

The logo for 'SuperReturn' features the word 'SuperReturn' in a dark blue, sans-serif font. A red curved arrow starts from the top left, loops around the 'S', and points towards the end of the word 'Return'.

**Does [China's] shift from a manufacturing-driven economy to a service-driven one make macroeconomic shocks like those seen this summer inevitable?**

*Peter Fuhrman:* China has enjoyed something of a worldwide monopoly on hair-raising economic news of late: a stock market collapse followed by a klutzy bail-out, then a devaluation followed by a catastrophic explosion and finally near-hourly reports of sinking economic indicators. As someone who first set foot in China 34 years ago, my view is we're in an unprecedented time of economic and financial uncertainty. Consumers and corporates are noticeably wobbling. For a Chinese government long used to ordering "Jump!" and the economy shouting back "How high?" this is not the China they thought they were commanding. Everyone is looking for a bannister to grab.

And yet, China still has some powerful fundamentals working in its favour. Urbanization is a big one. It alone should add at least 3-4% to annual GDP a year for many years to come. The shift towards services and domestic growth as opposed to exports are two others. For now, these forces are strong enough to keep China propelling forward even as it tows heavy anchors like an ageing population, and a cohort of monopolistic state-owned enterprises (SOEs) that suck up too much of China's capital and often achieve appalling results with it.

Look, the Chinese stock market had no business in the first place almost tripling from June last year to June of this. The correction was long, long overdue. It's often overlooked that China's domestic stock market has a pronounced negative selection bias. Heavily represented among the 3,000 listed companies are quite a number of China's very worst companies, with the balance made up of lethargic, low-growth, often loss-making SOEs.

The good companies, like Tencent or Baidu, predominantly expatriate themselves when it comes time to IPO. To my way of thinking, China's domestic market still seems overpriced. The dead cats are, for now, still bouncing.

**Given this overall picture, do you expect to see greater or fewer opportunities [in China] for alternative investments and why?**

*Peter Fuhrman:* The environment in China has been challenging, to say the least, for alternative investment firms not just in the last year, but for the better part of the last decade. A lot hasn't gone to plan. China's growth and opportunities proved alluring to both GPs and LPs. And yet too often, almost systematically, the big money has slipped between their fingers. Partly it's because of too much competition, and with it ballooning valuations, from over 500 newly-launched domestic Chinese PE and VC firms. The fault also sits with home-grown mistakes, with errors by private equity firms in investment approach. This includes an excessive reliance on a single source of deal exit, the IPO, all but unheard-of in other major alternative investment environments.

Overall PE returns have been lacklustre in China, especially distributions, before the economy began to slip off the rails. In the current environment, challenges multiply. A certain rare set of investing skills should prove well-adapted: firms that can do control deals, including industry consolidating roll-ups. In other words, a whole different set of prey than China PE investors have up to now mainly stalked. These are not pre-IPO deals, not ones predicated on valuation arbitrage or the predilections of Chinese young online shoppers. There's money to be made in China's own Rust Belt, backing solid well-managed manufacturers, a la Berkshire Hathaway. There's too much fragmentation across the industrial board. China will remain the manufacturing locus for the world, as well as for its own gigantic domestic market.

Another anomaly that needs correcting: Global alternative investing has been overwhelmingly skewed in China towards equity not debt. The ratio could be as high as 99:1. This imbalance looks even more freakish when you consider real lending rates to credit-worthy corporates in China are probably the highest anywhere in the advanced world, even a lot higher than in less developed places like India and Indonesia. Regulation is one reason why global capital hasn't poured in in search of these fat yields. Another is the fact PE firms on the ground in China have few if any team members with the requisite background and experience to source, qualify, diligence and execute China securitized debt deals. There's a bit of action in the China NPL and distress world. But, straight up direct collateralized lending to China's AA-and-up corporates and municipalities remains an opportunity global capital has yet to seize. Meanwhile, China's shadow banking sector has exploded in size, with over \$2.5 trillion in credit outstanding, almost all of which is current. There's big money being made in China's securitized high-yield debt, just not by dollar investors.

**What's the overall story of alternative investors engaging with central planning?  
How would you characterise the regulatory environment?**

*Peter Fuhrman:* China has had a state regulatory and administrative apparatus since Europeans were running around in pelts and throwing spears at one another. So, yes,

there is a large regulatory system in China overseen by a powerful government that is very deeply involved in economic and financial planning and rule-making. One must tread carefully here. Rules are numerous, occasionally contradictory, oft-time opaque and liable to sudden change.

Less observed, however, and less harrowing for foreign investors is the core fact that the planning and regulatory system in China has a strong inbuilt bias towards the goal of lifting GDP growth and employment. Other governments talk this talk. But it's actually China that walks the walk. The days of anything-goes, rip-roaring, pollute-as-you-go development are about done with. But, still the compass needle remains fixed in the direction of encouraging strong rates of growth.

