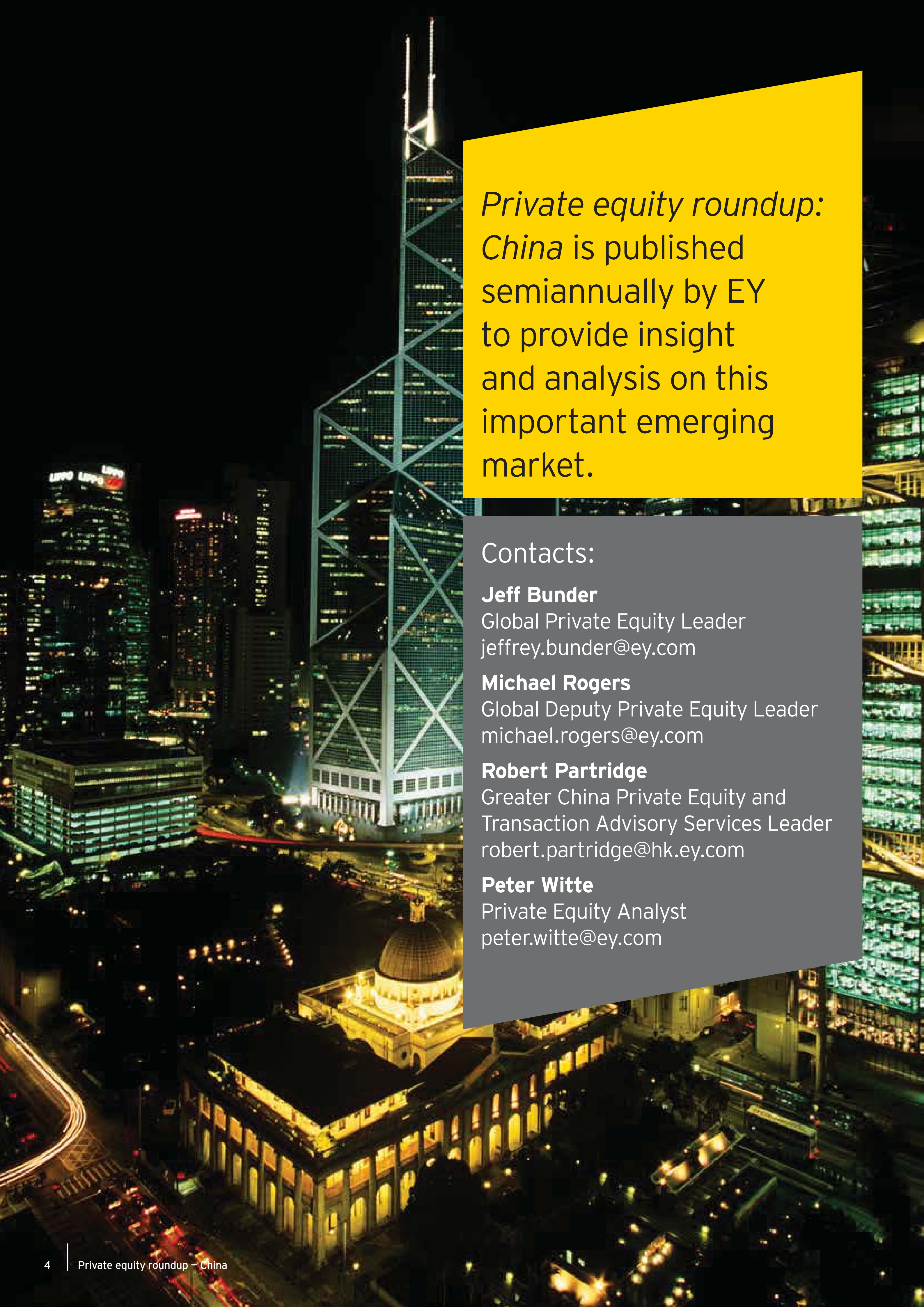

Private equity roundup: China is published semiannually by EY to provide insight and analysis on this important emerging market.

