



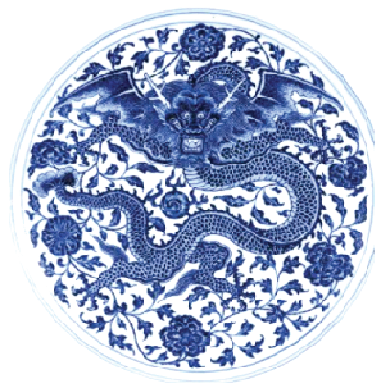
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Private Equity in China 2011-2012 Positive Trends & Growing Challenges



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How Big Can the PE Industry in China Grow?

By one conventional measure, China's private equity industry is still a fraction of the size of larger developed economies. The PE penetration rate calculates the total annual flow of private equity finance as a percentage of total GDP. In China, the PE penetration rate is currently 0.1% of GDP. In the US, it's eight times larger. In the UK, the flow of PE funding 2% of GDP, or twenty times the size of China.

While this calculation of PE penetration rate correctly suggests China's PE industry still has significant room for growth, it is also somewhat misleading. It's an apples-and-oranges comparison. Private equity in the US and Europe is mainly used to take over large underperforming businesses or subsidiaries of big public companies. These are control investments, usually financed with heavy amounts of borrowed money and a relative sliver of equity. These deals routinely exceed \$1 billion. Indeed, during the first half of this year, the ten

largest PE deals, all involving US companies, had total transaction value of over \$20 billion.

In China, these sorts of leveraged buyout deals, for the most part, are impossible. PE capital in China flows almost entirely into minority investments in profitable fast-growing private companies. Typical deal size is \$10mn for 15%-20% of a company's shares. Deals of this kind are far more rare in the US and UK.

The more accurate term for Private Equity investing in China is "growth capital investment." The goal is to add fuel to a fire, providing a fast-growing company with additional capital to build new factories or expand its sales and distribution channels. This kind of investing has a far higher success rate than PE investing in the US and Europe. In China, PE firms support winners. In the rest of the world, PE firms generally try to heal the wounded.

If you measured the penetration rate of growth capital investment, China would certainly be number one in the world. Nowhere else in the world can match China in the number of great private companies that are growing by over 30% a

year, have the scale, experience, management and market leadership to continue to double in size every two to three years. The only real limiting factor is a shortage of capital. That's where PE firms come in. They invest, monitor, then exit a few years later through an IPO.

That's another big difference between PE in China and the rest of the world. PE investors in China don't work nearly as hard as they do elsewhere. In China, the hardest part is finding good companies and then agreeing on the size and valuation of an investment. After that, it's usually smooth sailing. In the US and Europe, it's not only difficult to find good investment opportunities. The big challenge begins after an investment is made, in designing and then implementing often complex, risky restructuring plans, including a lot of hiring and firing.

With so much bank borrowing involved, short-term cash-flow problems can prove fatal for the PE firm's investment. Miss an interest payment and banks can seize the business, wiping out the PE firm's equity investment. One rather notable example: Cerberus's leveraged takeover of US automaker Chrysler. Within six months of the deal's closing, Cerberus's \$7.4 billion investment was mainly wiped out when Chrysler's sales plummeted.

In China, PE deals also occasionally turn sour. But, the most common reason is fraud or simple theft. PE money goes into a company and disappears, usually into personal bank account of the company's boss. This isn't very common. But, it does happen. The PE firm will usually have a legal right to take control of a company if its money is lost or misused. But, the legal process can be slow and the outcome uncertain. By the time a PE gains control, just about everything of value can be drained out of the company. The PE firm ends up owning 100% of a business worth far less than what they put into it.

In China, PE firms often play the role of a disciplinarian, setting up rules and doling out cash as a reward for good behavior. In the US and Europe, the PE is more like a doctor in a trauma ward.

McKinsey & Company, the global consulting firm, has estimated that China's private equity fund

penetration rate could more than quadruple in the next five years, to reach 0.5% of GDP. If so, the annual amount of PE capital flowing into private companies could reach Rmb200 billion (US\$30 billion.) There are clearly enough good investment opportunities.

At this point, the main thing holding the industry back is a lack of strong, talented people inside PE firms. In China, great entrepreneurs outnumber great investors.

A Three-Way Formula For Success in PE Investing in China

In the private equity industry in China, certain PE firms have an unfair advantage. They get the most cash, the most good deals and the most certain exit through a domestic IPO in China. These PE firms are one part of a tripartite alliance, the likes of which the investment world has never seen. The other two are China's National Social Security Fund, soon to be the largest source of investible capital in the world, and the CSRC, China's securities regulator, which has all the say in approving all domestic IPOs.

