

Privcap Webinar: Private Equity in China The State of Play in the Largest Emerging Market

David Snow, Privcap:

Hello and welcome to Privcap. This is David Snow, co-founder and CEO of Privcap. We are talking about private equity in China, a fascinating and important topic. Many institutional investors have, via the private equity asset class, put capital into the private equity strategy in China. And given the immense scope of this opportunity it is important that we get a sense of what is going on in that market, it has changed quite a bit but the opportunity remains huge. Luckily, we have three experts who are active in the private equity market in China who are going to help us understand what is going on there. And I'm pleased to introduce them all to you. Maybe starting with Jie Gong from Pantheon Ventures. Jie, if you can give us some quick background about yourself and your firm, that would be great.

Jie Gong, Pantheon:

Thank you David. Hello everyone, I am Jie Gong with Pantheon Ventures. Very briefly, Pantheon Ventures is a global private equity fund of funds with 29 billion dollars of assets under management. We are one of the earliest private equity fund-of-funds in the world, and we are the first that started our investment program in Asia back in 1992. China is a very important market for us, and we have invested across the spectrum of strategies in venture, growth capital as well as buyouts in China.

Privcap: Maybe we can now move to William Shen from Headland Capital Partners.

William Shen, Headland Capital:

Thank you David, first of all. Hi everyone, I'm William. I am a senior partner at Headland Capital Partners, which has been making direct investments in Asia for the past 25 years. Our three key geographies are greater China, southeast Asia, and Korea. Our average investment size is between \$50 [million] to about \$200M U.S., and I look forward to sharing our view about the private equity opportunity in China with everyone.

Privcap: And now, Bob Partridge from EY.

Bob Partridge, EY:

Great, thank you David. Bob Partridge with EY—I run our focus on private equity. It's a big focus for us across China as well as the rest of Asia, where

we regularly advise on transactions, audit, tax and advisory services of investee companies, [which is] a very important sector for us.

Privcap: I'd like to get into the meat and potatoes of the conversation. Let's get started with an overview of the most important private equity trends in China. Bob, your firm EY has put together numerous reports on the private equity opportunity there. We have just three slides, and I'm wondering if you can give us your overview, and why they're important for understanding the state of play in China private equity.

Partridge: We'll be brief on each of these slides, but it does help set the stage. The first one, for those of you who aren't very close to China, is just an overview of where the GDP growth has come over the past five years, and the IMF outlook for the next few years, as well as the percentage of investment as a percent of GDP. I think what's important on this slide is if you look at the yellow line, which becomes dotted after this year, just because it's a prediction we've all heard that some of the GDP growth rates in China have slowed down. We've certainly seen that to the 2010 to 2012 period, but the fact is the growth rates in China continue to be very strong. And even with that outlook at around 7.5 percent over the next few years, it will continue to be one of the fast growing markets in the world. And certainly as you think about the scale, China has one of the most attractive PE investment landscapes there could be. David could we go to the next slide? Thank you.

[There are] two things to take away from this slide: one is it's certainly continued to be a robust market for LPs investing, and we continue to see in the current year a lot of optimism about investing; the other thing is if you look at what's happened from 2012 to 2013, the top half of the bar chart in gray represents the rem and B funds. And certainly in the past three years we saw a lot of rem and B funds being raised. We've certainly seen that start to slow down as there has been a lot of capital out there, and as PE investments started to slow down last year, some of the overhang that was out there with funds did slow the new fundraising. But we continue to see in the current year that fundraising seems to be picking up, we just don't have the year-to-date stats yet. David go to the next slide if you would please.

What has the value of China PE acquisitions been over the last couple years? You could sort of see it as a steady state with a couple of quarters that peak, usually because there is a number of large unusual deals that get announced. But overall, a steady state in terms of the total value of China PE investments being you know, just about the \$2B range, ignoring the occasional quarter that goes up. So we continue at EY to have a very positive outlook for investing in China, and look forward to talking more about it with Jie and William as this progresses.

