Business Trends & Corporate Strategies

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Insider Advice: Private Equity in China

What are your options for bringing your business to China? In the last China Focus, we discussed how to use e-commerce to tap into the market. In this issue, we will explore private equity investing in China as a way to expand your operations - how to source deals, carry out due diligence and manage and integrate acquired companies.

We are proud to feature an interview with Shiv Dalvie of AEA Investors, who will explain the nuances of investing in China. Following this, we will give you advice on avoiding risks, while simultaneously setting a strong foundation by using due diligence. The third article addresses how Fiducia can help you manage your acquisition operationally. With our many years of experience, we can offer insider advice so our clients can take advantage of the many opportunities that exist in China.

Stefan Kracht

In this Issue:

"Private Equity in China is Growth Equity"

An interview with Shiv Dalvie of AEA Investors

The private equity market in China is at a much younger stage than in the West and thus presents a number of challenges, especially when it comes to sourcing deals and growing a portfolio company. Shiv Dalvie, Managing Director of AEA Investors, sheds light on what to look for and watch out for when investing in private equity in China. Shiv joined AEA's New York office in 1997 and moved to Hong Kong in 2007 to establish and oversee AEA's investment activities and operations in Asia.

CF: What is the difference between private equity in China and in the West?

Fundamentally, the difference is that in the West, private equity tends to be a control- and optimisation-oriented business. The focus lies on buying assets from corporates, families/founders and other private equity firms and then looking to do add-on acquisitions, consolidating the market and growing the bottom line. Organic growth often tends to be a smaller focus after an acquisition.

China is at a very different stage in the market, with more emphasis on finding avenues for the continued growth of the business and investing in that growth by helping improve marketing and sales strategies and learning how to win in the competitive landscape. Key to successful private equity operations in China is helping the organisation cope with growth by putting solid systems, financial management and talent in place.

From an investor mind-set, what works in the West is not necessarily useful in China because of the core difference in the state of where the markets are. The former is bottom-line focused, while the latter is top-line focused. However, they both require the necessary operational skills from us.

CF: How are companies in China different than in the West?

Companies in China tend to be smaller, even if they are long established. They may have only USD 50 - 100 million of revenue but would be considered equivalent to a USD 300-400 million business in the US in terms of the number people employed and their complexity. Though well-sized in China, these businesses often lack a high level of management depth, talent and expertise. But since the Chinese economy is growing rapidly and businesses tend to be founder-led, the talent pool around the founder is often thinner than in a professionally managed Western company. Our challenge as private equity investors is in growth equity situations where there are gaps in management talent and expertise. Then we have to ask ourselves how do we help the company? How do we inject the right talent? How do we work with the entrepreneur, leader, or CEO in a cooperative manner and help him achieve his goals?

CF: What is the entry market in China like?

There is no shortage of potential prospects available to look at. However, the number of companies that meet our expectations in terms of the quality of the business and management, as well as their readiness to accept capital from an institutional investor at a reasonable valuation is substantially lower. As a result, deals are fewer but we are willing to be patient and wait for the right market conditions. Consider it more a supply and demand issue: there is more capital chasing and fewer high quality opportunities but that will hopefully fix itself over time. We remain focused on finding as many good investments as we can, while still meeting our standard of deals we would like to do.

CF: What about exits in China vs. West?

For good companies there will always be exits available. The big issue has been that in the last several years most growth equity investors in China have relied on a single exit avenue – the public market. There are couple of things to note: (1) while the public market is quite slow at the moment, it will not stay so forever. You

“For us, the question is how we, as professional fiduciaries looking for good investments, **find the right place in this mosaic.**”

Due Diligence Tips

Leo Fang, Vice President of AEA Investors, tells us what to watch out for when doing Due Diligence.

1. Pay attention to commercial due diligence. At AEA, we use third parties to check external factors, such as market development, growth drivers, and competitor landscapes, as well as internal factors, including the operation and management style.

2. Understand the differences in Chinese laws and your home country laws.

3. Be prepared for poor corporate governance and accounting reporting of Chinese target companies You will have to translate the data you collect into financial reports that meet international standards.

4. Set an appropriate time frame: you will need 2-3 months for full commercial, financial and legal due diligence.

can already see that there is slight improvement in the IPO market in Hong Kong. (2) People will start looking for other exit avenues. There will be more secondary stake sales among investors and sales of entire companies, to maximise value.

The exit dynamic in China is more complicated than in the US, primarily because investments tend to be minority in nature, reducing the exit flexibility. If you are a majority investor you can drive the exit more easily in one direction or the other, but as a minority investor you have to work with founders to reach an agreement. A trade-sale often means that they will have to give up control of the business entirely and that’s a pretty big decision for most founders. Currently, the primary objective of most Chinese-owned firms is to go public. Trade sales are a relatively new phenomenon for private equity backed companies in China.

CF: What private equity opportunities do you see in China?