The PE firms get funding through one, and profits through the other. The deck is heavily stacked in their favor. For the hundreds of other PE firms active in China, including the global giants TPG, KKR, Carlyle, Blackstone and Goldman Sachs, making money investing in China is riskier, harder and slower.

Among the PE firms that are members of this new elite in China are CDH, SAIF, New Horizon, Hony Capital. To many investment professionals outside China, these names will be unfamiliar. Yet, they operate in an environment, and achieve outcomes, that ought to be the envy of other investors. The firms mainly got their start about ten years ago. They were present at the creation of the Chinese PE industry. They raised their initial

capital, in most cases, from prestigious American investors, like Stanford and Princeton endowments. The firms' investment focus has shifted somewhat over time – from technology deals to more traditional industries, from investing only dollars to now using also Renminbi. They did well almost from the beginning. This early success set in motion policies and preferences that have led more recently to their position today.

The two key developments took place within the last 18 months. First, in October 2009, China's Shenzhen Stock Exchange launched the ChiNext (创业板) board for private companies to go public. It's been a resounding success, with over 230 companies now listed, having raised over \$5 billion from the public. Chinext's total aggregate market cap is now over \$100 billion.

The Chinext p/e multiples, from the start, have been well above levels in the US and Hong Kong. Currently, the average is 42X trailing year's earnings. The high valuations make it a very profitable place for PE firms to exit from their investments. But, the CSRC acts as a strict gatekeeper, controlling both the number and quality of Chinese companies allowed to IPO on Chinext. Most Chinese firms who apply for Chinext listing are turned down.

The CSRC has a clear preference for companies that have received PE finance from one of the top PE firms in China, since this means, in effect, the company has already passed through a more rigorous due diligence process than the CSRC can attempt. The CSRC's logic is impeccable: if a good PE firm was willing to put its own capital at risk when the company was private, that business should be a safer investment for public shareholders than a Chinese company without a top PE investor.

Who comes top of the CSRC's list of favored PE firms? The firms listed above. This means that the companies invested in by these PE firms have a better chance of being chosen by the CSRC to go public on Chinext. In turn, because of Chinext's high valuations, this all but guarantees these PE firms achieve better annual investment returns than others.

When the NSSF announced it was going to begin investing up to 10% of the national pension system's capital in alternative investments, particularly PE, only a few firms were able to pass through its rigorous selection criteria. It chose firms with strong performance and high standards. Leading the list when the NSSF started handing out money last year: *CDH, SAIF, New Horizon, Hony Capital*.

The favored PE firms now have access to enormous capital from the state pension fund, along with what seems to be preferential access for its deals to China's IPO market. In the future, any gains these favored PE firms have from investments using NSSF funds will flow back into higher pensions for millions of Chinese retirees. Will the CSRC consider this, when it deliberates which Chinese companies should be approved for IPO? It seems a fair assumption.

China's pay-as-you-go pension system only got started recently. So, most of the profits from the PE deals won't get distributed to pensioners for many years. In the meantime, the gains will be recycled back into more PE investing in domestic companies that then get preferential access to China's capital markets. It's a process as elegant as it is practical: Chinese investors bid up the shares at IPO, locking in high profits for a PE firms investing NSSF money. The major part of the PE's profits is then returned to the NSSF to finance higher pension payments in the future to those same Chinese investors.

All the other PE firms outside this loop, including the global giants, will claim the system is rigged against them, that it's harder and harder for them to compete with the favored PE firms, and to get approval for their portfolio companies to IPO in China. They probably have a point.

But, in the end, this system in China will result in more private Chinese companies getting growth capital, leading to more jobs, more successful IPOs, and more comfortable retirements for China's many millions. Those are outcomes most Chinese can endorse unreservedly.

Delist-Relist Deals – the Worst New Business Model in Chinese PE

Hands down, it is the worst investment idea in the private equity industry today: to buy all shares of a Chinese company trading in the US stock market, take it private, and then try to re-list the company in China. Several such deals have already been hatched, including one by Bain Capital that's now in the early stages, the planned buyout of NASDAQ-quoted Harbin Electric (with PE financing provided by Abax Capital) and a takeover completed by Chinese conglomerate Fosun.

From what I can gather, quite a few other PE firms are now actively looking at similar transactions. While the superficial appeal of such deals is clear, the risks are enormous, unmanageable and have the potential to mortally wound any PE firm reckless enough to try.

