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Measuring Value®
The Changing Private Equity Landscape: What it means for investors

Deloitte has just completed its 2009 China private equity confidence survey, which provides a gauge of how private equity investors' sentiment towards the China PE market has been impacted since its 2008 survey by the global financial crisis and economic downturn of the past year, and their outlook on future prospects.

In Search of Capital Efficiency

The summer and fall have seen major developments in regulations and activities that define China's financial investment environment. Among these, most notable are the opportunities for inbound and outbound cross border investment and participation in RMB fundraising by global or regional private equity investment enterprises. During our survey, we considered three questions:

1. Why now?
2. What has really happened? and
3. What are the challenges in taking advantage of these changes?

China's private equity landscape is like no other in the world. Equity investors, the most capitalist of financial agents, are achieving prominence in China's reform. But the differences in Chinese equity investors are not simply of scale and maturity. They tap deeply into the hybrid fabric of China's economy. The "private" in Chinese private equity cannot be taken to mean such investors are fully market-driven or their capital is private or they invest primarily in non-listed targets.

Most important to grasp is the complex mix of domestic and foreign players, private and public monies, processes, and projects and an unfolding transformation of China capital linkages

Such mixing and transformation is now intensifying, energised by China's liquidity-propelled pull out from the economic slowdown.

Efficient capital allocation has not been a signal achievement of reform. China's reform potential was rarely in doubt after the mid 1980s; just the scale and speed were not foreseen. Amidst success, however, there remain more than a few unresolved problems. The sustainability of China's growth into a new, post-slowdown era will require better allocation of capital and efficiency of capital use. The changes underway address this need.

Why now?

China has put into play many policies and practices to support economic recovery

Among the first responses was a sharp reversal of the tight money policy that reflected years of worry about an overheated economy, especially in fixed asset investment, notably property. China's tight credit policy was just getting traction when globally credit suddenly froze. By the end of 2007, equity markets were well into a sustained slump, soon followed by property markets. Exports had slumped, and entire manufacturing zones were closing down. Banks, cautious about enterprise performance, lent record little in October 2008.

Sharp declines in key drivers of GDP growth, like exports, triggered a sharp reversal of the tight credit policy. The central government announced the stimulus spending plan and opened the bank windows to assure credit shortages did not aggravate declining growth rates. This energetic reversal set the pace for big bank lending of US 1.1 trillion in the first half of 2009, equal to more than half of China's reported FOREX holdings. Direct government investment added another half trillion. Most of this new capital went to major SOEs, through procurement, stockpiling, subsidies, and lending. Of the bank lending, half went to various short-term loans, including bill financing. SOEs, many already sitting on excess capacity, did not need to build more. The loans could be on-lent and much has been invested into various stores of wealth, including banks, real estates, commodities, and equity in unrelated industries. Appreciation of these assets classes gave evidence of China's recovery and added more liquidity, but it also raised fears of bubbles. Some core industries were significant beneficiaries of stimulus spending; others were not. But virtually all benefitted from the massive availability of low cost capital at the bank windows, while very few had a need for investment in additional capacity.

Amidst this stunning surge of bank lending, several concerns provoked intense discussions about the sustainability of such a robust intervention, about the use to which borrowed funds were put, about the future NPL risk and, last but far from least, the concentration of lending into the State-owned sectors

After the credit clamp down, SOEs would fail to take easy credit. They would take control of resources, whether they had an immediate need or not. From the State's perspective, nothing was lost in this practice, because SOEs borrowing and "storing" the capital provided timely support for the A share markets and real estate. But what about the rest of the economy, especially the SME sector, which had led growth for many years, was widely understood to be an important source of innovation and employment, and was in danger of being starved of new capital?

What has really happened?

With record levels of liquidity and liquidity growth, relevant ministries embarked on policies to rationalise and diversify financial services. China was not without equity investors, but mixed performance of old and new players up to early 2008 made evident the shortage of a competent cohort of investment professionals. By one count, on the eve of NDRC's formal submission of new rules (rules are not really explained here), China already had 586 equity investment funds with some level of formal recognition.