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Despite growing pains, China thesis remains intact for PE funds

Over the last decade, China has undergone one of the most remarkable transformations in modern history. Built on the strength of high demand for the country's exports and significant investment in heavy industry, China experienced several years of double-digit growth between 2003 and 2010, which have propelled the nation's economy to the second largest in the world.

However, China now finds itself at one of the most important periods in its recent history. After peaking in 2007 at 14.2%, China's GDP growth has steadily decelerated. In recent quarters, the slowdown has picked up pace, as China undertakes the structural reforms necessary to transition its economy from its export-led roots to a more sustainable model driven by domestic demand. Unprecedented market reforms — designed to reign in excess lending, reduce bureaucratic processes and open the market to increased investment — are currently underway.

PE firms have been investing in China's transformation for years, plowing billions of dollars into a wide array of consumer-driven industries such as health care, food and beverage, retail, telecom and other industries poised to accelerate as more of China's population of 1.3 billion enters the middle class.

However, in the first half of 2013, activity slowed, as the prospects of diminished growth over the near term met with regulatory uncertainty, and perhaps most importantly, a lack of liquidity for PE investors. Fund-raising in the first half was essentially flat versus the second half of last year, and transaction volume fell to US$4.3b in H1 2013, from US$8.7b announced in H2 2012.

Despite the slowdown, PE firms remain optimistic. Over the last several years, regulatory uncertainty has been a drag on activity as regulators grappled with PE's rapid expansion. Recent developments, however, suggest that increased regulatory certainty may be on the horizon, as policymakers work to develop a unified regulatory framework. This would be an important step in the continued maturation of the industry.

Moreover, activity has been challenged in recent quarters by a lack of exits, as IPOs on China's mainland exchanges ground to a halt while regulators undertook reviews designed to ameliorate concerns around the quality of new listings. With the moratorium seemingly nearing an end, exits could resume in the next several months. While a significant backlog will persist over the near term, increased liquidity will give LPs the confidence needed to make new commitments, and give GPs the conviction to make new investments.

In the meantime, PE firms have been actively working with companies to prepare them for the challenges ahead — instilling financial discipline, driving operational efficiencies and funding new growth plans. With growth rates moderating, PE's core competencies will be more important than ever to the legions of China's entrepreneurs and family businesses as they work to navigate and thrive in this new landscape.

1 Economic overview

China's rapid growth continued its trend of moderating in the first half of 2013, as the nation's leadership focuses on rebalancing the economy. China is implementing structural changes designed to help it transition from one led by exports and heavy industry to a more sustainable model with heavier emphasis on domestic consumerism.

Growth rates continue to moderate after 2012 deceleration

China's rapid growth moderated in the first half of 2013. Growth declined to 7.7% in the first quarter and 7.5% in the second quarter, marking five straight quarters of sub-8% growth. Reasons for the decline include pressure in recent quarters from slowing exports to Europe and the US coupled with domestic demand that has remained stagnant in the face of concerns around an overheated real estate market and slow wage growth.

After dazzling the world with the breakneck pace of its growth for much of the last decade, China now finds itself at an economic crossroads. Many of the policies that enabled the nation to grow into the world's second-largest economy have now run their course. China's leadership is now clearly focused on developing the model that will deliver the nation into the next century — based on sustainable growth driven by domestic demand.

While these initiatives are rife with long-term payoffs, many of these changes could limit growth over the near term, as China works to rebalance its economy and effect structural changes designed to accelerate wage growth and domestic spending.

Indeed, China's new leadership has already telegraphed comfort with growth rates within the current range and a reluctance to introduce additional stimulus — all in the name of transitioning China from a developing economy to one which is stronger, more resilient and more mature.

