# Private Equity Investing: Comparing China With the West

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**Feb. 14 @RDCY**

## Dr. Roger Leeds

Roger S. Leeds is a Professor at the School of Advanced International Studies (SAIS) of the Johns Hopkins University and Director of the School's Center for International Business and Public Policy. His teaching and research focus on international financial markets, private equity and venture capital investing in emerging markets, and financial sector development. The Center Dr. Leeds heads is involved in applied research and outreach activities that focus on a range of issues pertaining to private investing in emerging markets, and the nexus between private sector performance and public policy in developing countries. In addition, he served as the founding Chairman of the Emerging Markets Private Equity Association (EMPEA), a global industry association that is the preeminent source of research and information on private equity in developing countries. He currently serves on the board of directors.

He also has served as an Adjunct Professor in both the MBA and Executive MBA programs at Wharton, University of Pennsylvania and at the Columbia University Business School, teaching courses on private equity investing in emerging markets. Earlier in his career Dr. Leeds spent two years at Harvard's Kennedy School of Government, teaching and heading a research project on privatization in developing countries.

Prior to joining the SAIS faculty in 1999, Dr. Leeds was an international finance practitioner for 25 years, including positions as an investment banker at Salomon Brothers in New York, a senior staff member of the International Finance Corporation (World Bank), a partner at KPMG in charge of the firm's global privatization practice, and a managing director at a major private equity firm in New York. His international career began in Brazil, where he served for two years as a Peace Corps Volunteer. Since then he has worked in more than 100 developing countries in Africa, Asia, Latin America, Eastern Europe and the former Soviet Union. He made the first of numerous trips to China in 1976 when he was a graduate student.

Dr. Leeds is the author of *Financing Small Enterprises in Developing Countries* and more than 30 published articles and book chapters. He has lectured at numerous universities around the world, and been a guest commentator on various radio and television programs, including *CNN*, *Bloomberg News, CBS News*, *CNBC,* and *National Public Radio*. Dr. Leeds is a member of the Council of Foreign Relations in New York, and has served on numerous boards. He received his undergraduate degree from Columbia University, and his M.A. and PhD from SAIS.

# Today's Agenda

## 4 Hypotheses for discussion:

1. The specific characteristics that define Private equity(PE) differentiate it from all other financing techniques available to private companies.
2. PE in China and other emerging market (EM) countries is fundamentally different from PE in the West

   - Both the risks & opportunities are different.

   -The primary market is different-"growth capital" for the "missing middle"
3. The most serious obstacles to private sector growth in China are <u>opportunities</u> for PE investors.
4. The PE industry is cyclical everywhere-- sharp declines in 2012/13 demonstrate that China is no exception to this reality.

# “Private Equity 101”

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# PE Generic Term: Encompasses Broad Range of Companies & Financing Techniques

Venture / Growth Capital

Buyouts / Restructuring

Seed

Start-up

Early Stage

"Growth Capital"

Mezzanine

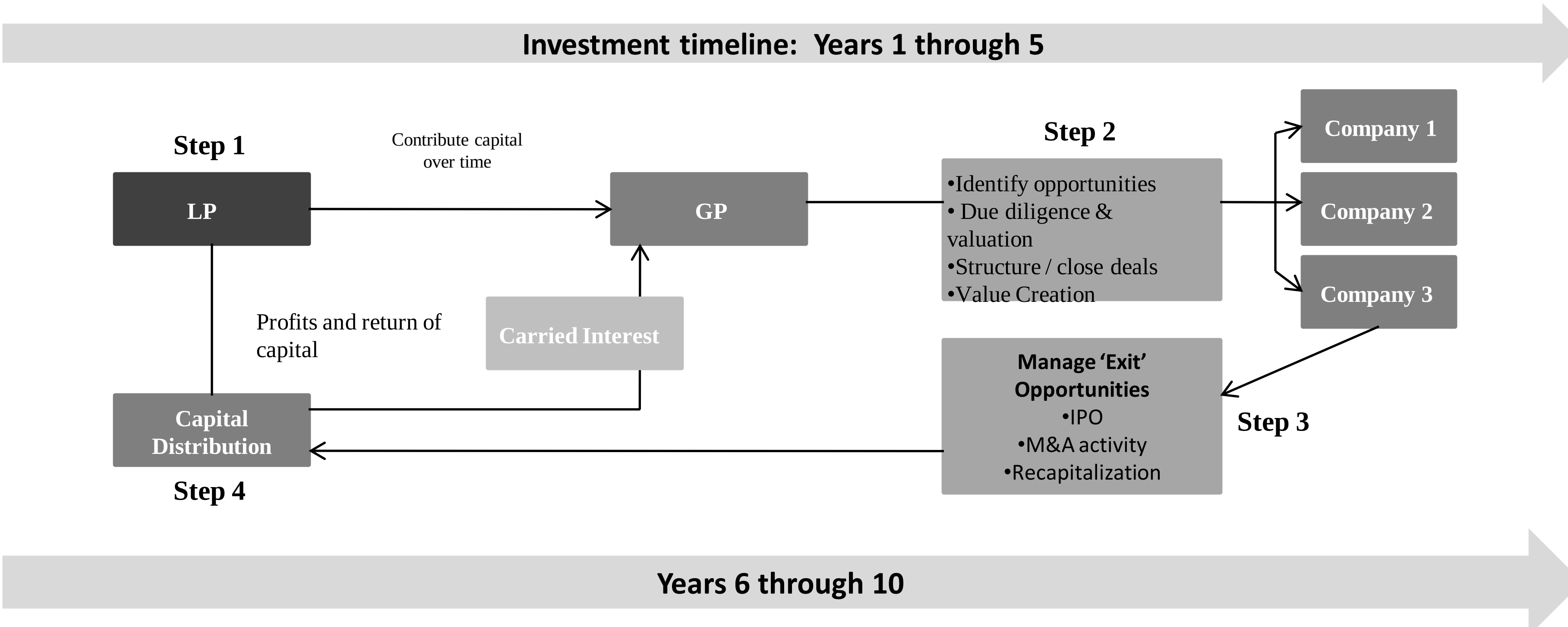
Corporate Restructuring, LBOs, Distressed