A bad investment idea often starts from some simple math. In this case, it's the fact there are several hundred Chinese companies quoted in the US on the OTCBB or AMEX with stunningly low valuations, often just three to four times their earnings. That means an investor can buy all the traded shares at a low overall price, and then, in partnership with controlling shareholders, move the company to a friendlier stock market, where valuations of companies of a similar size trade at 20-30 times profits.

Sounds easy, doesn't it? It's anything but. Start with the fact that those low valuations in the US may not only be the result of unappreciative or uncomprehending American investors. Any Chinese company foolish enough to list on the OTCBB, or do any other sort of reverse merger, is probably suffering other less obvious afflictions. One certainty: that the boss had little knowledge of capital markets and took few sensible precautions before pulling the trigger on the backdoor listing which, among its other curses, likely cost the Chinese company at least one million dollars to complete, including subsequent listing and compliance costs.

Why would any PE firm, investing as a fiduciary, want to go in business with a boss like this? An "undervalued asset" in the control of a guy misguided enough to go public on the OTCBB may not be in any way undervalued.

Next, there's the complexities of taking a company private in the US. There's no fixed price. But, it's not a simple matter of tendering for the shares at a price high enough to induce shareholders to sell. The legal burdens, and so legal costs, are fearsome.

Worse, lots can – and often will – go wrong, in ways that no PE firm can predict or control. The most obvious one here is that the PE firm, along with the Chinese company, gets targeted by a class action lawsuit.

These are common enough in any kind of M&A deal in the US. When the deal involves a cash-rich PE firm and a Chinese company with questionable management abilities, it becomes a high likelihood event. Contingency law-firms will be salivating. They know the PE firm has the cash to pay a rich settlement, even if the Chinese company is a total dog. Legal fees to defend a class action lawsuit can run into tens of millions of dollars. Settling costs less, but targets you for other opportunistic lawsuits that keep the legal bills piling up.

The PE firm itself ends up spending more time in court in the US than investing in China. It's unlikely this is the preferred career path for the partners of these PE firms. Bain Capital may be able to scare off or fight off the tort lawyers. But, other PE firms, without Bain's experience, capital and in-house lawyers in the US, will not be so fortunate. Instead, think lambs to slaughter.

Also waiting to explode: the possibility of an SEC investigation, or maybe jail time. Will the PE firm really be able to control the Chinese company's boss from tipping off friends, who then begin insider trading? The whole process of "bringing private" requires the PE firm to conspire together, in secret, with the boss of the US-quoted Chinese company to tender for shares later at a premium to current price. That boss, almost certainly a Chinese citizen, can work out pretty quickly that even if he breaks SEC insider trading rules, by talking up the deal before it's publicly disclosed,

there's no risk of him being extradited to the US. In other words, lucrative crime without punishment.

The PE firm's partners, on the other hand, are not likely immune. Some will likely be US passport or Green Card holders. Or, as likely, they have raised money from US institutions. In either case, they will have a much harder time evading the long arm of US justice. Even if they do, the publicity will likely render them "persona non grata" in the US, and so unable to raise additional funds there.

Such LP risk – that the PE firm will be so disgraced by the transaction with the US-quoted Chinese company that they'll be unable in the future to raise funds in the US – is both large and uncontrollable. The potential returns for doing these "delist-relist" deals aren't anywhere close to commensurate with that risk. Leaving aside the likelihood of expensive lawsuits or SEC action, there is a fundamental flaw in these plans.

It is far from certain that these Chinese companies, once taken private, will be able to relist in China. Without this "exit", the economics of the deal are, at best, weak. Yes, the Chinese company can promise the PE firm to buy back their shares if there is no successful IPO. But, that will hardly compensate them for the risks and likely costs.

Any proposed domestic IPO in China must gain the approval of China's CSRC. Even for strong companies, without the legacy of a failed US listing, have a low percentage chance of getting approval. No one knows the exact numbers, but it's likely last year and this, over 2,000 companies applied for a domestic IPO in China. About 10%-15% of these will succeed. The slightest taint is usually enough to convince the CSRC to reject an application. The taint on these "taken private" Chinese companies will be more than slight. If there's no certain China IPO, then the whole economic rationale of these "take private" deals is very suspect. The Chinese company will then be delisted in the US, and un-listable in China. This will give new meaning to the term "financial purgatory", privatized Chinese companies without a prayer of ever having tradeable shares again.

Plus, even if they did manage to get CSRC approval, will Chinese retail investors really stampede to buy, at a huge markup, shares of a company that US investors disparaged? I doubt it.

How about Hong Kong? It's not likely their investors will be much keener on this shopworn US merchandise. Plus, these days, most Chinese company looking for a Hong Kong IPO needs net profits of \$50mn and up. These OTCBB and reverse merger victims will rarely, if ever, be that large, even after a few years of spending PE money to expand.

