Private equity roundup
China
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Rising interest rates in the US and increased macroeconomic stability across Europe are precipitating a reversal of asset flows from the emerging markets back to the developed markets, which is likely to continue to create near-term volatility for many emerging economies. However, the underlying secular trends that have made China increasingly attractive to PE firms over the last decade – notably, a rising middle class and favorable demographics – remain intact. They will continue to play out over the course of the next decade and will continue to provide PE firms with a wide range of compelling opportunities.

EY’s Private equity roundup series delves into the drivers of fund-raising, investment activity and exits across a range of developing economies, including Africa, China, India and Latin America. Our quarterly, semiannual and annual reports deliver fresh insight into the forces shaping activity, including macroeconomic trends, regulatory developments and capital markets activity.
Private equity roundup – China is part of a series from EY focusing on private equity activity in the emerging markets.

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Introduction

China’s remarkable growth remains the most compelling story in the global economy today. Decades of strong performance have propelled China to the second-largest economy in the world, and China’s share of global GDP is now four times what it was in 1997. Recent quarters, however, have seen a measure of deceleration in China’s once white-hot growth, as the nation comes to terms with the sustainability of its trajectory and seeks a way to inject a greater degree of balance into its economy. To that end, 2013 was a year of transition – not just economically, but politically and socially, as China’s Government works to implement structural reforms designed to increase productivity, reduce regulatory barriers to business, rein in corruption and increase market competition.

Despite the short-term impacts of rebalancing China’s economy, the long-term secular trends driving China’s growth remain undiminished. China is in the midst of transforming from its export-led roots to a more consumer-driven economy, propelled by the nation’s expanding middle class and continuing urbanization.

Private equity (PE) in China, like the nation itself, is entering a new stage in its development, with firms placing an even greater emphasis on developing long-term value creation strategies that benefit their investors, the portfolio companies and China’s economy as a whole. China’s domestic PE industry is rapidly becoming increasingly sophisticated in the deals they pursue and more comfortable with complexity and scale.

PE fund-raising and investment activity both moderated in 2013. At fault were diminished growth and the regulatory moratorium on mainland IPOs, which had a chilling effect on PE activity across all stages of the cycle. Investors hesitated to commit to funds, unsure when they would see realized returns. Transaction activity diminished as few pre-IPO deals were consummated, and exits suffered from lack of access to China’s preferred exit route. While sales to strategic investors and secondary buyouts picked up some of the slack, there remains an overhang of portfolio companies in need in liquidity events. However, with a reopening of the IPO markets currently in process, and economic activity poised to increase, the environment is becoming increasingly accommodative for an acceleration of activity over the next several quarters.
After almost three decades of strong double-digit growth that has unlocked much of the country's vast potential, China is now at a crossroads in its economic evolution. The country is in the midst of moving toward a more sustainable growth model, with greater balance and diversification its key hallmarks. China's new generation of leadership, led by Xi Jinping, is expected to bring continuity to current policies while strengthening its focus on reforms intended to move China beyond the “growth at any cost” phase of its evolution in favor of higher-quality development.

As a result, China's growth rates have moderated from the stratospheric levels of just a few years ago. In 2013, China grew at 7.7%, in line with 2012, and slightly beating consensus expectations of 7.6%. During the second half of the year, Beijing adopted a series of small stimulus measures designed to spur growth. Domestic demand was driven by investments in infrastructure, which helped to offset weak external demand. Last year was a slower year for exports, the result of muted demand from the US and Europe, although signs of recovery began to emerge in November, when growth rates returned to double-digit levels. Global economic factors are also driving significant fluctuations in the yuan, pressuring many of China’s companies and potentially stemming the flow of cross-border transactions.

Figure 1. GDP growth and investment as a percentage of GDP, 2009-16

Source: IMF
Economic overview

Despite the macroeconomic deceleration, the outlook for China in 2014 is largely positive, driven in part by a reform-minded government agenda. On December 9, the Government announced a financial reform package designed to increase flexibility in the financial system. These measures should have a positive impact in the credit markets. Moreover, additional reforms are expected in the social, fiscal and judiciary arenas in the coming quarters. The impact of these reforms on PE could be profound, attracting additional private investment to China and allowing growth to continue at elevated rates, albeit well below the double-digit growth experienced in some past years.

