CHINA SOEs

Enemy of the State-OE

Cash-rich Chinese GPs are taking a greater interest in the country's state-owned enterprises. But are these massive organisations ready to accept foreign investment?
By Clare Burrows

Li Keqiang: pushing reform in China's SOEs

In 2013, private equity investment in China dropped to just $4.5 billion – about 47 percent below the equivalent figure for 2012, according to data from Thomson Reuters.

Since China's dry powder level was estimated at $59 billion at the end of 2012, it's clear that China's GPs need to find new ways to deploy the vast amounts of capital raised during better times.

What seems to be catching the industry's eye more than ever are the country's state-owned enterprises: large, government-controlled organisations, many of which are in dire need of restructuring.

While state-owned enterprises account directly or indirectly for 60 percent of China's GDP, according to research by China First Capital, almost 100 percent of institutional capital, especially private equity, has been invested into China's privately-owned sector.

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However, as the number of traditional opportunities falls, "this may leave investing in SOEs as the best, largest and most promising new area for private equity investment," Peter Fuhrman, chairman and chief executive at China First Capital suggests.

And, some industry sources ask: what better target for private equity than these bloated, inefficient giants, which the newly-appointed Chinese government is apparently so keen to reform?

SOEs are highly compliant when it comes to tax and accounting laws (a rare phenomenon among China's privately-owned companies). Better still, they're a bargain – because China's State-owned Assets Supervision and Administration Commission (SASAC) regulates their price based on net asset value.

"If you have a highly profitable SOE that has very low net assets, you can potentially buy it at incredibly low P/E multiples," Fuhrman says. With one deal China First is advising on, 51 percent of the business is being offered at 2x EBITDA, he adds.

China First is currently acting as an investment banker for five of China's largest SOEs, including China Aerospace, China State Construction, China Huadian, Wuliangye Group and Shandong Energy.

Unfortunately, it's not quite that easy. "More people have realised the difficulties of doing those deals and getting returns from them," says Dayi Sun, managing director at Jade Invest.

SOEs rarely cede control and typically have several controlling shareholders, including government-connected officials. According to Sun, this makes it even harder than investing in a business privately-owned by a single founder.

"It seems that it is really hard to change anything in [an SOE]. The biggest difference is still the overall culture and internal processes. It is very, very hard to make an outsider an integrated part of an SOE company – especially because SOEs have their own best practices and ways of working."

Sun cites one example when a privately-owned investment company sent a general manager into a large state-owned resources company.

"That general manager was killed by the workers there over discrepancies over different problems. [The] new GM probably discovered some grey areas about the current management. So the current management [pushed] the workers to start riots."

Moreover, GPs and SOEs are misaligned when it comes to exits, one Hong Kong-based GP adds, explaining that these SOEs have "100-year strategies" and don't offer put options to secure exits.

"The most successful cases will be when the [GP] can gain the support of the management team and get an alignment of interest," Sun suggests. For GPs, it may be a question of playing the long game. "Investing in SOEs as an asset class hasn't produced returns yet. But maybe in the future." ■