Against all these very real risks, the PE firms can point to what? That valuations are much lower for these OTCBB and reverse merger companies in the US than comparables in China. True. For good reason. The China-quoted comps don't have bosses foolish or reckless enough to waste a million bucks to do a backdoor listing in the US, and then end up with shares that barely trade, even at a pathetic valuation. Who would you rather trust your money to?

Crawling Naked & Blindfolded Through a Mine Field

Making a failed investment is usually permissible in the PE industry. Making a negligent investment is not. The PE firms now considering the "delist-relist" transactions are jeopardizing not only their investors' money, but the firm's own survival. The risks in these deals are both so large and so uncontrollable that if a deal were to go wrong, the PE firm would be vulnerable to a lawsuit by its Limited Partners ("LPs") for breach of fiduciary duty.

Such a lawsuit, or even the credible threat of one, would likely put the PE firm out of business by making it impossible for the firm to ever raise money from LPs again. In other words, PE firms that do "delist-relist" are taking existential risk

Before making any investment, a PE firm, to fulfill its fiduciary duty, will do extensive, often forensic, due diligence. The DD acts as a kind of inoculation, protecting the PE firm in the event something later goes wrong with the investment. As long as the DD was done properly, meaning no obvious risks were

ignored, then a PE firm can't easily be attacked in court for investing in a failed deal.

With the "delist-relist" deals however, there is no way for the DD process to fully determine the scale of the largest risks, nor can the PE firm do much to hedge, manage or alleviate them. This is because the largest risks are inherent in the deal structure.

The two main ones are the risk of shareholder lawsuits and the risk that the company, after being taken private, will fail to win approval for an IPO on a different stock market. If either occurs, they will drain away any potential profit. Both risks are fully outside the control of the PE firm. This makes these deals a blindfolded and naked crawl through a minefield.

Why, then, are PE firms considering these deals? One clear reason is that they appear easy. The target company is usually already trading on the US stock market, and so has a lot of SEC disclosure materials available. All one needs to do is download the documents from the SEC's Edgar website. Investing in private Chinese companies, by contrast, is almost always a long, arduous and costly slog – it involves getting materials, like an audit, and then making sure everything else provided by the company is genuine and accurate.

Another reason is ignorance of or indifference to the legal risks: many of the PE firms I've talked to that are considering these "delist-relist" deals have little direct experience operating in the US capital markets. Instead, the firm's focus on what they perceive to be the "undervaluation" of the Chinese companies quoted in the US. One PE guy I know described the Chinese companies as "miss-killed", meaning they are, to his way of thinking, basically solid businesses that are being unfairly scorned by US investors. There may well be some good ones foundering on US stock markets. But, finding them and putting the many pieces together of a highly-complex "delist-relist" deal is outside the circle of competence and experience of most PE firms active in China.

This investment approach, of looking for mispriced or distressed assets on the stock market, is a strategy following by many portfolio managers, distress investors and hedge funds. PE firms operating in China, however, are a different breed,

and raised money from their LPs, in most cases, by promising to do different sorts of deals, with longer time horizons and a focus on outstanding private companies short of growth capital. The PE firm acts as supportive rich uncle, not as a crisis counselor.

Abandoning that focus on strong private companies, to pursue these highly risky "delist-relist" deals seems not only misguided, but potentially reckless. Virtually every working day, private Chinese companies go public and earn their PE investors returns of 400% or more.

There is no shortage of great private companies looking for PE in China. Just the opposite. Finding them takes more work than compiling a spreadsheet with the p/e multiples of Chinese companies traded in the US. But, in most cases, the hard work of finding and investing in private companies is what LPs agreed to fund, and where the best risk-adjusted profits are to be made. How will LPs respond if a PE firm does a "delist-relist" deal and then it goes sour? This, too, is a suicidal risk the PE firm is taking.

Too Rich? Is the Chinese PE Industry Drowning in Cash?

The flow of money into private equity in China is fast becoming a deluge. Last year, new rules were introduced to allow the country's insurance companies to invest up to 5% of their Rmb4.8 trillion of assets in PE funds investing in China. If fully invested, that would be Rmb240 billion (\$36 billion) of new capital for an investment class that is already flooded with liquidity. Insurance assets are growing by over 15% a year, which means at least another \$5 billion a year available in coming years for PE investing.

The other fire hose of capital is the National Social Security Fund (NSSF). The NSSF is pumping Rmb80 billion (\$12 billion) into PE investing in China, and expects to add an additional \$1.5 billion a year in new capital for same purpose. Never before, in the space of twelve months has so much

new capital poured a single class of illiquid investing.

