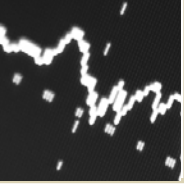

BY NICHOLAS CONSONERY

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Challenges of the Middle Market

While a few big name acquisitions are garnering headlines, mid-sized private equity deals are on the rise in China.

Investors dream about the promises of China's private equity industry and expect the sector to rise with Sisyphean certainty. As the economy expands, private equity investment is certain to grow.

The stakes are certainly high. In 1998, Sequoia Capital and Kleiner Perkins invested US$25 million in an internet start-up formed by two computer science graduate students at Stanford University. That investment has grown into the US$162 billion empire known as Google. Discovering the Chinese Google is now the holy grail of private equity investment.

Headline grabbing deals have drawn international attention to private equity in China, most notably the Carlyle Group's contested purchase of Xugong Construction Machinery Group in 2006. Other major international firms, such as Kholberg Kravis Roberts (KKR) and Blackstone, have also successfully pursued China deals. In September, KKR invested US$115 million in Henan Province's Tianrui Cement, betting on China's continued demand for infrastructure development.

China's private equity industry has grown rapidly, with investment doubling to nearly US$8 billion in 2006, up from US$4 billion in 2005, according to Asia Private Equity Research. However, a recent U.S. Department of Commerce report indicates that the results have been mixed. While there have been several breakthrough deals, overall growth has also been hampered by challenges such as industry resistance and a lack of legal recourse for deals that go south.

The major deals fuel the hopes of investors chasing the Chinese dream, but the real story behind China's private equity industry lies in the middle market.

Emerging middle market

The experiences of middle market firms, those pursuing small- to medium-sized investments ranging from US$20-50 million, may provide a more accurate picture of the private equity sector than the big players' major deals. Often overshadowed, a multitude of smaller private equity firms are navigating the testy waters of equity investment in China. Some encounter ongoing difficulties, while others are finding continued success.

China Century Capital (CCC) is a middle market firm pursuing private equity in China. CCC is the first Australia-based private equity investment fund focusing purely on Mainland China. "There is no shortage of good companies in China," says Thomas Su, CCC's investment research manager.

From hospitality to telecommunications and even finance, middle market firms are finding success across a wide array of industries. "In a way it is actually much easier to deal with small- to medium-sized enterprises," argues Su. "Bigger enterprises have many more layers of middle management. From our point of view, we see much more of these smaller deals. And the growth rates are amazing; some are doubling and tripling profits every year."

The Chinese economy is certainly not suffering from the capital gathering difficulties facing the U.S. market and some of the sector's prolific growth can be attributed to the plethora of cash available for deal making. "There is a lot of money out there… maybe too much" says John Caslione, CEO of GCS Business Capital, a mergers and acquisitions advisory firm working with middle market private equity and industrial clients in China, the U.S. and Europe. While industry prospects are great, no deal is guaranteed to turn a profit. "There is [also] a lot of foolish money that is going into deals," he says. "[Some] people are making investments just for the sake of making investments."

The Process

The process of finding potential enterprises for investment is difficult, though not for lack of options, says Thomas Schipper, director of international operations with Pacific Gateway Capital, a smaller American private equity firm pursuing investment projects in Shanghai. "There is a tremendous amount of opportunities out there. Every month we come across or are pitched an abundant number of investment opportunities in China. Picking the right one to invest our resources in is one of our biggest challenges, without a doubt."

Key challenges in uncovering target enterprises include conducting due diligence and negotiating value.

"In China, carrying out due diligence is the biggest risk, as it involves both commercial and relationship risk" says Su of CCC. "When you do due diligence, you can't rely on the figures you are sent. Normally these do not conform with Western standards."

Caslione advises building relationships to overcome the hesitancy of sellers. "The establishment of friendships and relationships has a 'halo effect' that transfers credibility onto other deals." Viewing deals as an "ongoing relationship rather than as a single investment" is key. Such an outlook often helps alleviate the hesitancy of entrepreneurs in target companies.