Privcap: Let's get right to the private equity opportunity. It's one thing to understand the macro themes in China, but I'd like to also integrate those themes with what it means for private equity. Jie, as you survey the population of GPs investing in China that you are in touch with and have invested with, what are some of the most important trends that are affecting their ability to execute private equity strategies?

Gong: David, I'll highlight two major trends. One is actually closely tied with the macro development outlined earlier. So China is going through a economic rebalancing to shift from a fixed-income, fixed-assets driven growth model to a consumption-driven growth model. So the implication here is that China currently, or has in the past, been the world's biggest factory, and now the focus is shifting to becoming the world's biggest market. And the ramification for that for private equity is really profound. Five years ago, the industry has broadly performed very well measured by growth. But a different pattern emerged in the last several years as the economic growth slowed down. You will see that there are sectors where over-capacity has accumulated, where the growth has really plunged, sometimes into contraction mode. But on the other hand there are other areas [of the] economy that are related to consumption, related to the domestic demand that continue to power along, and continue to register very impressive growth. So now more than ever, being a discriminating investor to discern what sectors to focus on and what sectors to avoid becomes very important. And that translates not only for us for fund-of-fund focusing on the right space, but also for GPs to navigate to the right sort of deals and the right sector in the food chain.

And the second trend is about the private equity industry itself. I would characterize today's private equity market as version 2.0 of Chinese PE. It has gone through a version 1.0, which really culminated in 2011 with a large influx of capital, as well as very strong domestic liquidity in the form of R and D funds. As one of the slides illustrated earlier, the capital pool has diminished in the last several years, and for us it's very good news because the market is much less picked over, much less crowded than it was three to four years ago. So broadly speaking, we think this actually puts the private equity market on to a much firmer footing. It is very good for the buyer of assets today, because there is a lot less noise in the market. And that also shows that the market in general is gaining maturity, and that the engaged model of the GP with the entrepreneurs, the founders have also shifted significantly. I think that is the point that William will be able to shed a lot of light on from his experience at Headland.

Privcap: Great, thank you. That's a good opportunity to move to William Shen from Headland. William, as a direct investor across China, how has the

changing macro-economic condition affected the way that your firm is executing its investment strategy?

Shen:

So let's talk a little bit on the macro transfers, and then we can dive deeper into the specific deals. I fully take on what Jie just mentioned about the opportunities. And China is shifting from a fixed-asset-investment-driven economy to more domestic consumption, but it's a painful transition. Now what are really the underlying drivers for consumption growth? It's the growing middle class and urbanization, so these are the two key trends. Urbanization meaning a lot of farmers living in the countryside are gradually migrating to towns, to fifth-tier cities, and then gradually to third-or second- tier cities. That implies they will also gradually upgrade their consumption needs as they start to make more income and all that. The growing middle class, people are well-fed, are thinking more about leisure, they are more concerned about their health rather than just the basic needs of food and clothing. So those are all positive trends. The complication is that as consumers become more sophisticated they tend to be more discerning. And they are faced with so many different options now compared to even five years ago, so take, for example, the apparel industry. You would think that people, as they become more affluent, would like to own more clothing, expand their wardrobe. And that's indeed true: the average spending per capita has been rising steadily over the past five years. However, because of the influx of the foreign brands, the domestic apparel brands have been severely impacted. So if you were investor and you bet on consumption in the apparel industry you are probably going to be disappointed at your return for your investment in this specific sector. So as Jie said, you need to have the industry knowledge, the depth to decipher what is really good, even within each sub sector within consumption. Apparel is not impacted the same way as sportswear, and there are a lot of different drivers for that, which I don't think we have time to go through. But, bottom line is that things are getting very complicated, a lot of multi-national and domestic companies are facing the same challenges because consumers want more, they become more sophisticated. And straight advertising and marketing is not going to cut it. Your products need to really tailor to the specific needs of the targeted demographics.