In part, these institutions are chasing returns. Insurance companies and the NSSF both have very large longer-term liabilities, mainly in the form of retirement pensions and life insurance policies. PE investing can jazz up overall returns for institutions that otherwise park their money in safe but tepid investments like government bonds.

PE investing in China has certainly been performing well lately. The more successful firms have been earning returns of +40% a year for investors. For insurance companies, that kind of performance (40% returns on 5% of its assets) would deliver 2% base annual return. For the NSSF, with up to 10% of its assets going to PE, the potential rewards would be higher.

The investments in PE also serve a patriotic purpose. By providing additional growth capital for Chinese entrepreneurs, PE investment should help increase employment and overall economic growth in China. The insurance companies are all majority state-owned. The NSSF is a branch of government. Invest carefully, earn a good return and contribute to building China. That summarizes the management goals for insurance companies and the NSSF alike.

Less clear is what overall effect of all this state-controlled money on the PE industry in China. Like any other asset class, the more capital that pours in, the lower the overall returns are likely to be. The insurance companies and NSSF aren't the only – or even the main – source of capital for the PE industry. There is already billions of dollars available for PE firms from LPs in China, the US, Europe, Japan. By some estimates, as much as \$30 billion in new capital has already flowed into PE firms over the last year for investment in China. This excludes the money from the NSSF and insurance companies.

All this new capital is enough to fund PE investments in over 5,000 companies, based on a typical PE deal size in China. Are there that many good deals out there? It's hard to say. Overall, we are very bullish about the number of great private companies and great PE investment opportunities in China.

The big bottleneck is certain to be within the PE firms themselves. The good ones, currently, do anywhere from 10-15 deals a year, and look seriously at another 25- 40 companies. They don't have the partners and skilled staff to review, close and manage many more deals than this a year.

The irony here: while PE firms demand portfolio companies use PE capital efficiently and scale quickly after investment, PE firms generally have no such ability. Adding capital to PE firms is like adding salt to soup. More is not necessarily better.

As the amount of capital has surged, the preferred deal size of the more successful PE firms in China has risen steeply, from \$10 million per deal, to over \$25 million now. But, in China, bigger deals are not generally better deals. Often, the opposite is true. The best PE investment in recent history, for example, was the \$5 million pre-IPO investment Goldman Sachs made in Shenzhen pharmaceutical company Hepalink. This investment multiplied 240 times in value, based on Hepalink's IPO price last year.

More capital also can also skew the priorities and tame the animal instincts of PE firms. When money is easy to raise, as it is now, PE firms can spend more time on this than hunting for great companies. It's easy to understand why.

For every \$100 million they raise, a PE firm generally keeps \$2 million in annual management fees. This management fee income keeps rolling in like an annuity, regardless of how well the PE firm is doing in its "day job" of putting capital to work on behalf of investors.

Insurance companies and NSSF can generally negotiate a lower management fee. But, the incentive is still there for PE firms to focus on raising money rather than investing it.

The PE industry in China is blessed, as nowhere else is, with abundant capital, stellar investment opportunities and favorable IPO markets. Our view: over the next decade, PE deals in China will produce more wealth for entrepreneurs and investors than any other major asset class anywhere in the world. Anything less will mean many opportunities in China were squandered rather than seized.

The Compelling Logic of Cross-Border M&A Deals in the US

We are entering a golden age of Chinese M&A deals in the US. There is certainly a sharp pick-up in activity going on – not so much of announced deals yet, though there have been several, but in more intensive discussions between potential Chinese acquirers and US companies. There is also a lot more shopping and tire-kicking by Chinese buyers. We certainly see it in our business. We're engaged now in several M&A deals whose goal is sale of a US company to a Chinese buyer. We expect to see more.

The reasons for this upsurge are many – including the recent appreciation of the Renminbi against the dollar, the growing scale and managerial sophistication of Chinese companies (particularly private as opposed to state-owned ones), attractive prices for target US companies, the launch in 2009 by the Shenzhen Stock Exchange of the *Chinext* board for fast-growing private companies.

The best reason for Chinese buyers to acquire US firms is one less-often mentioned – to profit from p/e arbitrage. The gap between stock market valuations in the US and China, on price-earnings basis, are wide. The average trailing p/e in the US now is 14. On China's *Chinext* board, it's 45. For fast-growth Chinese companies, the p/e multiples can exceed 70. This gives some Chinese acquirers leeway to pay a higher price for a US business.