Economic overview

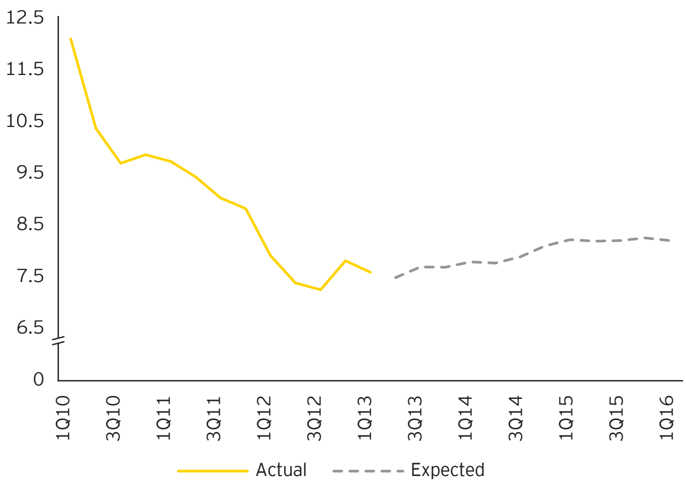
The continuing rise of the consumer

As a result, the near-term risk to China's economy has increased. But, the long-term outlook for PE in China remains strong. While growth rates are moderating relative to China's historically high standards, they are still expected to remain well above those in the US and across Europe. Barring any significant economic shocks, growth rates in the US and Europe are expected to average 2.9% and 1.2% respectively, over the next five years. Additionally, less reliance on Government intervention presupposes additional need for investment from private sources, of which PE can play a critical role.

Most importantly, Beijing's focus on the continued development of the domestic consumer implies significant opportunities for PE. Over the last decade, millions of Chinese have entered the middle class. Currently, the middle class accounts for approximately 12% to 15% of China's 1.3 billion population. Over the next decade, this could grow to more than 40% of the population, and some estimates suggest that China's middle class could ultimately become as large as 70% of the country's population. As a result, sustained demand for a wide range of consumer products including electronics, automobiles, mobile devices, health care, travel and education is expected to outpace overall GDP growth for the foreseeable future.

It is in these sectors where we expect to see continued PE activity. Rising consumerism has been an investible theme throughout the emerging markets, perhaps nowhere more so than in China. As the nation continues to pursue a strategy of moderated, pro-consumption growth, the opportunities for PE investors will continue to increase.

Figure 1. Quarterly actual and expected China GDP growth, 2012–2016



Source: Global Insight

40%

of China's 1.3 billion population could reach the middle class by 2020.

2 Fund-raising

Fund-raising for China's PE market met with significant headwinds in the first half of 2013. Slowing economic growth, regulatory uncertainty, and most importantly, a lack of liquidity is prompting many LPs to take a wait-and-see approach to new commitments. However, differentiated firms with strong teams and proven track records continue to close funds and will be active players in the market.

Fund-raising declines as LPs look for liquidity

China's rapid growth continues to attract new PE capital, although the pace of fund-raising has leveled off over the last 12 months. Having completed significant fund-raisings during the 2010 to 2012 timeframe, many funds focused on China now have ample capital available and limited need to return to the market. Additional headwinds in the form of slowing economic growth, limited distributions from current funds and the continued evolution of the regulatory landscape are also causing many investors to take a wait-and-see approach to additional commitments.

Firms raised US$8.8b in the first half of 2013, in line with the US$8.7b raised in the second half of last year. The first quarter was more robust, with US$5.2b, accounting for nearly 60% of the total commitments closed during the period.

Renminbi (RMB) assets accounted for just under one-third of the total amount raised, which was down from the 67% they represented in H2 2012. This trend could continue, as foreign funds react to increased uncertainty around the status of foreign-raised RMB funds.

In 2010, the Qualified Foreign Limited Partners Program (QFLP) was announced as a way to let foreign investors convert assets into RMB without prior approval from the State Administration of Foreign Exchange (SAFE). While foreign-based RMB fund-raising had been already ongoing for some time, the program held promise as a way to open the market to foreign-owned funds. However, last year the National Development Reform Commission (NDRC) placed strict limits on the types of funds that can be classified as local, which significantly diminished the impetus for foreign-based RMB funds.

Recent rulings from the China Securities Regulatory Commission (CSRC) that limit the ability of PE firms to partner with banks to raise funds could also have a significant impact on future fund-raising.

Perhaps the greatest threat to fund-raising in China, however, is a lack of distributions. While interest in China remains high, LPs are seeking to invest in GPs with established track records and a proven ability to effectively exit their investments. With China's moratorium on IPOs having closed off the industry's preferred exit route for the last nine months, PE firms face increasing difficulty in demonstrating their ability to produce liquidity events for their investors.