**What Common Characteristics Distinguish PE From All Other Financing Tools Available to Private Companies?**

# PE Common Characteristics

- **Medium to long-term illiquid** commitment (i.e. "patient capital")
  - **Illiquidity heightens risk-** justification for financial return premium
- PE funds **usually** legally structured as **"closed-end," private partnerships with limited life**
  - **GP (fund manager)-sophisticated investors with financial & operating expertise**
  - **LPs - institutional investors (passive)-**
- **Illiquidity & significant ownership create <u>strong incentives</u> to conduct <u>rigorous due diligence</u> & focus on <u>enhancing firm value</u>**
- **"Active" rather than "passive"-** post- investment success depends on **<u>alignment of interests</u>** w/ management
- **Valuation, terms & conditions result from process of <u>negotiation</u>** (except publicly traded companies)
- All of above geared to creating **exit opportunity with <u>exceptional financial returns</u> compared to investment alternatives**
- PE industry historically subjected to **recurring boom & bust cycles**

# The Mechanics &Timing of PE Investing*




*** Time line differs dramatically deal to deal**

Source: Merrill Lynch, "What are Alternative Investments?", 2010

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# PE Funds Specialize

- **Sector**
  - Healthcare
  - Clean tech
  - Infrastructure
- **Company size/growth stage**
  - VC (early stage)
  - **Growth capital** (established SMEs)
  - Buyout (privatizations, public-to-private)
  - Distressed
- **Geography**
  - Country
  - Regional
  - Global
- **Fund-of Funds**
- **Secondaries**

# PE has Evolved into Global Industry

- **1950s-60s:** Starts in U.S. w/ small VC funds financing **early stage, high growth firms** unable to access traditional debt & equity markets
  - Mainly technology, biotechnology
- **1979-Adjustment to "Prudent Man" rule (US Dept. of Labor)-**triggers exponential growth spurt
  - **Public policy matters!**
  - **More funds raised for PE in 1980 than entire 1970s**
- **By 2000**, no longer "**alternative asset class**" in U.S.& Europe- widely accepted by diverse range of mainstream investors
- **By 2008 (pre- financial crisis) in U.S**:*
  - Funds raised: ~$300 billion; Capital under management: $770 billion
  - Number of PE firms/funds: >2800; Number of professionals: >17,000
- **Increasing Globalization of PE**
  - Calpers (largest U.S. pension fund ) -1/3rd of PE allocated to non-U.S. funds
  - Largest buyout funds (e.g. Blackstone, Carlyle) invest worldwide & raise local currency funds in China, Brazil, elsewhere