In the best cases, a dollar of earnings may cost \$10-\$15 to acquire through purchase of a US business, but that dollar is immediately worth fifty dollars or more to the Chinese firm's own valuation. As long as the gap remains so large, it makes enormous economic sense for Chinese acquirers to be out buying US businesses.

This is equally true for Chinese companies already quoted on the Chinese stock market as well as those with that ambition. Indeed, for reasons unique to China, the incentive is stronger for private companies to do this p/e arbitrage. In China, public companies generally are forbidden

from doing secondary offerings, nor can they use their own shares to pay for an acquisition. When a Chinese public company consolidates an American acquisition's profits, its overall market value will likely rise. But, it has no way to capitalize by selling additional shares and replenish the corporate treasury.

For a private company, the larger the profits at IPO, the higher the IPO proceeds. An extra \$1 million in profits the year before an IPO can raise the market cap by \$50mn – \$70mn when the company goes public on *Chinext*. Private Chinese companies, unlike those already public in China, can also use their shares to pay for acquisitions. The better private companies also often have a private equity investor involved. The PE firms can be an important source of cash to finance acquisitions, since it will juice their own returns. PE firms like making money from p/e arbitrage.

In M&A, the best pricing strategy is to swap some of my overvalued paper to buy all of someone else's undervalued paper. At the moment, some of the most overvalued paper belongs to Chinese companies on the path to IPO in China.

Most M&A deals end up benefitting the selling shareholders far more than the buyers. That's because the buyers almost always fail to capture the hoped-for savings and efficiencies from combining two firms. Too often, such synergies turn out to be illusory.

For Chinese acquirers, p/e arbitrage greatly increases the likelihood of an M&A deal paying off – if not immediately, then when the combined company goes public.

If the target company in the US has reasonable rate of profit growth, the picture gets even rosier. The rules are, a private Chinese company will generally need to wait three years after an acquisition to go public in China. As long as the acquired business's profits keep growing, the Chinese company's market value at IPO will as well. Chinese acquirers should do deals like that all day long.

But, as of now, they are not. One reason, of course, is that things can and often also go wrong in M&A deals. Any acquirer can easily stumble trying to manage a new business, and to maintain its rate of

growth after acquisition. It's tougher still when it's cross-border and cross-cultural.

Another key reason: domestic M&A activity in China is still rather scant. There isn't a lot of experience or expertise to tap, particularly for private companies. Knowing you want to buy and knowing how to do so are very different beasts. I've seen that in our work. Chinese companies immediately grasp the logic and pay-off from a US acquisition. They are far less sure how to proceed. They commonly will ask us, investment bankers to the seller, how to move ahead, how to work out a proper valuation.

The best deals, as well as the easiest, will be Chinese acquiring US companies with a large untapped market in China. Our clients belong in this camp, US companies that have differentiated technology and products with the potential to expand very rapidly across China.

In one case, our client already has revenues and high profit margins in China, but lacks the local management and know-how to fulfill the demand in China. The senior management is all based in the US, and the company sends trained US workers over to China, putting them up in hotels for months at a time, rather than using Chinese locals. Simply by localizing the staff and taking over sales operation now outsourced to a Chinese "agent", the US company could more than double net profits in China.

The US management estimates their potential market in China to be at least ten times larger than their current level of revenues, and annual profits could grow more. But, to achieve that, the current owners have concluded their business needs Chinese ownership.

If all goes right, the returns on this deal for a Chinese acquirer could set records in M&A. Both p/e arbitrage and high organic profit growth will see to that. Our client could be worth over \$2 billion in a domestic IPO in China in four years' time, assuming moderate profit targets are hit and IPO valuations remain where they are now on China's *Chinext* exchange.

Another client is US market leader in a valuable media services niche, with A-List customers, high growth and profits this year above \$5mn. After testing the M&A waters in the US, the company is

now convinced it will attract a higher price in China. The company currently has no operations now in China, but the market for their product is as large – if not larger – than in the US. Again, it needs a Chinese owner to unlock the market. We think this company will likely prove attractive to quoted Chinese technology companies, and fetch a higher price than it will from US buyers.

The same is true for many other US companies seeking an exit. US businesses will often command a higher price in China, because of the valuation differentials and high-growth potential of China's domestic market.

China business has prospered over the last 20 years by selling things US consumers want to buy. In the future, it will prosper also by buying businesses the US wants to sell.

Renminbi Funds Confront the Chinese Taxman

The formula for success in private equity is simple the world over: make lots of money investing other people's money, keep 20% of the profits and pay little or no taxes on your share of the take. This tax avoidance is perfectly legal. PE firms are usually incorporated as offshore holding companies in tax-free domains like the Cayman Islands.