The Chinese government has also gotten more and more comfortable with the fact that most of the growth is now coming from the highly-competitive, generally lightly-regulated private sector. Along with a fair degree of deregulation lately in industries like banking and transport, China also often pursues a policy of benign neglect, of letting entrepreneurs duke it out, and only imposing rules-of-the-game where it looks like a lot of innocents' money may be lost or conned. To be sure, foreign investors in most cases cannot and should not operate in these more free-form areas of China's economy. They often seem to be the first as well as the fattest targets when the clamps come down. Just ask some larger Western pharmaceutical companies about this.

**In the long view, how long can the parallel USD-RMB system run? Do you expect to see the experiments in Shanghai's Pilot Free Trade Zone (FTZ) replicated and extended?**

*Peter Fuhrman*: Unravelling China's rigged exchange rate system will not happen quickly. Every baby step — and the steps are coming more fast of late — is one in the direction of a more open capital account, of greater liberalization. But, big change will all unfold with a kind of stately sluggishness in my view. Not because policy-makers are particularly wed to the notion of an unconvertible currency. There's the deadweight problem of nearly \$4 trillion in foreign exchange reserves.

What's the market equilibrium rate of the Dollar-Renminbi? Ask someone facing competition from a Chinese exporter and they're likely to say three-to-one, or an almost 100% appreciation. Ask 1.4 billion Chinese consumers and they will, with eminent good reason, say it should be more like 12-to-one. Prices of just about everything sold to consumers in China is higher, often markedly higher, than in the US where I'm from. This runs from fruit, to supermarket staples, to housing, brand-name clothing up to ladder to cars and the fuel that powers them.

I think the irrational exuberance about Shanghai's FTZ has slammed into the wall of actual central government policy of late. It will not, cannot, act like a free market pathogen.

**Reform of China’s state-owned enterprises has been piecemeal, and private equity has had patchy success with SOEs. Do you expect this to change, and why?**

*Peter Fuhrman:* For those keeping score, reform of SOEs has yet to really put any points on the board. The SOE economy-within-an-economy remains substantially the same today as it was three years ago. Senior managers continue to be appointed not by competence, vision and experience, but by rotation. The major shareholder of all these SOEs, both at centrally-administered level as for well as those at provincial and local level, act like indifferent absentee proprietors, demanding little by way of dividends and showing scant concern as margins and return-on-investment droop year-by-year at the companies they own.

There are good deals to be done for PE firms in the SOE patch. The dirty little secret is that the government uses a net asset value system for state-owned assets that is often out-of-kilter with market valuations. Choose right and there’s scope to make money from this. But, if you’re a junior partner behind a state owner who cares more about jobs-for-the-boys than maximizing (or even earning) profits then no asset however cheaply bought will ever really be in the money.

**TPP has been described as ‘a club with China left out’. If it comes to pass, how do you expect China to respond?**

*Peter Fuhrman:* China has responded. Along with its rather clumsy-sounding “One Belt, One Road” initiative it also has its Asia Infrastructure Investment Bank. The logic isn’t alien to me. When American Jews were barred from joining WASP country clubs, they tried to build better clubs of their own. When Chase Manhattan, JP Morgan and America’s largest commercial banks wouldn’t hire Jews, they went instead into investment banking, where there was more money to be made anyway.

But, China may not so easily and successfully shrug off their exclusion from TPP. It increases their aggrieved sense of being ganged-up upon. The US understands this and now frets more about China’s military power. The partners China are turning to instead – especially the countries transected by the “One Belt, One Road” – look more like a cast of economic misfits, not dynamic free traders like the TPP nations and China itself. I don’t think anyone in Beijing seriously believes that increased trading with the Central Asian -stans is a credible substitute. Even so, China will not soon be invited to join the TPP. China has hardly acted like a cozy neighbour of late to the countries with the markets and with the money. Being feared may have its strategic dividends. But the neighbourhood bully rarely if ever gets invited to the block party.

*Peter Fuhrman will be speaking at [SuperReturn Asia 2015](#), 21-24 September 2015, JW Marriott, Hong Kong.*

[http://www.superreturnasia.com/blog/super-return-private-equity-conference/post/id/7653\\_A-lot-hasnt-gone-to-plan-Peter-Fuhrman-China-First-Capital-on-alternative-investments-in-the-PRC?xtssot=0](http://www.superreturnasia.com/blog/super-return-private-equity-conference/post/id/7653_A-lot-hasnt-gone-to-plan-Peter-Fuhrman-China-First-Capital-on-alternative-investments-in-the-PRC?xtssot=0)

## CHINA FIRST CAPITAL CEO CONTACT DETAILS:

Peter Fuhrman | China First Capital  
Chairman and Chief Executive Officer

China Office : 0755 - 86590540 Mobile: 15889291362

Email: [peter@chinafirstcapital.com](mailto:peter@chinafirstcapital.com)

Website: [www.chinafirstcapital.com](http://www.chinafirstcapital.com)

Blog: <http://www.chinafirstcapital.com/blog>

Chinese blog: [www.chinaprivateequityblog.com](http://www.chinaprivateequityblog.com)