The second [key trend], which is related, is that because companies are facing a much tougher market today, they're facing much tougher competition. E-commerce has been a major threat to traditional industries, both to retailers and to brand owners. So they really need the help of private equity investors to work together bringing the additional knowledge to think out of the box in different capabilities for them to continue their growth. And from the private equity side, we need to have that in-house capability or outsource capability to work closely with

these companies and help them generate the incremental growth, which is very important for our IRR returns' bottom line.

Those are the two key challenges, or you could also view them as opportunities facing private equity in China today.

Privcap: Bob Partridge from EY, it's one thing to talk about the macro opportunity changing consumer preferences, changing consumer sophistication, but it's another thing for a private equity firm to actually be able to turn that into an investment that delivers returns. How are private equity GPs in China reconfiguring themselves, gearing up to address this new set of challenges and opportunities?

Partridge: Jie and William hit the trends spot on, and really feed into how we see the GPs reacting to the market. This whole idea of domestic consumption, urbanization, what does it actually drive, and the competitive threats that inevitably exist in any industry. The other part of the backdrop isn't just the trends, but the fact that the IPO market had slowed down in China, which did create a little bit of an overhang in investees across a number of GPs as that potential exit opportunity became a bit of a dry opportunity, although seems to be creating a lot of confidence in the market today. But we've had this overhang of investees that it really helped the GPs to realize it's not just about investing and flipping a Chinese investment very quickly. It's about value creation, and where we see the private equity firms really focus is adapting to some of those competitive challenges and market changes that William talked about. And the competitive threat that exists, because many made the investment two years ago, three years ago, thinking that that there was going to be one theme that was going to be critical to the overall investment. But as the landscape did change. I would say you've got almost every sector in China, as the GDP rates slowed down, urbanization continued while driving toward a domestic consumption model. You've really created unbelievable changing dynamics in almost every sector in terms of how to continue to maintain high growth rates in a profitable way. What we see the GPs doing, particularly the ones that are already starting to exit this year successfully is focus on maintaining margins. How do you help companies by creating a different direction that allows them to be a lot more flexible in an ever- changing environment? And certainly the ones that are going to survive are the ones that are a lot more focused on that value creation today than they were two years ago.

Privcap: Let's move on to more commentary about how the GPs are adapting, how they are working with their portfolio companies to really drive returns and drive the performance of the portfolio companies. Jie, can you talk about certain investment strategies, whether it's by sector, or whether it's

by post-acquisition value creation, themes that you're seeing that are very notable in Chinese private equity today?

Gong:

You framed this question very well, because indeed today's investment thesis is a lot more distinct than it was five years ago. Before, it was mere capital provision, coming in as a minority shareholder, attending board meetings, and today the whole mode of engagement is quite different. I would boil down what William and Bob said earlier as private equity being essential solution providers to the entrepreneurs and business owners today. As William commented, the competitive landscape for businesses today is a lot more intense. And as a result, there is greater need than ever for assistance coming from PE providers. And to fulfill that role the PE managers need to be very steeped in industry expertise. They need to develop their own domain experience, so that going deeper and setting up an industry-focused fund that became a more pronounced trend compared with several years ago. We are seeing more industry-focused funds—of course one needs to make sure that the definition is broad enough for them to have sufficient deal flow to support the team and the fund size. But on the other side, the in-depth understanding of an industry and developing the wherewithal and resources to provide help in a particular industry becomes more relevant than ever.

And the second part is just to be a lot more hands on and operationally invasive, and for that part to ring true, the GP needs to have a bigger role in the company than a very small shareholder. And we are seeing more deal flow on the control side as many entrepreneurs cede control to the PE players once they realize that they're hit their bottleneck in their capability or their bandwidth. And the team needs to be professionalized in order to be taken into the next phase. There is also a new breed of entrepreneurs reaching their retirement ages, and so succession issues have become more of a driver in the last several years in creating buyout type of situations. So we think those trends will continue to actually create a virtuous circle for GPs to become a lot more engaged, a lot more hands-on with the business founders, and also to be able to drive the exit a lot more effectively toward M&As as well as IPOs. So this also would enhance the ability for GPs on the realization front.