Even as China piloted new entities to manage investment capital, such as the industrial investment funds in Shanghai, Tianjin, Xian, Sichuan, and Guangdong, senior leaders from organisations like the State-owned Assets Supervision and Administration Commission (SASAC) openly criticised the investment readiness of Chinese enterprises, especially overseas. SASAC knew from where it spoke, as SASAC itself had used the tools familiar to private equity investors for the better part of a decade - fresh capital and focused restructuring - to drive consolidation and competitiveness of China's largest enterprises. At this year's Boao Forum, SASAC Chairman Li Rongrong urged large enterprises to maintain strong cash positions to manage through the financial crisis, recognising their key role in keeping the economic reform process on track.

Multinational private equity players had eyed China for a decade, but their interest increased after China joined the WTO and the regulatory regime developed. PE and VC money raised for China went from less than $1 billion to $16 billion between 2002 and 2006, a CAGR of 134 percent. But they faced high valuations and regulatory blocks, including a clamp-down on off-shore holding vehicles. By 2008, PEs focused even more sharply on China as financial leverage for North American and European investments all but disappeared in the crisis and China's own IPO activities came to a halt. Without IPO options, entrepreneurs at that point began to turn to PE and VC funders, In the meantime, a small group of "domesticated" foreign-funded equity investors was active and building good track records. Purely domestic equity investors continued to proliferate, and domestically driven M&A activity stayed at fairly high levels.

Large-scale initiatives involving large multinational private equity investors and investment banks made slower progress. Initiatives like the bids for Fuyao Glass and Xuzhou Industrial Machinery Corporation, dragged out into a protracted series of fallback positions and ultimately did not close. Key decision makers publicly questioned if China needed foreign capital of that sort at all and the overall potential contribution of foreign financial investors became a hot debate topic.

But progressive voices began calling publicly for China to embrace private equity and invite established and successful funds in. Bankers like Wu Xiaoling were outspoken; the door began to open. Long debated legislation, like the Anti-monopoly Law, specifically mentioned treatment of equity funds, basically confirming their place in China's financial landscape.

Developments have been fast and furious for at least the last two years. Private equity and venture capital funds, conferences, associations, and deals became the central channel of foreign investors in China. New funds are now announced on a weekly basis, and very large investors are scouring every region of China and every sector for targets, targets looking for growth capital.

Along with the growth of funds, last year witnessed structural experimentation, deals closed by almost every conceivable combination of foreign and domestic fund, as well as private and public capital. The National Social Security Fund has put billion of dollars under management of China-based but originally foreign-funded PEIs. Industrial investment funds, asset management companies, even the State Administration of Foreign Exchange have all closed deals or entered cooperation agreements with PEIs. Following a global trend since the crisis, new forms of cooperation emerged between financial investors and strategic investors.

In August new measures were announced by the State Council and National Development and Reform Commission that created a legal platform for limited partnerships and for foreign money managers to raise RMB funds in China. For years foreign funds piloted various work-arounds. As the new administrative measures were being made public, WOFE and JV RMB funds were announced by Blackstone, First Eastern, and CLSA, with KKR and Carlyle announcing talks. We estimate as many as 100 foreign owned renminbi funds will be setup by the end of 2009. Also supporting the trend is a major change in the conception of risk management, signaled in December 2008 when CBRC responded to a State Council call for commercial banks to support M&A transactions, removing a long-standing prohibition against lending for acquisitions.

There are two major drivers of this sudden bloom of funds.

First, at the national level, there is sufficient consensus on two points: Financial investors need to be integrated into China's capital allocation process, and more professional financial management needs to be brought in and brought in quickly

This consensus is reflected in the recent requirement that the Chinese Academy of Sciences (CAS), founder of Lenovo, sell a 29 percent stake in the company to a financial investor.

Secondly, at the local level there is intensified competition for investment capital and financial services

Shanghai's Pudong New Area has long piloted new regulatory space for foreign financial services, so it is not surprising they were in the first wave of local players to open the door. Shanghai needs important PEIs and VCIs to meet the goal of becoming Asia's financial hub by 2020.

Pudong added encouragement to accommodation, issuing special rules at the end of 2008 with incentives for two specific kinds of enterprises, Enterprises for Equity Investment and Enterprises for Equity Investment Management, "in company form" and "in partnership form." They had to locate in Pudong and invest in Pudong. Permitted targets included state-owned, high-tech, small and medium sized enterprises. The rules provided lump sum incentives directly to the enterprises, ranging to 1 percent of total funds raised, and salary and housing subsidies payable to senior executives and board members. Pudong issued Rules for Foreign ownership of equity investment funds in August, just before the NDRC announced the submission of its measures to the SC for approval.

