

Private equity roundup – China

Private equity roundup – China is published quarterly by Ernst & Young to provide insight and analysis on this important emerging market.

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China sees continued private equity (PE) activity amid a year of historic change

China is in a period of unprecedented change. The last decade has seen the country embark upon one of the steepest growth trajectories in history, the result of which has been enormous social and economic transformation. From this, China has emerged as the second-largest economy in the world. Millions of its citizens have joined the ranks of the middle class, and are now becoming key drivers for sustained growth in China's economy as they demand an ever-growing array of goods and services.

Now, China is poised to see additional change in the form of political transition. On 8 November 2012, China convened its 18th National Congress which saw more than 2,000 of its top leaders come together to chart the nation's course for the next decade. While confident about the future, China's leadership is also well aware that significant challenges remain. A weakening demand for exports and domestic consumers taking a wait-and-see approach to discretionary spending in 2012 forced China's growth machine to decelerate.

Amid an environment that continues to evolve, PE investors remain active. Global and domestic shops alike continue to open new offices, develop deeper relationships with China's business community and help a growing number of businesses and entrepreneurs grow their companies. Many PE firms are expanding the types of investments they are making in the region, moving beyond traditional buyout and growth capital deals into real estate, distressed debt, special situations, turnarounds and other investments. At the same time, regulators are continuing to work with industry leaders to thoughtfully manage the influx of capital, and erase some of the ambiguity that defines China's emerging capital markets and private investment environment.

As we embark upon a new year, PE investors will continue to pursue a wide range of opportunities across China's dynamic economy. As they do, they will assist China's economy in preparing for the next phase of its growth journey – by increasing companies' operating expertise, elevating management competency and raising governance standards. However, with volatility ever-present, and amid the risks of a still-developing market, PE firms must be more disciplined than ever in the sourcing and selection of deals. Combined with thoughtful and thorough due diligence and monitoring processes, this is what will define the winners of China's next decade.

Economic overview

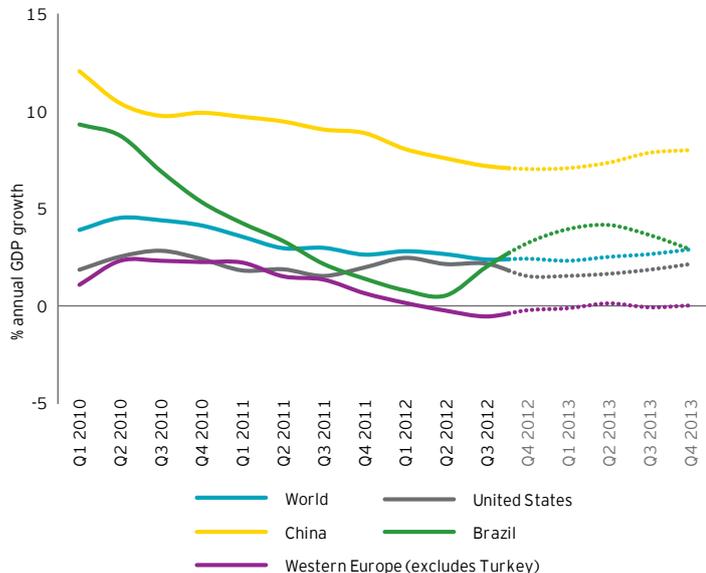
China's high growth rates to continue; domestic demand remains key to the country's growth

Last year was yet another volatile year for the global economy and China was not immune to the difficulties faced by most of the world. Global GDP growth is expected to bottom out at 2.3% in the first quarter of the new year, before resuming an upward path. China's economy is expected to follow a similar trajectory, dropping to 7% in the fourth quarter of 2012, before climbing back to an 8% to 8.5% range over the next year.

While markedly below the 10%-12% annual growth the country enjoyed over much of the last decade, it appears that China will avoid the hard landing that many economists had feared. Massive stimulus efforts undertaken in 2009 and 2010 deserve much of the credit. While these efforts leave the country with certain residual issues – namely, increased local government debt and a troubling real estate bubble – they have kept China's growth rate among the highest in world.

China is working to transition from an export-led economy to one driven more heavily by domestic demand. Exports to Europe in particular continue to be slow and are expected to remain so over the near and medium terms. China has bridged some of this gap with additional government spending, but domestic consumer demand is where China's hope lies for sustained growth. While the last decade has seen workers in China increase their wealth markedly, over the last several months domestic demand has been relatively muted, largely in response to macroeconomic drivers and uncertainty around the country's forecasted transition. As a result, a key priority will be structural reforms that put China back on the path towards a more consumer-led economy.