Depending on their nationality, partners at PE firms may need to pay some tax on the profits distributed to them individually. But, some quick footwork can also keep the taxman at bay.

For example, there are quite a few PE partners who are Chinese nationals, but live in Hong Kong. They plan their lives to be sure not to be in either Hong Kong or China for more than 182 days a year, and so escape most individual taxes as well. Even when they pay, it's usually at the capital gains rate, which is generally far lower than income tax.

The tax efficiency is fundamental to private equity, and most other forms of fiduciary investing. If the PE firm's profits were assessed with income tax

ahead of distributions to Limited Partners (“LPs”), it would significantly reduce the overall rate of return, to say nothing about potentially incurring double taxation when those LPs share of profits got dinged again by the tax man.

China, as everyone in the PE world knows, is very keen to foster growth of its own homegrown private equity firms. It has introduced a raft of new rules to allow PE firms to incorporate, invest Renminbi and exit via IPO in China.

So far so good. The Chinese government is also pouring huge sums of its own cash into private equity, either directly through state-owned companies and agencies, or indirectly through the country’s pay-as-you-go social security fund.

Exact figures are hard to come by. But, it’s a safe bet that at least Rmb100 billion (USD\$15 billion) in capital was committed to domestic private equity firms last year. This year should see even larger number of new domestic PE firms established, and even larger quadrants of capital poured in.

It’s going to be a few years yet before the successful Chinese domestic PE firms start returning significant investment profits to their investors. When they do, their investors will likely be in for something of an unpleasant surprise: the PE firms’ profits, almost certainly, will be reduced by as much as 25% because of income tax.

In other words, along with building a large homegrown PE industry that can rival those of the US and Europe, China is also determined to assess those domestic PE firms with sizable income taxes. These two policy priorities may turn out to be wholly incompatible. PE firms, more than most, have a deep, structural aversion to paying income tax on their profits.

For one thing, doing so will cut dramatically into the personal profits earned by PE partners, lowering significantly the after-tax returns for these professionals. If so, the good ones will be tempted to move to Hong Kong to keep more of their share of the profits they earn investing others’ money. If so, then China could get deprived of some experienced and talented PE partners its young industry can ill afford to lose.

It’s still early days for the PE industry in China. Renminbi PE firms really only got started two years

ago. The complaints haven’t started. But, our guess is that the complaining will begin just as soon as these PE firms begin to have successful exits and begin to write very large checks to the Chinese tax bureau. What then?

China’s tax code is nothing if not fluid. New tax rules are announced and implemented on a weekly basis. Sometimes taxes go down. Most often lately, they go up. Compared to developed countries, changing the tax code in China is simpler, speedier. So, if the Chinese government discovers that taxing PE firms is causing problems, it can reverse the policy rather quickly.

The PE firms will likely argue that taxing their profits will end up hurting hundreds of millions of ordinary Chinese whose pensions will be smaller because the PE firms’ gains are subject to tax. In industry, this is known as the “widows and orphans defense”. Chinese contribute a share of their paycheck to the state pension system, which then invests this amount on their behalf, including about 10% going to PE investment.

PE firms outside China are structured as offshore companies, with offices in places like London, New York and Hong Kong, but a tax presence in low- and no-tax domains. But, there’s currently no real way to do this in China, to raise, invest and earn Renminbi in an offshore entity.

Changing that opens up an even larger can of worms, the current restrictions preventing most companies or individuals outside China from holding or investing Renminbi. This restriction plays a key part in China’s all-important Renminbi exchange rate policy, and management of the country’s nearly \$2.8 trillion of foreign reserves.

The world’s major PE firms are excitedly now raising Renminbi funds. Several have already succeeded, including Carlyle and TPG. They want access to domestic investment opportunities as well as the high exit multiples on China’s stock market.

When and if the income tax rules start to bite and the firm’s partners get a look at their diminished take, they may find the appeal of working and investing in China far less alluring.

What Is The Major Source of Chinese Competitiveness? It's Not Low Labor Costs

True or false? The basis of China's strong global economic competitiveness is cheap labor? False. It's cheap factory land.

No doubt, until a few years ago, China's low labor costs were a vital part of its economic growth story. That is no longer the case. Labor costs have risen sharply in the last five years. There are now many countries with a decided labor cost advantage over China. And yet China remains the "factory of the world". For one thing, its workers have higher productivity than those earning lower wages in countries like Vietnam, India or Indonesia.