There remain big questions about the degree to which these regulatory changes will open foreign fund activity in China. The NDRC's EIF Rules cover funds of all sorts, not exclusively private equity. Subsequent clarifications and implementation circulars will likely both permit and constrain PEI activity in China, and do so with enough ambiguity that regulators will retain sufficient license on an on-going basis to shape their impact.

Regulators fully understand that foreign and domestic investment funds bring different skills and assets, including access to talent, global capital markets, and global LP networks. Their relative importance will shift over time.

To anticipate how the situation might unfold, we will take a look at the emerging chain of capital.

Challenges ahead

The rapid opening of China to expanded private equity activity is part of a new architecture for capital allocation

Governing that design is a constant of China's reform process, benefitting from the skills and assets of foreign participants without surrendering fundamental control of industry and commerce or underplaying and under-pricing home field advantage.

The massive liquidity being injected in the system in the custody of large SOEs is not demand driven, except for a few sectors, like Telecom, now installing 3G infrastructure. Given widespread overcapacity, the large credit flows are actually into a low demand part of the real economy.

SOE recipients of loans are being given a new financial role, as intermediaries of investment into other parts of the economy

A large number of cash-generating SOEs had already developed active portfolios, including real estate and securities. SOEs have invested outside their sector in banks, funds, retail chains, property, and industrial assets. According to an analysis by The Conference Board, borrowing outside the official banking channels has escalated rapidly in 2009.

Amidst concern about potential bubbles in property and equities, it is wise to redirect "speculative" use of surplus capital into "investment" use. Official media reported that as little as 5 percent of new bank lending went to SMEs, even though SMEs grew at 37 percent in the good year of 2007. It appeared that the credit tide would not directly benefit them, and that trickle-down or postponed benefits would be offset by a real diversion of credit from them in the short and mid-term. The solution is to connect SOE surpluses to SME enterprises, but how was this to be done?

The new role of financial intermediary tests SOEs in many ways. SOEs lack capacity to manage funds of the size involved, so there is urgency in finding professional hands in which they can be put. Risk resides is the asymmetry of the SOE financial linkages. To the banks their obligations are fixed-term and fixed-interest, and with very little leverage, downstream they are exposed to real estate and stock volatility. The big SOEs are critical to the foundation of China's real economy, and abrupt asset value contraction would pummel their operating cash and balance sheets. In a real sense, they needed to be put on a path away from speculation toward investment.

If well executed, the SOE role as financial intermediaries could prove transformational. With the opening of PE activity, SOEs now have the opportunity to link themselves to the world's best money managers, to invest as LPs in the foreign-owned funds and an expanded gallery of domestically owned ones.

To fill SOE pockets, then enable them to use professional fund management to on-lend to SMEs is potentially an inspired policy, with at least three benefits. First, the SOEs collect rent as financiers of growth companies and windfalls if they IPO, taking a share of the capital gains of foreign and private investors. Secondly, the SOEs get a good look at some of China's best growing companies, and they will be well positioned to acquire them. Thirdly, investment decisions are distributed, and capital is made available to the fast-growing SME sector on an equity basis, not a loan basis, potentially yielding a much greater return for the State's capital. It is a better financing structure than bank lending to SMEs directly, given the sheer numbers of candidates and limited capacity to manage the credit risk.

Foreign-owned RMB funds are seeking to raise most of their money on shore, and they understand the importance of government and SOE support in doing that. They also anticipate assistance on the investment side from their local investors, in navigating China's M&A hunting grounds.

Large public investors working with global private equity will be a new kind of LP, more engaged in fund activity than an LP in the US or Europe

How well will this work? How will investment decisions be made without distortion?

We are seeing new players and new relationship structures. For those who get it right, there are great benefits awaiting.

But given this new mix of players, resources, strategies, and investment goals, getting it right will take expertise and innovation, and it will be the mission-critical hurdle for China's new investment openness.

Forthcoming in Measuring Value®
RMB: Cash flowing and cash trapped

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