Figure 1. Quarterly actual and expected GDP growth for China versus major world economies, 2010-13



Source: IHS Global Insight

Public market valuations trending lower

One effect of the volatility in China's economy is a decline in public market valuations. Price-per-earnings ratios have also declined from more than 17 times forward EBITDA (earnings before interest, tax, depreciation and amortization) to 12.6 times since 2011.

While this provides a number of challenges for PE, it also has created a number of opportunities. High valuations in many sectors have clearly been a point of concern for many firms putting assets to work in China. While reduced valuations indeed make the exit environment more difficult, the more pressing issue for many investors is how to thoughtfully deploy the billions in capital earmarked for investments in China that are currently controlled by local and global PE firms. To the extent that lowered valuations in the public market translate to reduced seller expectations in the private market, the investment environment has the potential to become increasingly accommodating as the valuation gap narrows.

Figure 2. Forward price/earnings ratios for Shanghai A shares have declined steadily over the last two years



Source: Capital IQ

Regulatory update

China's regulatory bodies have faced many challenges in recent years as they attempt to thoughtfully manage the rapid growth of the nation's economy and the accompanying influx of new investment. New regulations that are having significant impact on the operating environment for PE in China are being developed and instituted at a rapid pace with a goal of increasing clarity and reducing the ambiguity that surrounds PE investment. To that end, 2012 saw a number of developments on the regulatory front, many of which the industry is still trying to fully assess.

China's insurance industry sees changes in amounts and ways it can invest

Over the last several months, China's primary insurance regulatory body, the China Insurance Regulatory Commission (CIRC) has made a number of announcements that could have a profound impact on the ways that China's insurance companies invest their assets.

In 2010, the CIRC allowed China's insurance companies to invest up to 5% of their assets in domestic PE firms, unlocking a portion of the insurance industry's estimated US\$1t pool of capital to PE. In July 2012, the CIRC doubled insurance companies' maximum allocations to 10% of their total assets. In October 2012, the CIRC published regulations that allow China's insurance companies to invest in foreign PE funds.

While renminbi funds were the primary beneficiaries of the CIRC's earlier pronouncements, US dollar-denominated funds are likely to see additional investment from this most recent ruling – in particular, the large global managers that are already active to a degree in China. The new rules state that eligible managers must have fund commitments of at least US\$300m, and total assets under management of US\$1b.

While the CIRC's new regulations clearly provide a boon to many foreign and local PE funds, other parts of China's domestic PE industry were dealt a setback. Under new regulations, insurance companies are disallowed from investment in the PE arms of non-insurance financial institutions. As many of China's largest domestic firms are affiliated with the nation's banks, the ruling effectively closes off what some had hoped would be a ready source of fresh capital for much of the domestic fund industry.

Reinvigorating the Qualified Foreign Limited Partners (QFLP) program

In 2010, China announced the QFLP program as a way to let foreign investors convert assets into renminbi without prior approval from the State Administration of Foreign Exchange (SAFE). While the program was initially met with significant enthusiasm from foreign funds seeking to establish an onshore presence, recent

developments have significantly diminished its likely impact. In April, the National Development and Reform Commission (NDRC) issued a ruling that puts strict limits on the types of funds that can be classified as local. According to the NDRC, any funds that receive capital in any amount from foreign sources would be treated as foreign funds, placing them at a significant competitive disadvantage when deploying capital, particularly in industries deemed as sensitive by the government.

Many industry watchers declared the NDRC ruling as a death knell for the QFLP program. However, recently proposed legislation could reinvigorate a revised version of the QFLP program. The Renminbi Qualified Foreign Limited Partners program would allow firms with offshore renminbi to make direct investments in Shanghai-based companies. Some firms have already begun raising funds under the new program. While a positive development, the revised rules do little to address the disappointments of the earlier QFLP program, and because the new rules apply only to firms already holding renminbi assets, the impact of the amended regulations could be very limited.