Partridge:

I'll just quickly comment that the two things you talked about are really hand-in-hand as well. We see that across the market. The sector focus and where the funds actually are able to demonstrate that they've got that in-house expertise, that's actually helping drive more control-stake deals. Because entrepreneurs and sellers really are looking for how private equity firms are differentiating themselves when they are considering giving up a control stake versus a minority interest. So I think you've hit both points very well and they actually converge with each other.

Privcap: That's, that's an interesting point, William, as a direct investor you've set the stage talking about the growing sophistication of Chinese consumers and some other themes. What have been some specific either sectors or post-acquisition strategies that Headland has spent a lot of time on lately?

Shen: We have had reasonable success in the consumer space, both in apparel and retail. Before we go into the details of sector specifics, let me just respond to what Jie and Bob just talked about, this growth capital vis-a-vis buyout. In this area I would tend to disagree a little bit. Because, despite the fact that there is a lot of growing talk about buyouts, the majority of private equity deals to be done in China will still be growth capital. I think it has something to do with the Chinese culture. If a Chinese entrepreneur is confident and driven, it's highly unlikely he will be willing to sell control. So what are the scenarios where he would sell control? Well, the guy gambled all his money in Macau—there has recently been a very high profile deal of a property tycoon who was forced to sell control in the company that he founded. So I think in general, what we like about companies, or company shareholders that we like to partner with, are people who are driven, who are charismatic, who are passionate about their business, and who are determined to really build their companies to last. That's just my first comment on the majority of deal opportunities in China.

The retail markets and the overall retail market has been really hit hard by e-commerce. So the key for us when we work closely with this hyper-market chain was to talk about, how do you draw foot traffic into your store? Why would people want to come to your store rather than buy on the computer? Alibaba or JD.com, a lot of that has got to do with fresh produce, because you're not going to buy some live fish over the internet. It's about category management. How do you define the right categories? What should be the foot traffic builder? What should be your margin contributor? Who are the star categories? And who are the complementary categories? So it has a lot to do with really understanding your customer—what they need, and where you fall short. And there are a lot of different tools that you can utilize. So you really need to dive down into the operation details and nitty gritty, but before you can do that...we are a significant minority shareholder, and here I echo Jie's point that in order to have influence you cannot be a 5 percent shareholder. Doesn't matter how high you try to cultivate that relationship with the owner, you're not going to get that. But let's say you have a significant minority—say between 20 to 35 percent—the key is to establish that trust with management, so that they understand you are really working with them to maximize shareholder value for everyone, not just for the PE fund. Because without that trust you can have all the industry knowledge, you can bring in operating team, those guys will not listen. And then there will be more tension and mistrust, and things are going to fall apart.

So the first thing to do is to help establish that trust, so the controlling shareholder and his senior management team feel comfortable that you are really here to help them. They know that you will need to exit down the road, but for the time being you are really there to work closely with them, and have their founder mentality. And this is something that's I think the most challenging thing for GPs to master. Because all that operating expertise, you can either outsource it or you can bring it in-house, but how you establish that trust up front is the most difficult thing. And in terms of general value creation, HR tends to be a key function that domestic companies really fall short on—how to retain talent, how to think about who are the right people to be in the right position. Do you have a transparent and fair performance review system? People get paid because of their contribution, not because they kiss up to you. So that's one key and the other is really understanding consumers—forecast those trends before it's too late. Those are the key things, and they apply across all key sectors within the consumer and retail space.

Privcap: Well thank you William, and I'm interested in your comment about the Macau casino. Maybe the best place for private equity GPs to do some deal flow hunting is at the pai gow tables in Macau. But that's a topic for a later webinar.

But my question, maybe I'll throw it to Jie first and then if the other experts would like to chime in that would be great. You mentioned the need to add value to help companies meet the challenges that they're facing as the China market and the global market changes. But do general partners who started life chasing growth, having the expectation that an IPO will monetize their investment, do they have the ability to change their strategy and the in-house talent to actually help portfolio companies? Or are they having to supplement their in-house talent by bringing in operating experts?

