Private equity roundup China
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Increasing macroeconomic stability in the developed markets, coupled with declining growth and geopolitical change, is leading to challenging times across many emerging markets. Despite the volatility, PE investors have remained committed, seeing opportunity in the long-term secular trends that have emerged over the last decade — namely a rising middle class, favorable demographics, low PE penetration and a lack of traditional financing infrastructure. These macro trends will continue to play out over the next decade and will continue to provide PE firms with a wide range of compelling opportunities.

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2014 was clearly a challenging year for private equity in China. Macroeconomic headwinds emerged as China sought to continue its shift from its export-led roots to a more balanced consumption-driven model, leading to a marked secular decline in growth rates from the heady highs of just a few years ago. Indeed, with the country’s growth closing out the year at 7.4%, according to China’s National Bureau of Statistics (NBS), 2014 was the first time since 1998 that China effectively missed its internal target GDP rate.

However, despite the more challenging operating environment, interest in China remains high for private equity firms. Fundraising increased versus 2013, and investment activity increased as PE firms sought to put to work the billions in dry powder raised over the last decade. Valuations across a number of industries declined, providing PE firms with attractive entry points for investments.

Regulatory reforms brought greater clarity to the shape of industry oversight, giving general partners (GPs) clear guidance on registration and disclosure obligations and putting an end to some of the ambiguity that has characterized PE oversight for the last several years. Perhaps more importantly, new regulations effectively increased the potential universe of investible companies for both domestic and offshore PE firms. One such reform streamlined the notification and approval process for cross-border investments, promising to increase the competitiveness of outbound bids. Another sought to open the country’s roughly 17,000 state-owned enterprises (SOEs) to significant outside investment, providing a wide range of new opportunities for PE firms.

As a result, the industry remains well-positioned to capitalize on the many growth opportunities present in the Chinese market. Low PE penetration relative to developed markets, a significant financing gap for small and medium businesses, and the continued growth of the country’s middle class will all provide significant tailwinds for PE investors over the coming years.
2014 was a challenging year for China’s economy. After more than 30 years of dynamic growth driven by an investment-centric model, China has arrived at a pivot point, whereby it must shift from its manufacturing-heavy roots toward a more balanced economy driven by domestic consumption.

Executing the turn has not been easy. The structural reforms required to transition China’s economy have come at a price, namely a secular reduction in China’s growth rates. According to the latest figures from the IMF, GDP growth fell to 7.4% in 2014, down from 7.8% in 2013, and well below the double-digit rates that China saw as recently as 2010. In fact, 2014 marked the first time that China has missed its internal growth target since 1998. In response, China’s Government has rolled out a series of fiscal and monetary stimulus measures designed to spur increased investment across a range of targeted sectors, including energy, infrastructure, real estate and banking.

Clearly, China sees its future in domestic consumption. In a move reflective of that end, the NBS recently announced that it would be revising its assessment of the size of its economy by 3%, as it works to better incorporate the true value of sectors such as services into its calculation methodology. The move underscores the rising importance of domestic demand as the key to China’s future growth and stability, and it is part of a larger set of initiatives designed to lessen the focus on GDP growth at all costs — what the NBS called “GDP supremacy.” The adjustments will broaden the set of criteria by which China measures its success by looking at a range of intangibles, such as environmental improvement and research output. The result

Figure 1. Actual and projected GDP growth for China, 2000–19

Source: IMF — World Economic Outlook Database
Economic overview

is expected to be a more complete picture of China’s social and economic progress, far beyond what was achieved through an overreliance on GDP growth figures.

While significant macro challenges remain, many observers expect that ongoing reforms will help pave the way for sustainable, albeit lower, growth. Perhaps most importantly for investors involved with the region, China’s long-term growth rate is expected to continue to exceed that of the developed markets for the foreseeable future. According to the IMF, developed markets are expected to grow 2%-3% annually over the next five years while China is expected to grow in excess of 6% per year through 2019.

Figure 2. Actual and projected GDP growth for China relative to key developed economies, 2013-19

China’s high growth, coupled with its increasingly open capital markets, population of 1.3b and rising middle class, will continue to make it an attractive destination for PE. Indeed, many of the reforms currently underway provide a clear road map for future investment. While the last decade has seen firms invest across a range of consumer-oriented industries, structural reforms implemented under the new Administration provide perhaps the clearest indication yet of the Government’s commitment to developing the domestic consumer.