Notably, however, the issue of an exits overhang is not unique to China. While the underlying causes differ, and the suddenness with which the issue has presented itself is markedly greater in China, PE firms across the developed markets are similarly grappling with ageing PE portfolios and an exits market that must accelerate significantly. For example, our analysis suggests that at current run rates, it could take approximately 7 years to exit the current North American PE portfolio and more than 11 years in Europe.

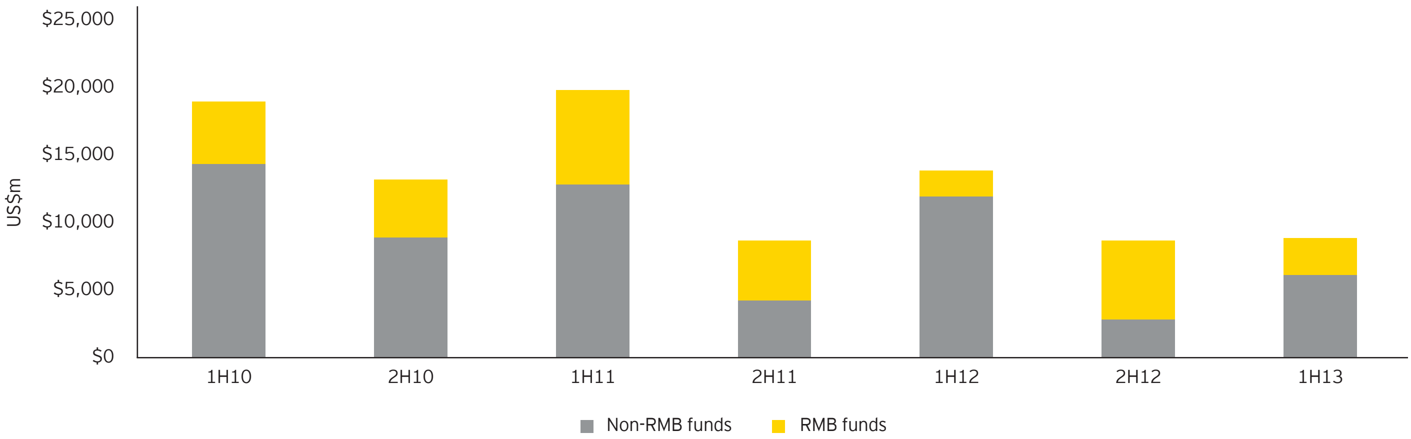
However, while significant challenges exist, optimism remains high. Growth rates continue to be higher than much of the rest of the world, and China's developing economy continues to provide attractive opportunities for PE firms offering financial discipline and operational expertise. Firms with differentiated strategies, strong teams and unique value propositions will continue to see strong demand from investors.

Fund-raising

The largest fund to close in the first half of the year was the US$3.5b RRJ Capital Master Fund II. The second fund from Hong Kong and Singapore-based RRJ Capital, the fund spent just seven months on the road. Although the firm was launched in 2010, RRJ's founder, Richard Ong, was the founder and former CEO of Hopu Investment Management Co.'s US$2.5b fund. The fund-raising helped RRJ move into the top 50 of the recently released Private Equity International PEI 300 rankings. Its five-year fund-raising total of US$5.8b has made RRJ the fourth largest domestic firm in China.

In addition to funds focused exclusively on China, there remain a number of pan-regional funds that have recently closed or are currently in the fund-raising process. Among these are TPG's sixth pan-Asia fund, with a target of US$4b and KKR Asia Fund II, which closed with US$6b, making it the largest-ever pan Asia PE fund.