Gong: That's a very good question David. This called for the evolution of the GP landscape such that there will be a new crop coming up with a combination of investment experience as well as the indigenous operational experience coming from somebody, a founder let's say, within the GP that comes from an industry background. So that combination is very helpful. You have the investment judgment that's resident with the team, and that teams up with somebody coming from an operator background. So we are seeing a new breed of such GPs coming up. With regard to the existing GPs that came from a more traditional finance background, many realize this need quite early on and have started to build industry verticals. They will focus their strength on where they've been good at, where they've built a reference track record and where they are the most legitimate in originating proprietary deals. And they would jettison sectors that they are more of a marginal player, or they don't

have the same kind of strength. So we're definitely seeing GPs focusing on core strengths and become a lot more focused.

And with regards to increasing their capability of value-add, there isn't one fixed answer, but suffice it to say that if a GP doesn't evolve with the times then it becomes less relevant in front of the business owners. It also becomes less relevant in front of the LP, so in order to survive it is essential for a GP to evolve even though there is no playbook by which they can tick the box to really enhance their operational value-add. It's not something that they can simply pay lip service, but it's something that has to be recognized by the other side, really by the business owners. And I would end this by saying that the scope for creating value on operational engagement is very large.

Historically, Chinese PE has been widely viewed as access to growth, and that's simply the story. But in fact, the efficiency gain, the improvement gain, that scope is tremendous. Chinese companies have had a large lag in return on equity compared with their western peers in the same industry. So through professionalization, through bringing the right skills, there is a lot to be gained. And these can be pretty low-hanging fruits in combination with the organic growth and also M&A to all together drive earnings growth. So the Chinese PE story today really relies on several levers of value creation. Whereas in the past it was relatively easy, one can just ride on the simple gain and growth, today the GP can do a lot more. But having said that, there is a lot of space for their efforts to be rewarded.

Privcap: We have a great question from the audience. It's a big topic, so I'm going to throw it to Bob. It has to do with regulations, and we can give the quick overview. But the question is: are there regulatory changes that would materially impact direct private equity investing in China during [Xi's ?] tenure? Bob what could change the game from a regulatory perspective?

Partridge: Thanks David, it's a great question, and I'm probably going to generalize here and certainly invite William or Jie to comment. There seems to be nothing but positive signals coming out of the government, particularly at the national level, but as well at some of the major city levels. It's clear that the government now sees private equity venture capital investing as part of the macro-economic environment in China, and the value that it can create in helping grow companies, create value of the capital markets, we've seen a relaxation of certain regulatory approvals at the NDRC level. We continue to see, not just as it relates to private equity, but relaxation of approvals as it relates to outbound investments, which is fairly important because we do see a number of PE houses looking to do deals overseas that have a China angle and might be brought back into China. So some of these relaxation or regulations that are occurring aren't

specifically focused on private equity, but private equity is going to benefit through them.

I mentioned cities are doing things as well. Last week the Shanghai government unveiled some measures that were intended to boost probably more venture capital, so smaller-sized funds. But [it's] yet another recognition that the government does see the value that sponsors play in helping create value, and helping the overall market caps. I don't know if William or Jie would have anything to add.

Shen: I think you summarized it quite well.

Gong: I echo your comments. One thing I would add is, more broadly speaking, the new administration by Mr. Xi has unleashed its roadmap for the next several years on a pretty reform-heavy agenda, which is quite pro business. It aims at breaking down some of the competitive barriers of certain industries, increasing the efficiency of some of the industries already suffering a glut of over-capacity, and also generally bringing up the service levels, which China really seriously lacks. So, all in all, it actually creates quite good guidance as to what the industries are that will ride on the tailwind of the government policy. So I think there will be quite a lot of new development coming out of that roadmap for the PE investors to benefit from.

Privcap: So William, there is more than just Headland Capital in China—it's getting more competitive. What is unique about your deal origination?