In Germany in the late 1990s, the generational change between founders and their children heralded one of the biggest waves of private equity investments in Europe. People are speaking about something similar in China today, with the key difference being that some Chinese entrepreneurs either do not want to have their children in the business because they have worked hard for a better life for them, or, on the other hand, their children are not willing to take on that responsibility of bringing the first generation business forward. We are seeing more entrepreneurs who are interested in selling their businesses but only time will tell how big that market will be. A business needs to transition to professional management eventually to stay competitive so it will be an interesting time coming up for growth equity investing.

CF: What influence do government policies have on private equity investing?

It varies from industry to industry, as there are different levels of government involvement for each. For instance, in the cement business, government policy plays a big role, as the state has encouraged consolidation over the past few years. But when it comes to quick service restaurants, they may be less involved though there still are food safety and pricing regulations. As an investor, you have to understand what the government wants and where they are heading. How important it is depends on the industry, though in general, government issues are much more significant now than they were when we first started looking at China.

Consolidation is necessary in many industries but the government is unwilling to take action because of unemployment rates in specific areas. This clashes with the fact that actually the state is reducing its influence. But state-owned enterprises are still taking a large share of the economy, competing more effectively in many instances. It is clear that we need to take the increased government influence into account in all the deals that we are looking at.

CF: How do you source deals in China?

In the West, established companies work with intermediaries, such as banks, to market themselves. In China, deal sourcing is driven by personal relationships. Brokers tend to be individuals, instead of institutions, who will directly introduce you to the chairman of a company looking to raise capital or sell his/her business. Using your personal networks and consulting firms such as Fiducia are essential for finding good deals.

The process is changing and becoming more professionalized, a direction it will continue going in. Slowly you will see more intermediaries, banks and sell-side advisors emerging and brokers becoming more institutional. This is happening already and is likely to increase in the coming years.

CF: What challenges does the future hold for private equity investing in China?

The China market was at an early stage in its development when we came out here. Over the last 5 years, the market has grown dramatically in size and in the amount of capital it has attracted but it has done so without sufficiently experienced investors. The capital grew faster than the skill level of the people who are investing the capital. Some really good firms have emerged from this, who figured out how to invest effectively. But we also see a bit of indigestion already. How will the competition shake out in this business? Some market leaders have been created and will continue to emerge over the next few years. But also significant chunks of capital were misallocated. It will be interesting to see how this will play out.

For us, the question is how we, as professional fiduciaries looking for good investments, find the right place in this mosaic. There will be successful and unsuccessful local competition – we will have to find a way as a foreign-owned firm to create a lasting niche in this market. We have to adjust without impacting our core values, as we have learned more about the China market over the years. There are certain parts of our business where we remain rigid and stick to our guns but in other ways have become more flexible. Investing is more nuanced in China – it is certainly not one-size-fits-all. We focus on the value that we bring to the table to create that niche for us.

The 7 Rules for a Successful Acquisition

Thorough due diligence is without a doubt the most important step when acquiring a company. While financial and legal due diligence are essential to the process, commercial due diligence is often overlooked and undervalued. Especially in China, the lack of set procedures, documentation, and organisation frequently yields inaccurate information making it necessary to dig deeper than what is written on paper and what is told. You will avoid expensive mistakes down the road if you look past the numbers and understand the bigger picture early on.

The Checklist

If the target company checks out in all of the below indicators, it is in good shape for a future acquisition:

▶ **Organisation & ownership**: Understanding the organizational set-up and profiling key stakeholders and decision makers will shed light on how the business is run and if it fits with the managing style of your company.

▶ **Strategy:** Can the company drive sustainable growth? What are their current strategies and more importantly, what were their strategies in the past? These factors can give you a good indication of a company's long term viability.

▶ **Sales & Marketing**: Reviewing distribution set-ups and networks, as well as historic sales performance is essential to make sure that the company can provide a continued stream of income after the take-over. Sales may be through the roof today, but looking at trends and movements in the company's history can help avoid flukes.

▶ **Operations:** The reliability of the supply chain is crucial to ensure that there is no chance the operations will fall apart after acquisition. Full comprehension of how production and inventory management work will give you an idea of how smooth the operations are and if there are any issues that need to be addressed.

▶ **Staff:** It goes without saying that the quality of the workforce is the cornerstone to a healthy, functioning company. This does not just mean the senior management!

▶ **Financials**: Yes, thorough financial due diligence follows commercial due diligence, but it still should not be overlooked at this stage. The basic elements should be reviewed to at least rule out the obvious no-no's when it comes to finances. Additionally, any findings here can be used as a framework for financial due diligence later on.

▶ **Relationships**: the least straightforward yet most important factor in commercial due diligence is investigating the company's external relationships. The complexity of this task is staggering: from assessing the company's reputation in the market to examining the impact it has made on the local community, this research is far more comprehensive than simply doing internal interviews or accessing data. The local community and even the government must be asked for feedback. All of this must be carried out with what we call a 'closed approach', meaning that the people in question cannot be made aware of the intention behind the interview in order to obtain the most reliable and unbiased responses.