China Securities Regulatory Commission (CSRC) develops draft law to increase regulation of PE funds

The CSRC has been active in issuing a number of proclamations and draft rules governing the PE industry in China. One of these, draft revisions to China's Securities Investments and Funds Law, could place an increased regulatory burden on PE funds by increasing disclosure requirements. The proposals would classify PE funds and more hedge fund-like private funds as "securities" and subject both to CSRC oversight. Several drafts of the new regulations have already drawn significant interest from the PE community and this latest version is certain to be closely watched by industry participants.

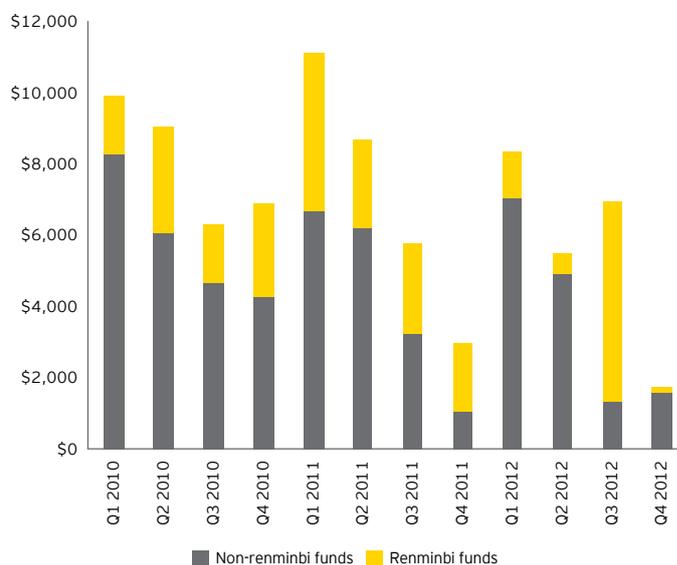
Another recent CSRC regulation has increased the number of firms that can invest in private assets. Until recently, public fund managers were disallowed from investing in PE-type investments. However, on 1 November 2012, new rules went into effect that allow public fund managers to invest in non-listed assets. In order to provide a measure of safety to investors' existing public funds, the non-listed investment vehicles must be established under a separate subsidiary and insulated financially from managers' public investments. It remains to be seen what the uptake will be among public managers – the expertise and infrastructure required for each asset class differ significantly. However, the new rules could ultimately increase competition in an already crowded market, especially in the pre-IPO space.

Fund-raising

Firms focused on China raise US\$22.8b

PE firms raised approximately US\$22.5b in 2012, below the US\$28.5b raised during 2011. Activity was buoyed by closings in the first and third quarters, which saw US\$8.3b and US\$6.9b committed by investors, respectively. Notably, fund-raising for renminbi-denominated funds climbed in the second half of the year. While these funds accounted for just 14% of aggregate China-focused fund-raising in the first half of the year, several closings by local and global renminbi funds in the second half propelled these to over two-thirds of total funds raised.

Figure 3. China fund-raising, 2010-2012 (US\$m)



Source: Preqin

Three key factors will continue to drive PE fund-raising in China

Despite the slowdown in fund-raising activity, firms focused on China continue to have significant stores of unspent capital to funds new acquisitions, and investors across the globe are seeking to allocate an increasing percentage of their portfolios to the emerging markets and China in particular. The shape of such investment will be defined by the interplay of a number of factors, most of which are very bullish for PE:

1 Institutional investors are under-allocated to China

Despite their rising economic prominence, most investors remain severely under-allocated to emerging markets investments, including China. Emerging markets represent just 4% of US-based investors' equity portfolios, despite accounting for 36% of global GDP and 68% of global GDP growth. Many institutional investors are actively addressing this by continuing to shift more assets towards emerging market investments, but it could be years before asset allocations catch up to the new economic order.

2 Limited access for investments into public markets

One of the primary reasons that emerging market allocations remain low is structural. Only a sliver of China's vast economy is investable through public markets. While roughly 200 mainland China companies list H-shares and other securities on the Hong Kong market, approximately 75% of China's market capitalization trades in A-shares listed on the mainland China stock exchanges, which are subject to strict foreign capital controls. While quotas

are increasing, allowing more foreign money into the market, there remains a significant amount of pent-up demand for Chinese equities.

A recent survey of more than 200 foundations, endowments and other institutional investors conducted by CommonFund showed that 53% expected to increase their exposure to emerging markets over the next 12 to 18 months. As more investors attempt to achieve exposure to China, PE funds, which allow for diversified exposure across a range of industries, are a natural choice and should see an increase in committed capital.