Shen: Deal origination has always been the biggest challenge for all GPs operating in China. We all know that it's a very competitive market, and good companies are really hard to come by. So there is no true proprietary deal flow, because when a company is looking for private equity funding they will for sure meet with at least five-to-10 different houses. However, unlike a very well intermediated market where they will hire a financial advisor to run a process, these are more casual discussions. So I guess the first thing is you need to make sure that you are amongst that five-to-10 companies that will have a chance to meet with this great company. And then it's really just to demonstrate why you are worthy to become their partner. The fact that you have a great character is really important. And entrepreneurs are smart, they don't want all this marketing pitch. They want to really understand how you have helped this particular company to become great. And maybe you just picked the right company, as Jie mentioned before. It's access to growth and you generate great returns—that's not going to impress this gentleman or this chairlady. What they want to know is that you have the capability to help the company generate that incremental growth, and that's the key. And what are the different tools and processes that you

have deployed to generate that incremental growth? The second thing is body chemistry. As I've mentioned, this entrepreneur needs to feel comfortable that you will be sitting on the board, and that you are the right guy, you are a good guy to work with—so not only are you capable, you also need to be the right guy who he feels comfortable working with. If you can convince him or her of these two things, then you have a pretty good chance of winning the deal.

Privcap: Great, I have a question now for Jie Gong, and that has to do with venture capital in China. It's a big question, and I'm sure you get asked it a lot, but the question is: is the venture capital market in China overcrowded? What do you think?

Gong: Is it overcrowded? I think the venture capital market in China is, in a way, quite related to the overall level of NASDAQ, and how Silicon Valley's temperature gauge is. I think in the venture markets these days the country lines are increasingly blurry, and there are many cross border activities in terms of U.S. technologies being applied in China, and Chinese technology companies are going to be listed in the UK and U.S., as well as expanding to the U.S. market. Whether or not it's crowded is, at this point in time, difficult to say, because I think the fundamental disruptive force of the new economy represented by the Internet is enormous on the traditional industries, as William alluded to earlier. And there are quite a lot of players in that industry. So it's, at this point, difficult to say because the opportunity universe isn't very clear in terms of what size it's going to develop into.

But I'll just mention a couple of trends. One is that these days to be effective in venture [capital], I would probably favor an earlier-stage investment focus rather than a late stage investment focus. As the barrier for earlier-stage investing is higher, it requires a lot more expertise, and the judgment plays a much bigger role. So it's harder for the growth capital guys to creep into the earlier part. To send off competition, to stay on the early stage is likely a good strategy. And the second part is that we're seeing increasing exit opportunities [for the venture strategy]. The NASDAQ market, also New York Stock Exchange, have been welcoming technology companies from the Chinese market to IPO. And also, importantly, there is increasing deep-pocketed domestic technology firms with a very inquisitive appetite. So we think that this bodes very well for the exits, the realization part of the equation for Chinese VC. But I do see there is some cross in valuation when it comes to the hot areas. So to develop one's own point of view, as well as to be on the earlier side in the venture stage, would be important.

Privcap: The ringing is continuing a sign of bullishness for the China IPO market. Bob, we have less than one minute: what is your outlook for IPOs in China and its effect on the private equity market there?

Partridge: Thanks David. [It's] very robust; I think private equity is going to help drive that activity, as well as overall confidence levels in the market. We think the outlook going into the second half of this year will be very strong, but also entering next year. To some of the points Jie and William made, it will be survival of the best. It's going to be the top and the investees' top in class who are going produce the successful IPO as exits for the GPs like Headland and others. So I'm very optimistic [about the] outlook.

Privcap: Well that's a nice way to end this expert webinar. I'd like to thank our three experts: Jie Gong from Pantheon, William Shen from Headland, and Bob Partridge from EY. If you'd like more thought leadership on private equity in China, if you go to Privcap.com you will see that we have a whole series starring Bob Partridge and two other GPs talking about a number of topics in Chinese private equity, including the credit and distressed market there. Very interesting, but for now we're going to sign off and say thank you very much for being part of a Privcap program.