Amid this shift, the universe of attractive opportunities is evolving, making insightful sector and company selection increasingly important. Some sectors that have performed well in the recent past could be challenged, while investments based on the continued growth and evolving spending patterns of China’s middle class will yield attractive opportunities. This, coupled with lending markets that remain underdeveloped relative to the growth of its economy, will continue to provide a range of interesting opportunities to fill the financing gap for entrepreneurs and family owners.
Fundraising activity increased in China over the course of 2014, with US$30.4b raised by funds focused on the country, according to Preqin. This represents an increase of 15.7% over the US$26.2b raised in 2013.

Many of the large domestic players stood down from the fundraising market in 2014, having raised significant amounts of capital over the last several years. One notable exception was CDH Investments, which closed its fifth growth capital and buyout fund in February with US$2.6b in investor commitments, which was slightly above its target. The fund drew investors roughly equally from North America, Europe and Asia. Underscoring the continuing institutionalization and maturation of China-based managers, the fund represented a first investment in a China-based manager for several of the fund’s global limited partners (LPs). Founded just 12 years ago, the firm has rapidly ascended the Private Equity International rankings, currently sitting 46th in the listing of the world’s largest PE firms. Perhaps more importantly, CDH is already following in the footsteps of its diversified global peers; presently just three-quarters of its business is derived from PE. The fund also manages vehicles dedicated to real estate, mezzanine and public equities.

TPG, The Carlyle Group, CVC Capital Partners and the Blackstone Group were among the large global funds that closed Asia-focused vehicles in 2014, of which significant amounts of capital are expected to target Chinese opportunities. The Carlyle Group’s US$3.9b fund, which closed in September, was the largest of these and brought the firm’s assets in the region to US$13.6b. The fund significantly exceeded its US$3.5b target and was

**Figure 3. Aggregate China-focused quarterly fundraising, 2012–14 (in US$m)**

Source: Preqin
Fundraising

50% larger than its predecessor fund, which closed in April 2010. The fund is expected to direct at least half of its capital to China, seeking investments across a range of industries, including consumer products, financial services, health care, and technology, media and telecommunications (TMT). Similarly, TPG’s sixth Asia-focused fund raised US$3.3b for investments across the region, with a significant focus on China, while CVC Capital Partners raised US$3.5b for its latest vehicle. Their success in attracting capital reflects investors’ desire to place allocations with well-established teams that have a significant local presence and strong track records in the region.

Over the last 18 to 24 months, exits have been a primary roadblock to greater China fundraising. With a relative lack of IPOs, a limited market for secondary buyouts and a quiet market for trade sales, many GPs have struggled to return capital to LPs from investments whose time is coming due.

Firms that are currently seeking capital from LPs will need to provide solid evidence of their ability to exit in order to successfully raise new capital. Currently, a significant pipeline of funds is at various stages of the fundraising process. According to Preqin, there are over 130 funds with a significant focus on China seeking an aggregate US$50b in investor commitments. While many of these are first-time teams, a significant percentage are firms returning to the market. For them, a proven ability to return capital in a challenging exit environment will be key to their success.
Acquisitions and exits

Acquisitions

Investment activity increased versus last year, despite the challenging macro environment. PE firms announced investments valued at US$14.2b in 2014, a 31% increase over 2013, when sponsors announced deals valued at an aggregate US$10.8b.

Many observers cite lower valuations as one of the primary drivers of the increase. Given reduced growth expectations, valuations across a number of industries have declined from the lofty levels seen over the last several years. According to data from Dealogic, average M&A valuations for companies based in China fell to 12.7x EBITDA in 2014, from 13.4x in 2012 and over 14x in 2010.

Figure 4. PE acquisitions in China, 2012–14 (in US$b)

Source: Thomson One, Dealogic
Acquisitions

In 2014, many China-based PE firms increasingly looked beyond their borders for high-quality acquisitions, where they could benefit both from a strong international brand as well as the opportunity to expand within China. One such deal was the July acquisition of a majority stake in UK-based PizzaExpress by Hony Capital. Hony acquired the company from Cinven-backed Gondola Holdings in a secondary buyout valued at US$1.5b. The deal gives Hony the opportunity to take a company with locations throughout Europe and the Middle East and help build its presence in the domestic Chinese market. Currently the company has just 23 locations across China but is targeting 100 locations in the country over the next five years. The deal represents the largest acquisition of a foreign company by a PE firm to date, though almost certainly not the last – one of Beijing’s key reforms in the M&A space in 2014 was to relax regulatory oversight of cross-border M&A activity, designed to encourage overseas investment by strategic and financial investors alike.

While valuations and global expansion opportunities represented some of the key market drivers over the last year, structural changes underway in China’s market may dictate the shape of additional activity. Namely, regulators are pushing SOEs across many jurisdictions to streamline their operations. In many instances, SOEs are being pushed to spin off underperforming assets, the effect of which is an increase in the universe of attractive companies seeking to partner with PE, as well as a potential steady source of deal flow for the industry over the next several years.