At the local level, overinvestment throughout the last decade has led to high indebtedness for many local governments. As a result, there is an increased role for private investment in driving China’s additional growth. Moreover, the ascension to the middle class of millions of people has created a huge consumer base that should keep internal demand resilient, the result of higher family incomes and increasing property prices.

As 2014 unfolds, China remains alert toward the need for additional policy interventions to support growth targets, and as needed. With China’s industrial sector well-positioned, many measures will now be focused on consumption, in particular services, a segment that has seen significant investment from PE investors in the past and that looks poised to remain rife with opportunities over the near- to mid-term time horizon.
Fund-raising

PE firms raised a total of US$19.8b in 2013.

After a robust 2012, China saw a muted year for fund-raising in 2013. PE firms raised US$19.8b, down from US$28.7b in 2012. Approximately 30% of the aggregate value came from RMB funds, which was slightly lower than last year. After starting the year essentially in line with the first half of 2012, with US$12.7b raised, fund-raising in China saw a sharp deceleration in the second half of the year, with just US$7.1b raised, down from US$14.8b over the same period in 2012. The third quarter was particularly quiet, accounting for just US$2.8b.

Many attributed China’s moratorium on IPOs as a key factor in the decline. Investor uncertainty around exit timing and liquidity led many to scale back their intended allocations, especially to funds with a significant focus on the pre-IPO space.

Figure 2. China PE fund-raising, 2012–13 (US$m)

Source: Preqin
Fund-raising

Despite the slowdown, high-quality funds continue to be in demand, and the year saw final closes from a number of significant funds. The largest of these was the second-half closing of MBK Partners III, which closed with US$2.7b in October. MBK set an initial target of US$2.25b for the fund, which was launched in September 2012 and reached a first close of US$1.25b just two months later.

While aggregate fund-raising in 2013 ended lower, the outlook is positive. Globally, fund-raising is on an upswing. Last year was the best year for global PE fund-raising since 2008. PE firms raised a collective US$401b, well above the US$341b they raised in 2012. Cash distributions to globally diversified LPs are rising, enabling them to reinvest in the asset class in greater amounts relative to recent years. Perhaps most importantly, in December 2013, China ended the IPO ban that had been in place since November 2012, reopening the industry’s preferred exit route in China. While ultimately achieving exits for the current backlog of PE portfolio companies could take some time – the China Securities Regulatory Commission said in a statement in November that 760 companies are waiting for their IPOs – it is a critical component to the health of the industry. Sales to strategic investors and PE secondaries have picked up some of the slack in the meantime, but a functioning IPO market will give investors the liquidity and the confidence they need to allocate additional assets to China-focused funds.

Figure 3. Largest PE funds to close in 2013

<table>
<thead>
<tr>
<th>Fund name</th>
<th>Manager</th>
<th>Type</th>
<th>Commitments</th>
<th>Closed</th>
<th>Industry focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>RRJ Capital Master Fund II</td>
<td>RRJ Capital</td>
<td>Buyout</td>
<td>US$3,500m</td>
<td>10 Mar 13</td>
<td>Diversified</td>
</tr>
<tr>
<td>MBK Partners III</td>
<td>MBK Partners</td>
<td>Buyout</td>
<td>US$2,670m</td>
<td>17 Oct 13</td>
<td>Diversified</td>
</tr>
<tr>
<td>Guochuang Kaiyuan Fund of Funds</td>
<td>China Development Bank Capital</td>
<td>Fund of funds</td>
<td>CNY15,000m</td>
<td>28 Feb 13</td>
<td>Diversified</td>
</tr>
<tr>
<td>Urban Construction Fund</td>
<td>Suzhou International Development</td>
<td>Infrastructure</td>
<td>CNY10,000m</td>
<td>17 Apr 13</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>CLF Fund I</td>
<td>Global Logistic Properties</td>
<td>Real estate</td>
<td>US$1,500m</td>
<td>14 Nov 13</td>
<td>Property</td>
</tr>
</tbody>
</table>

Source: Preqin
Take-private transactions continued to play a role in 2013, a year that saw 161 transactions with a total value of US$10.8b.