***Various sources; all numbers approximate**

# Western Headlines Focus on Gigantic Buyouts

- **Rapid growth by small number of mega-funds**
  - **AUM of buyouts (2011): ~ $1 trillion of PE worldwide; ~2/3 = buyouts (**3X 2005 total); **Highly concentrated** in top 10 funds
  - **Mega deals/ mega funds, mega leverage**
    - 9 of 10 largest LBOs in history occurred 2006-07, averaging $30B/deal'
    - **leverage** may increase investment size 3 or 4X base capital of fund
    - **Blackstone** raised largest fund- ~$22B ('06); new $16 B fund raised spring '12 (**largest post-crisis**)
  - **Largest funds becoming global, <u>diversified asset managers</u>**
    - **Carlyle**-~$180 AUM; 84 different funds—PE, hedge, real estate, distressed debt, Alpinvest (fund-of-funds)
    - **Blackstone-**
  - **Publicly listed**—KKR $5B IPO in '10; Blackstone $7.8B IPO in '07; GP Investments (Brazil) IPO in '06; Apollo (2011)…

# "Western" Buyouts" Don't Fit Predominate PE Profile in China or Other EMs

- **<u>TRANSACTION SIZE</u>:** TEND TO BE HUGE (US$ Billions)
- **<u>CONTROL</u>:** MAJORITY OR 100%
- **<u>PUBLICLY LISTED COMPANIES</u>**
- **<u>HIGHLY LEVERAGED</u>—** 60-80% DEBT; ASSUMES AVAILABILITY OF RELATIVELY CHEAP DEBT
- **<u>COMPETITION</u>** FOR DEALS MORE INTENSE
  - **<u>AUCTIONS & "CLUB DEALS</u>"** INCREASINGLY COMMON
- **<u>FINANCIAL ENGINEERING/RESTRUCTURING</u>** RATHER THAN HANDS-ON VALUE CREATION
- **<u>DEVELOPED FINANCIAL MARKETS</u>** TAKEN FOR GRANTED (E.G. IPO EXITS, CREDIT MARKETS)

Although some similarities with China, **Western PE fund structures & deal profile suggest <u>fundamentally different asset class</u>**

# Why PE in China/Other EMs Fundamentally Different

# A Different Investment Climate

## Compared to China/ other EMs, PE "Ecosystem" in West Fundamentally Different - mitigates some but not all risks

- Receptive private sector policy & regulatory environment
- Confidence-inducing legal framework; dispute resolution mechanisms; relatively "level playing field"
- Globally accepted standards of corporate governance, accounting, financial reporting
- Deep pools of skilled human capital (e.g. PE professionals, company managers & technical staff)
- Well established 30-40 year PE track record (e.g. deal flow, realized exits, accumulation of human capital)
- Well developed financial markets (debt & equity)