Figure 2. Quarterly China fund-raising, January 2010–June 2013 (US$m)



Source: Preqin

Figure 3. Funds closed 2013 YTD

Fund name	Manager	Type	Commitments (US$m or RMBm)	Closed	Industry focus
RRJ Capital Master Fund II	RRJ Capital	Buyout	US$3,500	10 March 2013	Diversified
Urban Construction Fund	Suzhou International Development Venture Capital Holding	Infrastructure	RMB10,000	17 April 2013	Infrastructure
FountainVest China Growth Partners II	FountainVest Partners	Growth	US$1,350	13 November 2012	Diversified
L Capital Asia II	L Capital Asia	Growth	US$1,000	12 June 2013	Health care, consumer products, Retail, consumer services, beverages, entertainment, food
CITIC Capital China Retail Properties Investment Fund	CITIC Capital	Real Estate	RMB4,300	5 June 2013	Property

Source: Preqin

3 Transactions and exits

The last 12 months have seen a number of large take-private deals for China-based companies. However, with valuations rising in the US and continued pressure on China's equity markets, the valuation gap is narrowing. Moreover, with so many deals over the last several quarters, the population of attractive targets is dwindling.

Transaction activity declines versus H2 2012, as take-privates take center stage

PE firms announced 108 transactions valued at US$5.2b in the first half of 2013 up over 20% from the US$4.3b announced over the same period a year ago, but down from the US$8.7b announced in new deals in the second half of 2012.

Among the largest of these was the US$875m bid for AsiaInfo-Linkage by a consortium that included CITIC Capital Partners, Temasek Holdings, and China Broadband Capital Partners. The Beijing-based company, which listed on the NASDAQ, produces billing and customer relationship management software used by major telecoms throughout China. The company was initially approached by CITIC Capital Partners over a year ago and ultimately agreed on a price that represented over a 50% premium to the public valuation. The deal is currently expected to close in August, at which point it would delist from the NASDAQ exchange.

Another significant deal was the May closing of the take-private of digital advertiser Focus Media by a consortium that included The Carlyle Group, CITIC Capital Partners and FountainVest Partners. At US$3.7b, the deal marked the largest-ever buyout of a Chinese company. Focus Media went public in July 2005 on NASDAQ, and reached a peak of US$65 by November 2007. However, as concerns around accounting practices by Chinese companies grew in 2012, shares fell to less than US$20, providing an opportunity for privatization.

The AsiaInfo-Linkage and Focus Media deals were just two of a number of recent take-privates that have seen Chinese companies listed on global exchanges shift into the hands of PE ownership. Over the last 18 months, 9 companies have received offers from PE firms to delist from global exchanges. Another 25 companies delisted or are in the process of delisting after receiving offers from strategic acquirers. Many of these deals were predicated upon a marked differential in the valuations afforded them between the US and European exchanges and their potential valuations in China. However, with valuations rising in the US and continued pressure on China's equity markets, this valuation gap is narrowing. Moreover, with so many such deals over the last several quarters, the population of attractive targets is dwindling.

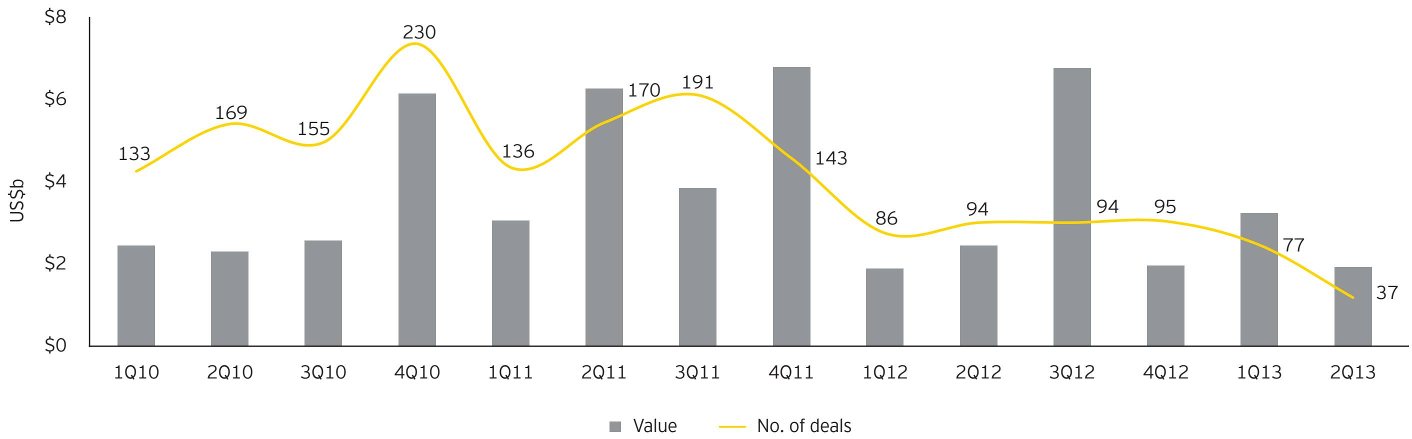
As a result, it remains to be seen the extent to which the take-private trend will continue. In the meantime, firms that undertake such deals will need to be increasingly mindful of the importance of thorough due diligence. Many of the remaining foreign-listed companies have been already been thoroughly reviewed by a number of PE firms. Finding value while avoiding potential pitfalls will increasingly require both creativity and caution in equal measure.