Table 1. Top China deals 2014

<table>
<thead>
<tr>
<th>Announcement date</th>
<th>Target</th>
<th>Financial sponsor</th>
<th>Deal value (US$b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>29-Aug-14</td>
<td>China Huarong Asset Management Co Ltd (20.98%)</td>
<td>Warburg Pincus LLC</td>
<td>$2.4</td>
</tr>
<tr>
<td>18-Feb-14</td>
<td>Iowa China Offshore Holdings (Hong Kong) Ltd (34%)</td>
<td>Hopu Investment Management Co</td>
<td>$2.4</td>
</tr>
<tr>
<td>28-Apr-14</td>
<td>Youku Tudou Inc (18.5%)</td>
<td>Yunfeng Capital</td>
<td>$1.2</td>
</tr>
<tr>
<td>29-Dec-14</td>
<td>Beijing Xiaomi Technology Co Ltd (Stake%)</td>
<td>Hopu Investment Management Co; Yunfeng Capital</td>
<td>$1.1</td>
</tr>
<tr>
<td>30-Jul-14</td>
<td>NQ Mobile Inc</td>
<td>Bison Capital Asset Management LLC</td>
<td>$0.6</td>
</tr>
<tr>
<td>19-Aug-14</td>
<td>Henan Jinkai Investment Holding Group Co Ltd (Industrial gas assets)</td>
<td>Warburg Pincus LLC</td>
<td>$0.5</td>
</tr>
<tr>
<td>27-Jan-14</td>
<td>Shanda Games Ltd (24.0376%)</td>
<td>Primavera Capital Management Ltd</td>
<td>$0.5</td>
</tr>
<tr>
<td>27-Aug-14</td>
<td>Fujian Sunner Development Co Ltd (18.0034%)</td>
<td>KKR &amp; Co LP</td>
<td>$0.4</td>
</tr>
<tr>
<td>05-Jun-14</td>
<td>Inner Mongolia Yili Livestock Development Co Ltd (60%)</td>
<td>CITIC Private Equity Funds Management Co Ltd; Yunfeng Capital</td>
<td>$0.3</td>
</tr>
<tr>
<td>25-Apr-14</td>
<td>South Beauty Group (69%)</td>
<td>CVC Capital Partners Ltd</td>
<td>$0.3</td>
</tr>
</tbody>
</table>

Source: Dealogic
Exits

In the developed markets, exit activity has hit a record high after years of concerns that the level of PE exits was insufficient to liquidate the portfolio of companies that had accumulated in the pre-crisis years. Indeed, global PE exit activity reached US$473b in 2014, a record high, and exits outpaced new acquisitions by a rate of roughly 1.7:1.

In China, activity picked up after the IPO moratorium was repealed. With the IPO window effectively closed throughout 2013, firms had to decide whether to wait out the shutdown or pursue alternative exits such as trade sales and secondary buyouts. However, the reopening of the market has prompted a new wave of PE-backed deals. To date, companies headquartered in China backed by PE firms have listed 20 companies on the world’s exchanges, and with China’s regulatory agencies now actively pursuing market-driven reforms designed to streamline the listing process, mainland venues should become even more accommodating to PE-backed offerings.

The largest listing was the US$25.0b listing of e-commerce portal Alibaba on the NYSE. The IPO wasn’t just the largest PE-backed IPO of all time; it was the largest IPO ever, surpassing the US$22.1b offering by the Agricultural Bank of China in 2010.

The company was backed by a range of sponsors, including Silver Lake, General Atlantic, China Investment Corporation, CITIC Capital Management and The Canada Pension Plan Investment Board, and debuted to significant investor demand, increasing 38% on its first day of trading and closing out the year up over 60% from its offer price.

According to figures from Dealogic, exits via trade sales or secondary buyout more than doubled by value in 2014, to US$12.5b. However, the majority of value was attributed to a single deal, the US$10.9b sale of Greenland Holding Company to Shanghai Jinfeng Investment Co. Ltd. in a reverse merger designed to list the company on the Shanghai exchange. Greenland’s backers included CDH Investments Ltd.

Exits remain one of the most critical elements for the sustainability and long-term success of the PE industry across the emerging markets, and China in particular. As 2015 unfolds, observers expect an increased focus by PE firms on liquidating positions in companies acquired over the last five years. Their progress will be watched closely by LPs seeking to rationalize their allocations to the China market.