For the middle market firms who lack the name recognition of major firms, Schipper of Pacific Gateway sees advantages. While the big firms are instantly recognized, they may have difficulty negotiating in China because their resources are known to be significant. "That gives us a lot more bargaining power," says Schipper. "We have negotiated very favorable terms on our deals compared to other deal structures in today's market."

After discerning a deal with clear value prospects, gaining the trust of local entrepreneurs, and overcoming inexperience and name recognition issues, a middle market firm might finally solidify an investment. But then what?

> *"The growth rates are amazing; some are doubling and tripling profits every year."*

IMAGINECHINA

PRIME EXAMPLE: For now, the Carlyle Group's 2006 purchase of a stake in Xugong Construction Machinery Group remains the best-known foreign private equity investment in China.

Earning Profit

The ability of firms to effectively manage investments and turn companies around is every bit as important, and challenging, as securing deals in the first place. "Bringing in a deal is only half of the battle," says Peter Kwan, CEO of Pacific Gateway. "Overcoming operational issues and making the business successful is the other half. Getting money together and signing the contract is one thing. But to be able to use it properly and be successful all has to do with daily operations."

John Caslione of GCS is quick to emphasize the importance of effective business operations. "For our firm it includes not just making investments, but building up the [acquired] businesses themselves. You have to look at it from business-building fundamentals, not just financial fundamentals, and be prepared to change your models without compromising your company's core business strategy." The process of building up a firm "takes a lot more time and money than some private equity firms realize," he says.

After overcoming operational issues and achieving profitability, a private equity firm will start looking for an exit strategy. Exiting can be burdensome, and achieving an overseas IPO listing is notoriously difficult, especially for smaller firms. Recent government regulations have further restricted this process, with the newly-minted Partnership Enterprise Law limiting an international firm's ability to move assets offshore.

But the new law also allows international funds to pursue mergers and acquisitions activity through domestic partners, which expands the opportunities for exiting by listing domestically in the A-shares of the Shanghai or Shenzhen stock exchanges. The strong performances of these markets in 2007 make this strategy all the more attractive.

Domestic Newcomers

At the same time that international private equity firms aggressively pursue investments in China, domestic firms are beginning to make headway into the middle market. Large domestic firms, like Zero2IPO, have been successful in closing several major deals. But it is the emergence of smaller Chinese firms that may eventually fuel the growth of the entire industry. "In the past decade, the private equity market was very much dominated by foreign players," says Su of CCC. "Over the next years, that representation will shift a lot. There are quite a few Chinese private equity firms popping up."

Another emerging player in the middle market is the Chinese financial institution. In the United States, major banks like Goldman Sachs and JP Morgan are long term participants in the private equity industry. In China this has not been the case.

But there is evidence that financial institutions in China are starting to look more favorably on equity investments, and their initial activity will likely be small scale. Chinese banks are "expanding their financial planning and wealth management positions, and private equity is one such area they are considering" says Su. "This is a change that is likely to happen."

The Forecast

Growth in China's private equity industry has been spectacular. But whether this growth will lead to sustainable development of the middle market remains to be seen. The efforts of international firms, coupled with the emergence of domestic players, bode well for this section of the industry.

Obstacles remain. In certain sectors, such as telecommunications, finance, and research and development, there is still both official and unofficial reluctance to assets going into foreign control. In these industries, international private equity firms are often pushed into smaller stakes and less control than desired. Exit options are becoming more varied, but profitability is still elusive for some middle market firms.

The prospects are evident. "There is so much demand due to the rapidly growing affluent domestic population," says Schipper of Pacific Gateway, "that there are tremendous amounts of opportunity."

Kwan agrees: "There are more private entrepreneurs in China, and more small-sized companies with successful business models. Small-sized private equity firms can help these Chinese companies overcome development hurdles and make it to an IPO. And we see a lot of opportunities there."

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