Transactions and exits

While the days of privatizations may be drawing to a close, the trend towards Western-style buyouts could continue as China's market matures. China has a deep pool of mid-market companies, many of which are family-owned and facing significant succession issues. Moreover, China's banks are becoming increasingly comfortable with the strategy and anecdotal evidence suggests they are becoming more aggressive in their lending practices for such deals. While the Chinese lending market has a long way to develop before it sees US and European level debt multiples become available in China, some firms are moving to get ahead of the trend. Given the limited attractiveness of pre-IPO investments in the current environment, a shift toward traditional buy-and-hold investments could fill an important role in helping firms to deploy capital on a larger scale.

Growth capital deals will continue to play an important role as well. China's rapid economic growth has taken small-scale companies that began years ago and transformed many into complex organizations with operations crossing multiple geographies. With GDP growth settling in at lower rates than in the past, many entrepreneurs are looking to PE as a source of operational expertise and financial discipline that will enable them to grow at elevated rates relative to the broader economy.

Figure 4. China PE deals



Source: Thomson One; through 30 June 2013

Figure 5. Announced deals 2013 YTD

Company	PE firm	Deal value (US$m)	Date	Sector
Gansu Jiu Steel Group Hongxing Iron & Steel Co. Ltd.	Haixiang Tianjin Venture Capital Management, Rich Asset Management Co., Ltd.	1,294.67	29 January 2013	Mining and metals
Asiainfo-Linkage Inc.	CBC Capital, CITIC Capital Partners, Ltd., CITIC Private Equity Funds Management Co. Ltd., Temasek Holdings Pvt Ltd.	874.85	13 May 2013	Technology
7 Days Group Holdings Ltd.	Actis LLP, The Carlyle Group L.P., Sequoia Capital	688.00	28 February 2013	Real estate
Beijing Jingdong Century Trading Co Ltd.	Kingdom Holding Co., Tiger Global Management LLC	400.00	16 February 2013	Retail and wholesale
3SBio Inc.	CPE China Fund, L.P.	370.00	30 May 2013	Life sciences

Source: Thomson One

Transactions and exits

PE firms focus on value creation as IPO moratorium wears on

Among the key drivers for China's rise on investors' radars has been the evolution of the nation's capital markets. Where investors were once limited to overseas listings in the US mainland or Hong Kong, or trade sales to strategic investors or fellow PE firms, China's efforts to modernize its capital markets have not gone unnoticed by the industry. However, recent quarters have seen the China IPO machine ground to a halt, as regulators imposed a moratorium on new domestic listings beginning last October.

The driver behind the stoppage is concerns by authorities around listings by companies without the necessary robust governance and accounting practices required to sustain investor faith in China's public markets. The result was a de facto halt to mainland listings, as China's primary securities regulator, the CSRC, undertook a series of reviews of companies in the IPO pipeline in order to improve the quality of the country's listings.

In the meantime, PE firms have been exploring a range of alternative exit options, including trade sales and secondaries. Moreover, they have continued to focus on implementing the operational improvements, growth policies and governance initiatives needed in order to optimally position their companies to clear regulatory hurdles and cultivate strong demand from public market investors.