3 Pension reform

Pension managers and regulatory officials have grown increasingly familiar and comfortable with PE over the last several years, as investment to emerging market destinations has grown. Countries including Colombia, Brazil, Kenya, Chile, Peru and others have all seen increased investment from local pension funds, and many have recalibrated regulations to allow for greater PE investment by local institutions. In China, the National Social Security Fund (NSSF) announced in June that it would be increasing its PE allocation by more than 50%, from RMB19.5b (US\$3.1b) to approximately RMB30b (US\$4.8b) by the end of 2012. As of September 2012, the NSSF was well on its way, announcing it had invested nearly RMB23b (US\$3.7b) across 16 PE funds. And there is still significant room for additional growth as the NSSF's charter allows it to invest up to 10% of its RMB870b (US\$139b) in PE.

Fund-raising (continued)

2012 sees significant fund-raising from local and global firms alike

In 2012, there were a number of significant fund-raising from China-based and global funds alike, across a range of investment strategies. The largest local fund raised during the year was CITIC Private Equity Fund III, which closed in late September with RMB12b (US\$1.9b) in assets. It was closely followed by the Shanghai Cultural Industrial Fund, which closed in early August with RMB10b (US\$1.6b) in commitments. Managed by Haitong Kaiyuan Investment, the fund aims to invest in growth-oriented companies across the media and communications industries. Other growth-oriented funds to close during 2012 included Fang Fund, New Horizon Capital China Fund II and ChengBai I Fund (CBC Capital). ChengBai I closed with RMB2b (US\$320m). In the mezzanine space, CITIC Partners closed on its RMB5b (US\$800m) fund in July.

Figure 4. Top RMB and US\$ funds closed in 2012

	Fund	Vintage	Type	Final size (m)
Top RMB funds	CITIC Private Equity Fund III	2011	Growth	RMB12,000
	Shanghai Cultural Industrial Fund	2012	Growth	RMB10,000
	Fang Fund	2012	Early stage	RMB5,000
	CITIC Mezzanine Fund	2011	Mezzanine	RMB5,000
	New Horizon Capital China Fund II	2012	Growth	RMB4,000
Top US\$ funds	Mount Kellett Capital Partners II	2012	Special situation	US\$4,000
	Bain Capital Asia II	2012	Buyout	US\$2,300
	Axiom Asia III	2012	Fund of funds	US\$1,150
	CapitaMalls China Development Fund III	2012	Real estate	US\$1,000
	Pantheon Asia Fund VI	2011	Fund of funds	US\$647

Source: Preqin

Global managers were likewise busy in 2012 raising assets for investments in China. The largest fund to close with a significant focus on China was the US\$4b Mount Kellett Capital Partners II. The special situation fund will invest opportunistically across a range of asset classes, including distressed debt. The fund is emblematic of increasing interest by a growing number of institutional limited partners (LPs) in the many opportunities present across the region outside of traditional buyout and growth capital investments. In the buyout space, Bain Capital closed the largest fund of the year, raising US\$2.3b for opportunities in China and the rest of Asia.

Non-growth and buyout strategies see more funds raised

One of the current dynamics at work in the global fund-raising market is segmentation – firms that historically addressed multiple investment types and pursued pan-regional investment opportunities have, over the last several years, begun offering a wider array of smaller, targeted funds based on particular geographies or very specific strategies.

Such segmentation is beginning to be seen in China, with local and global managers raising assets for strategies distinct from the standard growth capital or buyout model. For example, distressed assets have attracted a significant amount of attention in China over the last year as banking reforms have created an opportunity for PE funds.

Much of the financing for China's non-financial firms comes from bank loans, some of which will inevitably become non-performing. In 2012, there were two funds that raised an aggregate US\$4.6b to target distressed opportunities across China and other parts of Asia. Moreover, funds currently on the road could raise an additional US\$640m for the market.