Knowing When to Say No

Recognizing which boxes the target company has to tick in order to give the green light is only half the battle. Clearly defining what the deal breakers are is just as important, especially when doing business in China. For example, what is your tolerance for corruption or environmental negligence? Yes, morally speaking you must be able to draw the line, but also from a macro perspective, the Chinese government has been clamping down on these issues in recent years and we can certainly expect there to be more policies along these lines in the future. China is increasingly conforming to international standards when it comes to business best practices, so turning a blind eye now could result in huge damages not only to your China operations but also to your brand image in general.

Chinese Pitfalls

Beware of the accounting practices of Chinese companies! Not uncommonly, a company may be keeping 2 or 3 different books with liabilities unknown to you. They may boost their revenue without having the real numbers to back it up. Digging deeper pays off to avoid having the Chinese government charge you with tax evasion or not paying your social security contributions .

Another potential problem can arise from the politics among the staff. Frequently in China, top contracts will go to family members or close friends of senior management, unrelated to merit. These sensitive relationships could pose a huge risk to you and the retention of your staff later on. Moreover, there is often a general sense of panic and insecurity among the ranks, once it surfaces that there are talks of an M&A transaction. If most of them are migrant workers, they may all have left before you even signed the papers. We recommend to cross-check internal and external sources to shed light on any discrepancies.

In the News

▶ International Private Equity giant KKR acquired a 10% stake in China's largest appliance manufacturer Haier after revenues surged in the last decade under CEO Zhang Ruimin, who employed unique management tactics to grow the business.

▶ Shuanghui International, one of China's biggest pork processing companies, has taken over US pork producer Smithfield Foods, completing the largest Chinese acquisition of a US company ever made, worth USD 7.1 billion. Backed by several big international investors and New Horizon Capital, a leading Chinese Private Equity fund, this cross-boarder M&A deal indicates a high probability for future collaboration between international and Chinese investing powerhouses.

▶ China's largest technology outsourcing company, Pactera International, has signed a definitive merger agreement for USD 625 million with Blackstone Group. This move will take the currently US listed company private, a growing trend after suspicions over the last few years by US investors over Chinese listed companies' accounting practices.

With years of experience, **Fiducia has been successfully advising** both strategic and financial investors, as well as their portfolio companies on their China strategy and operations.

Achieving Lasting Growth for Your Investment

Once you have made a successful acquisition, the next hurdle is optimising it for business in China. The portfolio company you invested in may be completely healthy, but do you have the expertise, China knowledge, and manpower to grow it further? Conversely, the company may need a clean-up from previous management and you lack the resources to start. We offer a fully integrated approach that will enable a smooth start with your newly acquired portfolio company's China business.

Corporate Governance Support

We will review your portfolio company's current corporate set-up and let you know if there are any major red flags that need to be addressed. If you are planning on expanding and setting up a new entity in China or Hong Kong, we can help you with all the paperwork and making sure you meet all required criteria. We will confirm that all necessary control mechanisms are in place, such as company chops, signature authorities, and other checks and balances, so you comply with the Chinese law. Moreover, we will evaluate your portfolio company's business scope and compare this to its actual activities. Checking what the current and paid up capital is against what the future needs will be is also essential in ensuring your portfolio company has a solid structure and good corporate governance. As part of our check-up, we are also able to assess if your portfolio company is eligible for the high tech status (ATEC).

Finance and Accounting Support

While most big companies will want to place their own CFO to monitor the accounts, this is not always an option for an SME. Why not let Fiducia be your trusted 3rd party advisor in handling all accounting and controlling related tasks? Not only will we review the accounting system and make recommendations based on the results, but we can also fully take over the bookkeeping so that your portfolio company can focus on what they do best – their business. Since we provide these services as an online ERP platform, the investor overseas can monitor the financial status of the portfolio company at any time.

Organisational Support

When taking over a company, staff retention and trust will be a big issue. Some may be worried about layoffs or new management practices, while others could feel threatened by the sudden, unwanted change. At this stage, it is important to review job functions and responsibilities to make sure that all staff are placed according to their strengths. In addition to this, we will assess the incentive and bonus schemes, as well as the salary and benefit alignment for key positions. Following this, we will make suggestions for retention mechanisms so that there is no staff flight and business can continue as normal. This step is essential because the experience of your staff is invaluable while you are still new to the game. Our cross-cultural understanding will bridge the gap between you and your new staff, facilitating synergy and interaction. Conversely, we can also find new talent for you through our Executive Search department to carry out your China strategy.

Strategy Support

Setting the operational foundation is the key to success, but having a sound growth strategy will take your portfolio company to the next level. With over 30 years of experience in the Chinese market, we will establish a customized strategy for your business, based on the overall industry outlook and growth drivers. We will provide a snapshot of local and international competition so you know who you are up against. Armed with knowledge of industry trends and the market landscape, you will be able to make educated decisions for your portfolio company. In addition to providing reports, we do hands-on work in the field, interviewing the necessary parties to gather knowledge. Our expertise is to do on site market research and talk to different people to collect information that will help you identify what the right direction is for you. With the amount of industries and projects we have serviced, it is easy for us to think outside the box and offer a different point of view.

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