While there has been no official word on when China's IPO market will reopen, speculation is growing that new listings could be imminent. Already, China's A-share market has seen an increased volatility in recent weeks in anticipation of reduced liquidity as new IPOs hit the market.

When listings do resume, there will be a significant backlog of companies seeking to move forward with an IPO, which could take several years to fully resolve. Despite nearly 300 companies pulling their IPO plans in light of additional scrutiny from regulatory authorities, there remain more than 700 companies, many of which are PE-backed, in the IPO pipeline.

While IPOs were offline for the first half of 2013, the year has not been without significant exits from a number of PE firms. According to Dealogic, there were nine trade sales by PE firms in the first half of the year, with a combined value of US$2.6b.

Among the largest of these trade sales was the US$1.6b sale of baby formula producer Yashili International to China Mengniu Dairy in June by The Carlyle Group and Zhang International Investment. The two firms acquired a two-thirds stake in Yashili in 2009 and worked with the company to internationalize its operations, including setting up facilities in New Zealand. This was the second PE portfolio company acquired by China Mengniu Dairy, which bought China Modern Dairy from KKR and CDH Investments in May for a reported US$310m.

The backlog of exits is one of the most important issues facing China's developing PE market. The lack of distributions is giving pause to LPs who might otherwise allocate new commitments, and the uncertainty around timing is a drag on the pace of new acquisitions. As these markets improve, they will not only drive liquidity, but a renewed wave of PE activity across China.

With the IPO moratorium still in effect, PE firms are focused on necessary operational improvements, growth policies and governance initiatives to optimally position their companies when the window reopens.

4 Regulatory update

The rapid evolution of the PE industry in China has challenged regulators to keep pace, with multiple regulatory agencies exerting oversight. Recent reports, however, suggest that a unified regulatory regime may be forthcoming.

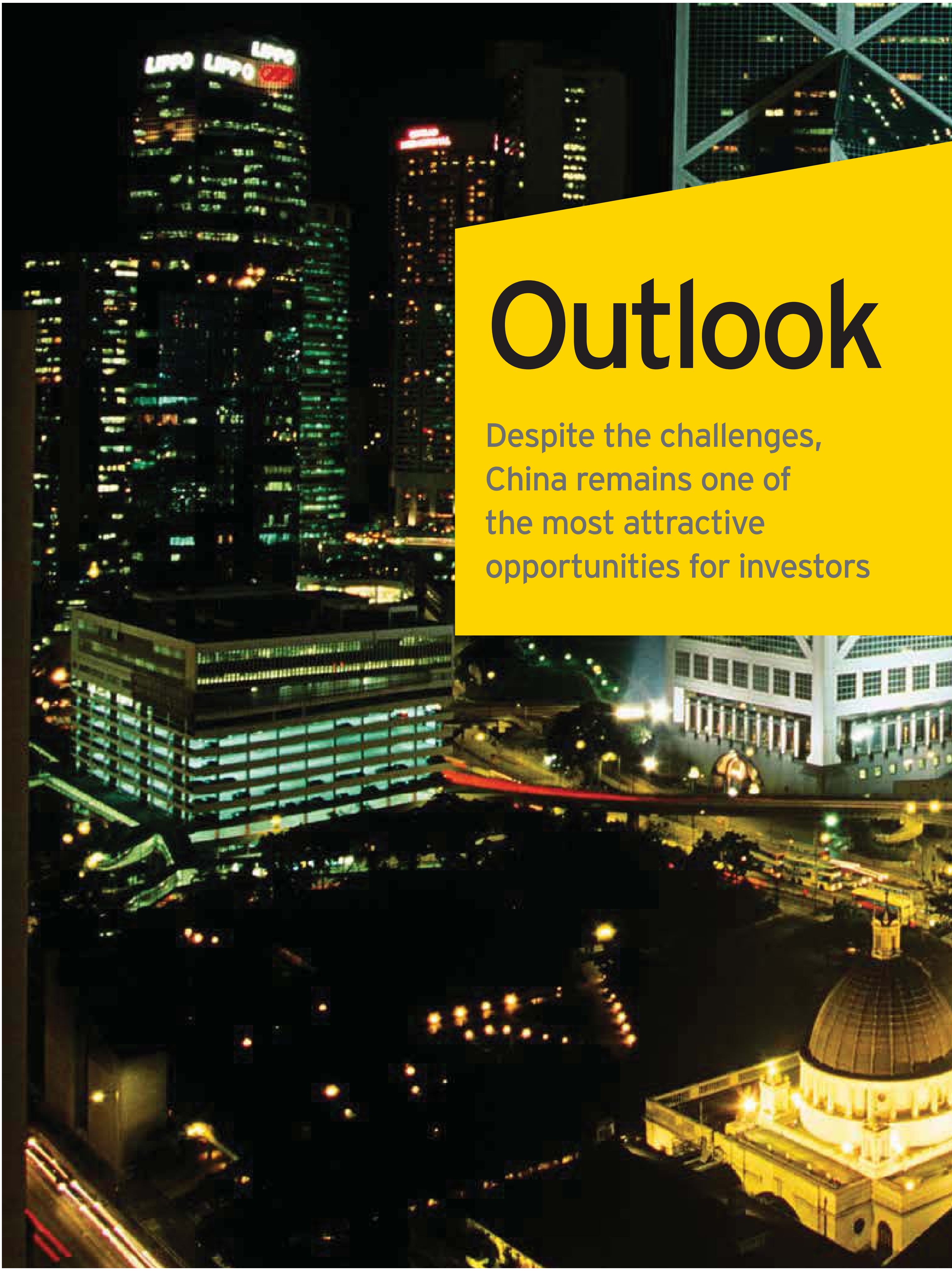
Is greater regulatory certainty around the corner?

