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Commentary

Peter Fuhrman -- Chinese firms are reinventing private equity

A man walks on a bridge in the financial district of Pudong in Shanghai. © Reuters

Henry Kravis, his cousin George Roberts and his mentor Jerry Kohlberg are generally credited with having invented private equity buyouts after forming KKR 40 years ago. Even after other firms like Blackstone and Carlyle piled in and deals reached mammoth scale, the rules of the buyout game changed little: Select an underperforming company, buy it with lots of borrowed money, cut costs and kick it into shape, then sell out at a big markup, either in an initial public offering or to a strategic buyer.

This has proved a lucrative business that lots of small private equity firms worldwide have sought to copy. China's domestic buyout funds, however, are trying to reinvent the PE buyout in ways that Kravis would barely recognize. Instead of using fancy financial engineering, leverage and tight operational efficiencies to earn a return, the Chinese firms are counting on Chinese consumers to turn their buyout deals into moneymakers.

Compared to KKR and other global giants, Chinese buyout firms are tiny, new to the game and little known inside China or out. Firms such as AGIC, Golden Brick, PAG, JAC and Hua Capital have billions of dollars at their disposal to buy international companies. Within the last year, these five have successfully led deals to acquire large technology and computer hardware companies in the U.S. and Europe, including the makers of Lexmark printers, OmniVision semiconductors and the Opera web browser.

So what's up here? The Chinese government is urgently seeking to upgrade the country's manufacturing and technology base. The goal is to sustain manufacturing profits as domestic costs rise and sales slow worldwide for made-in-China industrial products. The government is pouring money into supporting more research and development. It is also spreading its bets by providing encouragement and sometimes cash to Chinese investment companies to buy U.S. and European companies with global brands and valuable intellectual property.

While the hope is that acquired companies will help China move out of the basement of the global supply chain, the buyout funds have a more immediate goal in sight, namely a huge expansion of the acquired companies' sales within China.

This is where the Chinese buyout firms differ so fundamentally from their global counterparts. They aren't focusing much on streamlining acquired operations, shaving costs and improving margins. Instead, they plan to leave things more or less unchanged at each target company's headquarters while seeking to bolt on a major new source of revenues that was either ignored or poorly managed.

So for example, now that the Lexmark printer business is Chinese-owned, the plan will be to push growth in China and capture market share from domestic manufacturers that lack a well-known global brand and proprietary technologies. With OmniVision Technologies, the plan will be to aggressively build sales to China's domestic mobile phone producers such as Huawei Technologies, Oppo Electronics and Xiaomi.

The Chinese buyout firms see their role as encouraging and assisting acquired companies to build their business in China. This often boils down to business development and market access consulting. Global buyout firms say they also do some similar work on behalf of acquired companies, but it is never their primary strategy for making a buyout financially successful.

Chinese buyout funds count on two things happening to make a decent return on their overseas deals. First is a boost in revenues and profits from China. Second, the funds have to sell down their stake for a higher price than they paid. The favored route on paper has been to seek an IPO in China where valuations can be the highest in the world. This path always had its complications since it generally required a minimum three-year waiting period before submitting an application to join what is now a 900-company-long IPO waiting list.

The IPO route has gotten far more difficult this year. The Chinese government delivered a one-two punch, first scrapping its previous plan to open a new stock exchange board in Shanghai for Chinese-owned international companies, then moving to shut down backdoor market listings through reverse mergers.

The main hope for buyout funds seeking deal exits now is to sell to Chinese listed companies. In some cases, the buyout funds have enlisted such companies from the start as minority partners in their company takeovers. This isn't a deal structure one commonly runs across outside China, but may prove a brilliant strategy to prepare for eventual exits.

There is one other important way in which the new Chinese buyout funds differ from their global peers. They don't know the meaning of the term "hostile takeover." Chinese buyout funds seek to position themselves as loyal friends and generous partners of a business's current owners. A lot of sellers, especially among family-controlled companies in Europe, say they prefer to sell to a gentle pair of hands -- someone who promises to build on rather than gut what they have put together. Chinese buyout funds sing precisely this soothing tune, opening up some deal-making opportunities that may be closed to KKR, Blackstone, Carlyle and other global buyout giants.

The global firms are also finding it harder to compete with Chinese buyout funds for deals within China, even though they have raised more than $10 billion in new funds over the last six years to put into investments in the country. They have basically been shut out of the game lately because they can't and won't bid up valuations to the levels to which domestic funds are willing to go.

The global buyout giants won't be too concerned that they face an existential threat from their new Chinese competitors. It is also unlikely that they will adopt similar deal strategies. Instead, they are getting busy now prettying up companies they have previously bought in the U.S. and Europe. They will hope to sell some to Chinese buyers. Along with offering genial negotiations and a big potential market in China, the Chinese buyout funds are also gaining renown for paying large premiums on every deal. No one ever said that about Henry Kravis.

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