PE firms announced 161 separate transactions with an aggregate value of US$10.8b in 2013, an 18% decline from the US$13.1b announced in 2012. The third quarter was the most active by value, with US$3.9b in announced deals, while the fourth quarter was the least active, with just US$1.7b in aggregate deal value.

Take-private transactions have been a powerful trend in recent years, and 2013 was no exception. The year saw the largest take-private ever of a US-listed company by a Chinese company, when Smithfield Foods received a US$7.1b offer from Shuanghui International Holdings. Shuanghui is backed by CDH China Holdings Management, Temasek Investments, New Horizon Capital and Goldman Sachs.

Other significant transactions during the year included the US$1.5b take-private of Giant Interactive Group. The NYSE-listed company received a US$1.5b take-private offer in November from the company’s chairman, Yuzhu Shi, and Baring Private Equity.

Figure 4. Value of China PE acquisitions, 2012–13 (US$b)
The company, founded in 2004, develops and operates online games primarily for the China market. The company first listed on the NYSE in 2007, in an offering that raised US$886.5m for the company and its shareholders. The year also saw the privatization of telecom software provider Asiainfo-Linkage by a consortium that included CITIC Capital Partners, Temasek Holdings and China Broadband Capital Partners which was announced in May 2013 and was completed in mid-January 2014.

These deals underscore the growing sophistication and reach of China-based funds. Where not long ago, local funds were focused largely on the domestic market, firms are increasingly seeking opportunities outside their local market that provide both scale and the potential for high growth. While many of these deals have most recently taken the shape of take-private, local firms may increasingly look to global carve-outs, private sellers and even secondary buyouts as sources of deal flow. With valuations rising in the US and a dwindling population of viable candidates, the time for Chinese take-private deals may soon be coming to a close, and the next stage of the cycle could soon begin, as PE firms begin to relist companies acquired in delistings over the last several years.

Figure 5. Largest PE deals 2013 (excludes add-on transactions)

<table>
<thead>
<tr>
<th>Announcement date</th>
<th>Target</th>
<th>Deal value (US$m)</th>
<th>Financial sponsor</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 Jun 13</td>
<td>Giant Interactive Group Inc. (52.0656%)</td>
<td>$1,534.4</td>
<td>Baring Private Equity Partners Ltd.</td>
</tr>
<tr>
<td>06 Nov 13</td>
<td>Gansu Jiu Steel Group Hongxing Iron &amp; Steel Co., Ltd.</td>
<td>$1,294.7</td>
<td>Haixiang Tianjin Venture Capital Management Co. Ltd., Rich Asset Management Co., Ltd and 7 undisclosed firms</td>
</tr>
<tr>
<td>15 Aug 13</td>
<td>Asiainfo-Linkage Inc.</td>
<td>$874.9</td>
<td>Temasek Holdings (Pte) Ltd., CITIC Capital Partners Ltd., China Broadband Capital Partners LP</td>
</tr>
<tr>
<td>25 Sep 13</td>
<td>RDA Microelectronics Inc.</td>
<td>$779.0</td>
<td>Shanghai Pudong Science &amp; Tech</td>
</tr>
<tr>
<td>07 May 13</td>
<td>7 Days Group Holdings Ltd.</td>
<td>$688.0</td>
<td>Actis LLP, The Carlyle Group LP, Sequoia Capital</td>
</tr>
</tbody>
</table>

Source: Thomson One, Dealogic
Exits

Over the last several years, China’s capital markets have matured considerably, enabling investors to actively participate in China’s growth story. In 2003, there were just 66 companies that listed on mainland exchanges, raising US$5.2b. Just seven years later, companies had raised more than US$80b across nearly 350 separate listings. However, in late 2012, regulators took the next step in the development of China’s equities exchanges, making the difficult but necessary decision to suspend new equities issuance until reviews could be completed that were designed to ensure a higher standard of quality for companies going public in China.

As a result, PE exits were challenging in China in 2013. While IPOs have long been the preferred exit route for PE investors in the region, the lack of a functioning IPO market posed a question to investors: wait until the IPO markets reopen, or seek out alternatives among strategic buyers and secondary PE investors?