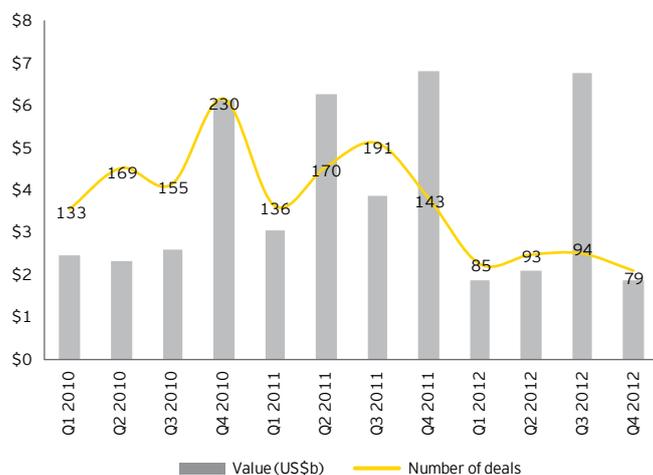
While such investments provide a number of challenges for offshore funds in particular, including obtaining regulatory approvals, the enforcement of contract rights, due diligence and an overall lack of transparency, they also provide significant opportunities for those firms willing to brave the market.

Acquisitions and exits

PE firms announced US\$12.6b in new transactions

PE firms announced US\$12.6b in new transactions in 2012, down from the US\$20b announced in 2011. Activity climbed steadily through the first three quarters of the year before dropping in the fourth quarter. In the first quarter, PE firms announced just 86 deals valued at US\$1.9b; in the second quarter, the value of PE deals grew by 32% to US\$2.5b; and by the third quarter, PE firms had announced 94 transactions valued at US\$6.8b quarter. Q4 saw an additional 79 deals valued at an aggregate US\$1.9b.

Figure 5. China PE transactions, 2010-2012



Source: Thomson One

Figure 6. Top deals announced in 2012

Date	Company	Fund	Deal value (US\$m)
13 Aug 2012	Focus Media, Inc.	The Carlyle Group LLC, CITIC Capital Partners Ltd., FountainVest Partners (Asia), Ltd.	3,700.0
2 Jul 2012	Suning Appliance Co., Ltd.	Hony Capital, Ltd.	740.3
30 May 2012	Hong Kong Broadband Network, Ltd.	CVC Capital Partners, Ltd.	643.7
9 Jul 2012	HCP Holdings, Inc.	TPG Capital LP	600.0
13 Nov 2012	Beijing Jingdong Century Trading Co., Ltd.	Tiger Global Management LLC, undisclosed firm	400.0
4 Jul 2012	CECEP Solar Energy Technology (Zhenjiang) Co., Ltd.	Two undisclosed firms, Jiangxi Poyanghu Industry Investment Management Co., Ltd.	393.9
28 Jun 2012	Fushi Copperweld, Inc.	Abax Global Capital, Ltd.	364.0
21 Mar 2012	Tianhe Chemicals Group	Morgan Stanley Private Equity	300.0
28 Feb 2012	Shaanxi Bicon Pharmaceutical Co., Ltd.	PAG	250.0
3 Mar 2012	Shanghai Bright Dairy & Food Co., Ltd.	Greenwoods Asset Management, Ltd., undisclosed firms	224.1
24 Jun 2012	Beijing Xiaomi Technology Co., Ltd.	Digital Sky Technologies Ltd.	216.0

Source: Thomson One

Despite the macroeconomic downturn, GPs and LPs alike continue to believe in China's long-term growth story. Investments remain focused on companies that are poised to benefit from China's emergence as an economic world power and the rise of China's middle class. One such example is CVC Capital Partner's investment in Hong Kong Broadband Network, among the largest transactions of 2012. The acquisition provided CVC with a platform of more than two million customers of high speed broadband and other telephony services at a time when usage is increasing significantly.

Declining valuations in the public markets are providing a source of additional deal flow for many PE firms. A number of formerly publicly-listed companies have been taken private in recent months. The largest of these was the US\$3.7b bid for US-listed Focus Media. The Shanghai-based company went public on the Nasdaq in July 2005 at a price of US\$17.00/share, and an average multiple of approximately 35x forward earnings. By August 2012, shares had come under significant pressure from short sellers, and Focus Media's forward multiple dropped to roughly 8.3x, a price at which several firms saw significant value. A consortium including The Carlyle Group, CITIC Capital Partners, Fountainvest Partners and China Everbright offered to take the company private on 13 August 2012.

Acquisitions and exits (continued)

There are a number of similar take-private deals that have already been completed or are currently in the pipeline, including China Fire & Security Group, Inc. which was taken private by Bain Capital in November 2011; Chemspec International, which was acquired by Primavera Capital; and Fushi Copperweld, which was taken private by Abax Global Capital. These companies and others, orphaned by the public market investors that clamored for them not long ago, should continue to provide interesting opportunities for the foreseeable future.