Table 2. Top exit deals 2014

<table>
<thead>
<tr>
<th>Date</th>
<th>Company</th>
<th>Type</th>
<th>Sponsor</th>
<th>Market or deal value (in US$b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>18-Sep-14</td>
<td>Alibaba Group Holding Ltd.</td>
<td>IPO</td>
<td>Silver Lake, General Atlantic, China Investment, CITIC Capital Management, The Canada Pension Plan Investment Board</td>
<td>169.4</td>
</tr>
<tr>
<td>29-Jul-14</td>
<td>WH Group Ltd.</td>
<td>IPO</td>
<td>CDH China Holdings Management Co. Ltd.</td>
<td>11.7</td>
</tr>
<tr>
<td>18-Mar-14</td>
<td>Greenland Holding Group Co. Ltd.</td>
<td>Trade sale</td>
<td>CDH China Holdings Management Co. Ltd.</td>
<td>10.9</td>
</tr>
<tr>
<td>13-Jun-14</td>
<td>Tianhe Chemicals Group Ltd.</td>
<td>IPO</td>
<td>Morgan Stanley Private Equity Asia Ltd., PAG Asia Capital Ltd.</td>
<td>5.9</td>
</tr>
<tr>
<td>25-Mar-14</td>
<td>Harbin Bank Co. Ltd.</td>
<td>IPO</td>
<td>CITIC Capital Holdings Ltd.</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: Dealogic
Over the last decade, China’s market-oriented reforms have dramatically changed the country’s business landscape, and regulators continue to push growth-oriented reforms. For the private equity industry, this has resulted in greater clarity around regulatory requirements. Late last year, China’s Government took steps to mitigate the overlapping regulatory authority of the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) by appointing the CSRC the industry’s primary regulator. Observers are hopeful that this will mitigate some of the ambiguity in the regulatory framework governing PE.

One of the CSRC’s first priorities was the release of rules governing the registration and marketing of new funds. The release included guidance on what constitutes a “qualified investor” and provided registration requirements for committed funds. The new regulations also included a series of disclosure guidelines around fees, investment strategies and conflicts of interest, which provide GPs in China a degree of long-awaited clarity around the specifics of their obligations and bring China’s regulatory framework more in line with other jurisdictions, including the US and Europe.

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Another important regulatory development was the relaxation of rules governing the oversight of M&A activity. In October, the NDRC and the Ministry of Commerce (MOFCOM) approved new regulations designed to streamline and simplify the review and approval process for foreign M&A transactions. As of October, outbound deals valued in excess of US$1b that do not involve sensitive industries or geographies are no longer required to seek pre-approval from the agencies. The streamlined review process should help to reduce the competitive disadvantage that many China PE firms faced when pursuing cross-border investments.

Perhaps the most significant regulatory development from the perspective of PE is Beijing’s focus on streamlining the structure of the country’s roughly 17,000 SOEs, which by some measures represent nearly 50% of China’s market capitalization. In November of 2013, China’s Third Plenum discussed ways to open many of the country’s SOEs to outside investors, the result of which has been a push for many SOEs to sell off underperforming assets to strategic investors or private equity funds. While PE investors have long invested in SOEs with varying degrees of success, the new initiative will increase the universe of assets coming to market and formalize the pipeline, adding a greater degree of formalization to the process.

However, while SOEs as a source of potential deal flow represent a significant opportunity for well-positioned firms, open questions remain. Chief among these are the degree of control that the Government is willing to cede to outside investors, the sectors likely to see the most activity and, perhaps most importantly, the proper alignment of incentives to drive the success of all PE deals for SOE spinoffs.

While the rules governing PE activities are still evolving, 2014 saw a number of significant strides designed to make the industry more competitive and better integrate PE into China’s growing economy. Though China’s regulatory oversight of PE has been characterized by fits and starts, as regulators continue to gain comfort and experience in working with the LPs and GPs, the ultimate vision of a comprehensive, well-designed regulatory framework is perhaps drawing nearer.
Outlook
The increasing importance of China as a key driver of the world’s economic growth has been one of the defining macro trends for the last decade. However, now is a time of significant change, as China seeks to evolve from an economy dependent on manufacturing exports to one driven by domestic demand. The successful investors of the next decade will be those that can effectively pivot alongside China, directing their own growth in the same new direction.

PE firms remain undeterred by the challenge. Indeed, activity across China remains robust. Firms continue to raise new funds, and significant deals continue to occur. However, an environment of sustained lower growth is poised to make clear that the most fruitful deals of the future will be those by firms that can add significant operational expertise, financial discipline and good governance practices over an extended period.

China remains rife with opportunity. The challenge, as always, lies in its identification. PE firms with well-defined and well-articulated strategies predicated on adding lasting and tangible value – and experience and infrastructure to effectively partner with the legions of small and medium-sized business owners, entrepreneurs and, increasingly, with SOEs and foreign divestors – will be those that most benefit from China’s new direction.
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