Many chose the latter. According to Dealogic, between 2012 and 2013, PE exits by M&A more than doubled to US$5.4b. The largest of these was the US$1.4b sale of Yashili International Holdings Ltd. in June to China Mengniu Dairy Co. by The Carlyle Group. Carlyle first invested in the baby formula maker in 2009, and it debuted on the Hong Kong exchange a year later.

While the vast majority of exits went to strategic investors, PE firms are increasingly looking at PE buyers as yet another viable exit route. The rationale is clear – China remains a very diverse market, with a range of opportunities across an array of industries. The increasing maturity of the PE industry means that successive owners are able to add value by leveraging very different skill sets – a growth capital investor can help an entrepreneur grow their business regionally, while later-stage investors can layer in greater levels of financial sophistication and operational expertise to help companies achieve their next level of growth. As the industry continues to mature in China, secondary buyouts will play an increasing role in providing liquidity and as a source of new deals.
Exits

While the IPO moratorium has elevated the role of sales to strategics and secondary buyouts, IPOs remain the top choice for many PE firms and the entrepreneurs and family owners with whom they are partnered. As such, regulators’ recent decision to reopen the mainland markets to new activity is welcome news to PE firms across the region. However, a dense pipeline of companies waiting to IPO means a rush of exits may not yet be imminent. According to estimates, there are currently more than 700 companies waiting to list on China’s stock exchanges. As a result, it could still be years before the current backlog of exits is able to achieve liquidity.

Regardless of the ultimate path to exit, the need to divest assets and return capital to LPs is emerging as one of the key imperatives for PE firms in the region. A recent report by consultancy Zero2IPO found that for funds established post-2008, 90% of LPs have yet to receive back their principal investment. And while growth capital investors in China might typically expect longer hold periods than in the US or Europe, the time has arrived where liquidity will be a key criterion for determining which funds will see successful new fund-raisings over the next several years.

Figure 6. Top PE exits 2013

<table>
<thead>
<tr>
<th>Announcement date</th>
<th>Target</th>
<th>Deal value (US$m)</th>
<th>Financial sponsor</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 Jun 13</td>
<td>Yashil International Holdings Ltd. (89.8172%)</td>
<td>$1,441.8</td>
<td>Carlyle Group LP</td>
</tr>
<tr>
<td>06 Nov 13</td>
<td>RDA Microelectronics Inc.</td>
<td>$904.6</td>
<td>Warburg Pincus LLC</td>
</tr>
<tr>
<td>15 Aug 13</td>
<td>Magic Holdings International Ltd.</td>
<td>$843.1</td>
<td>Baring Private Equity Partners Ltd.</td>
</tr>
<tr>
<td>25 Sep 13</td>
<td>UT Capital Group Co., Ltd.</td>
<td>$715.0</td>
<td>TPG Capital LP</td>
</tr>
<tr>
<td>07 May 13</td>
<td>China Modern Dairy Holdings Ltd. (26.931%)</td>
<td>$409.2</td>
<td>CDH China Holdings Management Co., Ltd., KKR &amp; Co. LP</td>
</tr>
</tbody>
</table>

Source: Dealogic
Outlook
Private equity roundup — China

PE in China, like the nation itself, is entering a new stage in its development. After decades of export-driven double-digit growth, China’s economy is moving into a new phase characterized by a sustainable balance of external drivers and domestic demand. For PE firms operating in the region, long gone are the days of riding China’s GDP growth to solid returns. Firms must be increasingly selective in the companies in which they invest, identifying opportunities that have the potential to outperform China’s expected “new normal” of 7%-8% GDP growth.

While long a staple of PE in China, firms will increasingly be required to invest greater amounts of time and energy with family owners and entrepreneurs helping to professionalize operations, instill financial discipline, streamline cost structures and grow businesses organically. PE firms will need to tap into expertise from a wider range of sources – networks of senior managers and operators, formalized operating partners, service providers, and others that can bring to bear the increasingly complex skill sets that will be required as China’s industries mature and its economy continues to grow.

Despite a slower growth rate, China’s economy retains the dynamism that has made it so attractive to PE investors. Disciplined firms with well-conceived and unique strategies, extensive local networks, and innovative ways to add value to the companies in their portfolio will remain active in the market, pursuing a wide range of compelling opportunities. With China’s emergence as a developed nation still in the earliest of stages, the thesis for PE investment remains intact.
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