Exits challenged by lower IPO markets

While new acquisitions have continued at a healthy, albeit reduced pace, exits continue to be challenged by volatile IPO markets. While traditionally the favored exit route for many firms, overall declines in global IPO volumes have impacted the ability of PE firms to exit through this route. In 2012, the value of global new issuance was down 25% from 2011. And while the Shenzhen Stock Exchange was the most active in terms of the number of IPOs with 120 deals priced, Hong Kong, traditionally the venue for larger deals, saw just 2 IPOs price between August and October.

From an exits perspective, perhaps of greater concern are the valuation trends. While global PE firms and well-established local firms have developed investments with value creation as their core thesis, many others in the market have relied heavily on multiple expansion – arbitraging the valuation differentials between the private and public markets. If today's reduced valuations mark the start of a longer-term trend, many of these investments could face significant headwinds as they attempt to profitably exit. Moreover, the IPO markets could ultimately trigger a broader shift in exit modalities for funds of all types. The early weeks of 2013 have seen an encouraging rebound in China's equities markets, but many PE firms will be patiently waiting to see whether this holds. If activity continues to be slow, it could produce an increase in the number of exits achieved through trade sales or secondaries.

Global PE firms continue to open shop on the mainland

Perhaps one of the greatest signs that PE in China is around to stay is the number of global managers that continue to open shops in the country. Already firms including Blackstone, KKR, TPG, Warburg Pincus, Bain Capital, Permira and The Carlyle Group have well-established operations in China. Over the last year, additional firms have continued to open offices in order to establish a local presence and better facilitate deal sourcing, investor relationships and portfolio management and monitoring.

While Hong Kong has long served as a base of operations for many firms in the region, and will continue to do so, many PE investors are increasingly moving to establish a physical presence on the mainland. Providence Equity Partners recently established a new Beijing office to facilitate investments in the country. Providence first established the firm's Hong Kong office in 2007 to manage its investments throughout the Greater China region. Similarly, fund-of-funds manager HarbourVest Partners announced in April that the firm would open its first China office in Beijing, and Advent International announced in November that the firm would open its first office in China in Shanghai, bringing the total number of offices that the firm operates worldwide to 17.

While the clear trend among global firms is moving from offshore to onshore, there are a handful that are taking a different approach. In August, Zurich-based Adveq Partners opened its doors in Hong Kong, after establishing offices in Beijing and Shanghai in 2008 and 2011, respectively.

Outlook for 2013 and beyond

China's enormous opportunities matched only by the pace of change

China is in many ways the world's most unique market for PE investment. It has emerged as a world economic leader in a historically remarkable period of time, and in the process has yielded growth rates far higher than what investors could achieve in most other parts of the world. Yet China's story is not completely a "rising tide lifts all boats" narrative. A rapid influx of capital, unpredictable regulatory pronouncements and volatile capital markets have yielded a playing field that is markedly uneven and constantly changing. As a result, investments must be selected with extreme care. Diligence practices must meet or exceed the developed markets and a commitment must be made towards continual monitoring in order to yield the best chances for a positive outcome. And as the focus of PE investors in China expands from making investments to value creation, more local talent will be needed to help make their portfolio companies larger, better-run and more profitable.

The last year has seen a great deal of change throughout the PE industry globally. PE firms are adapting in new ways to an operating environment that is evolving at a rapid rate – firms are diversifying into new lines of business, adding capabilities in distressed debt, advisory, capital markets, hedge funds and other asset classes. At the same time, firms are responding to LPs' demands for increased geographic diversification by offering an ever-widening array of funds across a range of geographies.

Perhaps no where is the pace of change more evident than in China. In seemingly just a few short years, China has gone from a "nice-to-have" to a key pillar of many general partners' and LPs' portfolios. Moreover, the strategies that PE firms are employing are evolving as well. From traditional buyout and growth capital investments to pre-IPO, privatizations and distressed, PE firms must remain nimble and responsive while remaining true to their core competencies. It's a delicate balance, and the next several years will undoubtedly see a number of firms stumble. But for those with the talent, resources, discipline and resolve to persevere amid continued volatility and uncertainty, the opportunities should outweigh the risks, and they should find themselves key players as China enters into the next stage of its journey of growth.

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