## Although gradually improving, these characteristics less prevalent in China/other EMs

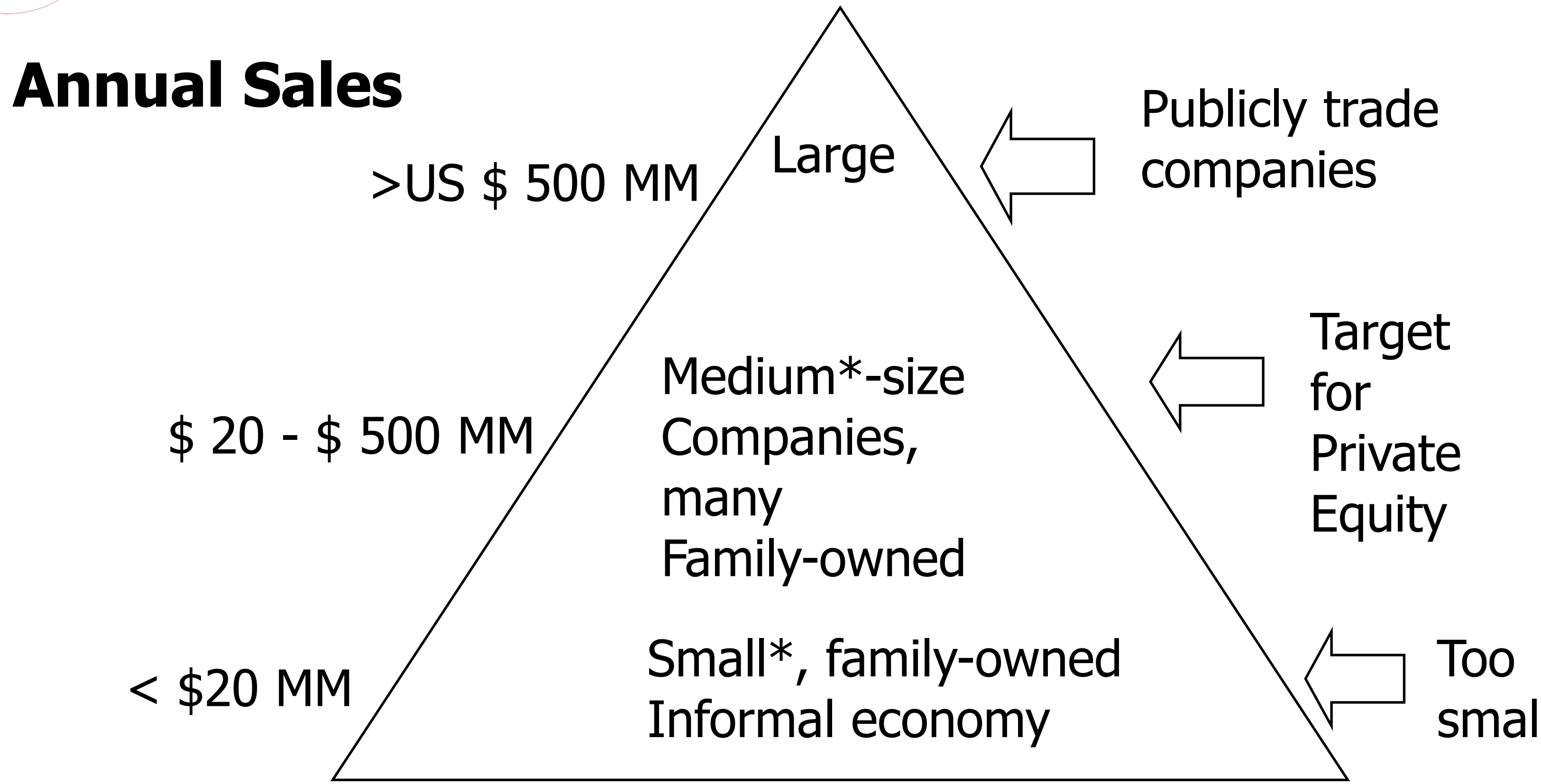
# A Different Deal Profile

## Although notable exceptions, the "typical" China deal profile: "growth capital" for middle market businesses

- **no sectors off-limits** (e.g. domestic infrastructure, health care, basic manufacturing)
- **Smaller transaction size**;
- (no?) **leverage**
- More **focus on long-term value creation; company and sector inefficiencies create opportunities**
- More emphasis on **companies selling in domestic markets**
- More **minority positions**
- Almost **no "public to private"**
- Fewer **IPO** exits

## With this profile, what's PE target market (broadly defined)?

# Developing Country Private Sector: The "Missing Middle"




**Definitions of "small" and "medium" vary significantly depending on country's size & economic development**

# Huge PE Market Between 2 Extremes- "Growth Capital"

**"Family & Friends"** ⟷ **Public Market**

**"Family & Friends"**

- Small/medium size
- Weak Corp. Gov.
- High risk (limited track record)
- Limited information
- Poor transparency
- Family-run/ closely held

**Public Market**

- Large size
- Many shareholders
- Established track record
- Profitable
- Acceptable accounting standards
- Legal documentation
- Professional management

# China PE Market-Covers Broad Range

**Company stage**

- **Established family-run firms** seeking to expand & become more competitive
- Medium-sized, established companies at **pre-IPO stage**
- **Consolidation** of independent firms within same sector **("roll-ups")**
- **Restructuring/ turn-around** situations for distressed companies
- **Privatizations**

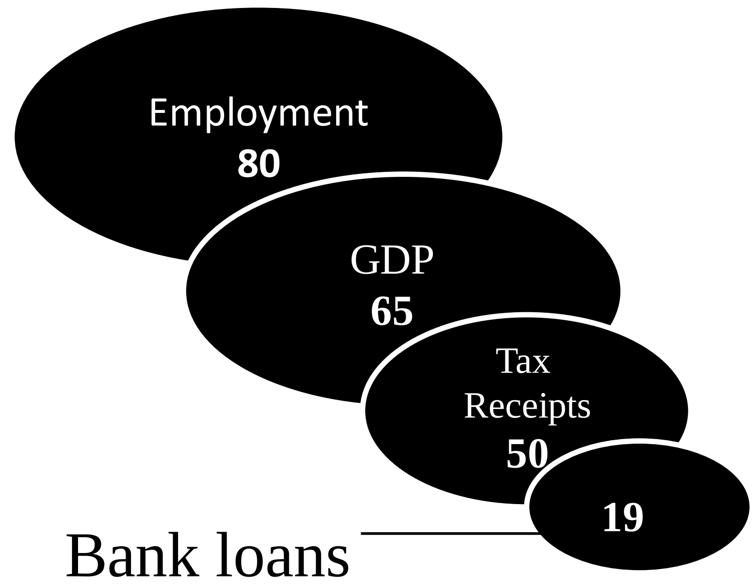
**Sectors**

- **"High growth" (**not just high tech)
- **Sector inefficiencies (e.g. fragmentation)** generate across-the-board opportunities
- **Weak, inefficient financial sector** source of PE opportunities