The rapid development of China's PE industry and the massive influx of capital in recent years has spawned significant challenges from a regulatory standpoint. While the prevailing trend has been towards greater acceptance of PE investment amid increasing recognition of the critical role it can play in China's economy, jurisdictional disputes have clouded the operating environment for PE funds in China. Over the last several years, both the NDRC and the CSRC, have issued regulations affecting the industry, which have sometimes conflicted with one another.

Recent reports suggest that the uncertainty may be coming to a close. In late June, the State Commission Office for Public Sector Reform of China (SCOPSR) released a circular that outlined the scope of each agency's mandate. Lead oversight for the administration of PE funds would be handled by the CSRC; the NDRC would be responsible for developing related regulations to guide and promote the development of the industry.

Although much yet remains to be defined, China is clearly taking steps to provide increased transparency around the regulatory structure. A unified regulatory framework is an important step in the continued maturation of the industry, and the lack thereof would have been a significant impediment to the further development of PE in China at a critical time.

Over the next several months, it is expected that the agencies will work together to address and clarify previously issued guidance and identify and resolve overlaps. As a result, a new round of regulatory pronouncements could be imminent. As the new regulatory regime begins to coalesce, PE players in China and throughout the world will be watching closely anxious to assess the impact on their firms and the landscape in which they operate.



Outlook

Despite the challenges, China remains one of the most attractive opportunities for investors

China is currently in the midst of significant structural reform that could place a cap on activity over the near term. However, despite a slowing economy, China remains a place that diversified investors see as critical for their continued growth.

Moreover, a number of factors suggest that the long-term China thesis remains intact: China's leadership has successfully completed its transition, removing much of the political uncertainty that has characterized the market in recent quarters. Recent regulatory developments look poised to give investors increased certainty around the regulatory landscape. The mainland IPO markets are expected to reopen soon, ending the IPO moratorium and markedly increasing firms' abilities to exit. Most importantly, at just 0.08% of GDP, or less than one-tenth the rate of the US and Europe, China remains significantly underpenetrated by PE investors.

There remains a massive population of privately-held small and medium enterprises, which are increasingly looking to PE as a funding source as entrepreneurs and family owners become more familiar with the benefits that partnering with PE can bring. As Beijing works to reign in speculative lending, the opportunity for high-quality firms with attractive value propositions and genuine operational expertise will only increase.

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