But, there is a more fundamental, and most often overlooked, reason for China's global economic competitiveness. Factories, and other productive assets like mines or logistics centers, are built on land that is either free or close to it. The result is that in China land costs usually represent an inconsequential component of overall manufacturing costs. This, in turn, gives China an inbuilt edge and, when added to the productivity of its workers, an insurmountable cost advantage over the rest of the world.

There is no good international data on the percentage of a company's fixed costs that come from purchase or rental of land. But, it is certainly the case that in China, this percentage will be far lower than in any developed – and many developing – countries. This isn't because land is cheap in China. It isn't. The market price, in most areas, is often on par with land costs in the US. But, good businesses in China don't pay market price. Often they pay nothing at all.

This has two useful aspects for the favored Chinese business. First, it means the cost of expanding operations is limited primarily to the cost of new capital equipment and factory construction. Second,

the business given a plot of land is thus endowed with a valuable asset it can use as collateral to secure more funding from banks. Even better, if the business runs into trouble or later goes bust, the owner will be able to sell the land at market price and pocket a huge personal gain.

It can't be overstated just how important this is to a business owner's calculation of risk, and so the success of Chinese entrepreneurial companies. Owners know that if all goes bad, they still hold land acquired for little or nothing for that is worth millions of dollars.

All land in China belongs to the Chinese government. Every year, a fraction of it is released on a long-term lease (usually forty years or longer) for development into commercial or residential land. While there is no official central policy to make land available at low prices to successful businesses, in practice, this is the way the system works. Land is sold at deeply-discounted prices, or given outright, to businesses that are seeking to expand, often by building a new factory or office building.

Land in China, it goes without saying, is in very high demand. It's a crowded country, and only 15% of the land is flat or fertile enough to be suitable for cultivation. This "good land" is also where most new factories get built.

There isn't enough new land released every year to meet the enormous demand. This is true both for residential land, a key reason why housing prices are so high, and commercial land. For most businessmen, it's impossible to get new land, at any price. A privileged group, however, not only gets land to expand, but gets it at artificially low prices. In China, land prices are elastic. Different levels of government have ways to transfer land to companies at prices equal to 5%-15% of its current market value.

Officially, the land allocation system in China is meant to work in a more market-oriented way, with new land for development being auctioned publicly, and selling prices controlled and verified by higher levels of government. In other words, the system is meant to discourage, if not prohibit,

land being given to insiders at low prices. In practice, these rules are often more observed in the breach. Local governments have ways to control the outcome of land auctions and so guarantee that favored businesses get the land they want at attractive prices.

These below-market sales deprive the local government of revenue it might otherwise earn from a land deal done at closer to market prices. But, there is some economic logic at work. The sweetest of sweetheart land deals are generally offered to successful companies whose growth is being stifled by insufficient factory space. The new land, and the new factories that will be built there, will increase local employment and, down the road, tax revenues.

Note, the deeply-discounted land prices are available mainly to companies that are already successful, and straining at the leash to maintain growth and profits. Both private and state-owned companies are eligible. It's a rare example of even-handed treatment by officials of state-owned and private companies.

Is corruption also a factor? Are cheap land deals really not all that cheap when various under-the-table payments are factored in? CFC's direct experience, though limited, suggests such payoffs, if they happen, are not compulsory.

CFC has played a walk-on part in several below-market land deals. Our role is to meet with local officials, usually the mayor or party secretary, to urge them to provide our client with the land needed for expansion. All local government officials in China are also motivated by, and rewarded for, having local companies go public. We stick to that point in discussions with the local officials – our client needs land to grow and so reach the scale where the business can IPO.

In each case, the deal has gone forward, and clients have gotten the land they were seeking, at a price 5-15% of its then-market value. Our client wins the trifecta: the business grows larger, unit costs remain low because of scale economies and the cheap land, and the balance sheet is

strengthened by a valuable asset purchased on the cheap.

In all respects, this system of commercial land acquisition is unique to China. It is also a key component in the country's economic policy, though it never has been proclaimed as such. The government at all levels is keen to keep GDP growing smartly. This process of rewarding good companies with cheap land for growth plays a key part in this, everywhere across China. China's government (at national, provincial and local levels) is not hurting for cash, unlike for example America's. Tax revenues are growing by upwards of 30% a year. So, maximizing the value of land released for development is not a fiscal priority.

Who loses? There are likely incidences where peasants are thrown off land with little or no compensation to make way for new commercial district. But, that way of doing things is becoming less common in China.

Mainly, of course, the losers are the international competitors of Chinese companies getting cheap land to expand. It's hard enough to stay in business these days when facing competition from China. It verges on hopeless when the Chinese companies can build output and lower unit prices because of land they get for free or close to it.

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