**PE <u>selectively</u> provides private companies with <u>2 scarce resources</u> they require to grow & compete: <u>financing & expertise</u>**

# Small and medium-sized enterprises in the Chinese Economy*

% share, latest estimates




**Financial Times, May 23, 2013*

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# Bridging the Financing Gap

- **Majority** of Chinese small & mid-size private companies, regardless of sector or performance, have limited or no access to medium/long-term capital
- **But not due to capital shortage**
  - China has one of highest savings rates in world; (much lower in U.S. & Europe)
  - Deep pool of financial assets in largest institutional investors (NCSSF, other pension &insurance )
- **Dominant role of few state-owned banks** lending primarily to SOEs limits access of private companies to financing
- **Unresponsive state-dominated financial sector creates huge potential PE demand by private companies**

# PE is More than Money: Sharp Focus on Value Creation

- **Rampant inefficiencies a primary driver of rapid PE growth in China/other EMs**
  - **<u>Companies</u>** - weak corp. governance, financial controls, marketing.....
  - **<u>Sectors</u>** - over-populated with under-financed companies unable to achieve scale
  - **<u>Country</u>** - anti-competitive regulations, labor law rigidities, taxes
- **Successful PE investors perceive of <u>management and sector inefficiencies as opportunities,</u> and...**
- **PE investors have both the <u>experience and financial incentives to address value creating opportunities</u> (alignment of interests with management)**

# Different Asset Class Requires Different Skill Set

**"LPs allocate their capital increasingly to PE funds that can prove their track record in <u>operational</u> value creation." (BCG)**

- **Skill set** required to <u>make</u> an investment very different than to <u>enhance firm value post-investment</u>
  - **Investment bankers** – do deal, collect fee, move to next deal; no operating experience
  - **Creditors-** focus on borrower capacity to generate sufficient cash flow to service debt in-full, on-time
  - **PE investors-** focus on **post-investment value creation**
- **More attention to country risk assessment**
- **More challenging due diligence & valuation** (e.g. less disclosure, sub-standard accounting, more acute info asymmetry, weaker corp. governance)
- **More need for local presence 24/7**
  - "Funds w/ strong local presence significantly outperform international funds w/out local presence." (IFC finding)

# PE Contribution to Value Creation*

**"The real work begins <u>after</u> money disbursed."**

**For example:**

- Financial engineering-B/S restructuring
- Identify & negotiate additional funding sources
- Advise on scaling-up business
- Access new markets
- Recruit new management & board members
- Strengthen corporate governance practices
- Leverage industry contacts to identify suppliers, customers, markets
- Operational restructuring- gross margin improvement, operating expense reduction
- IPO preparations-strengthen corporate governance, accounting & disclosure
- Exit preparation

*** Earnings growth, multiples expansion**

# The Private Equity Investment Cycle

# Stages of The PE Investment Cycle

**PE Investor's mindset different than other financiers at every stage-- significant long-term, illiquid ownership stake**

- Deal origination (sourcing and screening)
- Detailed due diligence (e.g. financial, operational, legal, environmental)
- Financial modeling and valuation
- Preparation of term sheet
- Negotiations and preliminary agreement
- Legal documentation
- Closing
- Post-investment value added/portfolio management
- Exit preparations & exit

## What's biggest challenge at every stage of cycle?

# Information Asymmetries

Risk of "**adverse selection**" (pre-investment) & **"moral hazard"** (post-investment)-always present in finance, but **much** worse in China/other EMs

- Lack of acceptable corporate governance standards
- Weak accounting & financial reporting
- Tax delinquency & other contingent liabilities
- Poor financial controls- intermingle family & company accounts
- Unreliable legal protection/enforcement

**PE investors better suited to mitigate (not eliminate!) informational risks than any class of investors …**

**Highest priority is strengthening corporate governance**

# Why Corporate Governance?

**Ambiguous term,** but:

(i) accurate, timely, transparent flow of operating and financial information

(ii) management accountability to "outsiders" (e.g. independent directors)

**CG more important & difficult with unlisted firms:**

- Investments illiquid for longer time
- Less **legal** disclosure requirements; limited **legal** recourse
- Therefore **more susceptible to "information asymmetries"**

**McKinsey research: investors pay up to 30% premium for well governed firms**

**Calpers- announced will not invest in any EM that does not meet its CG standards**

# Corporate Governance & PE

**Most small and mid size companies in China/other EMs do not meet acceptable CG standards**

- But **weak corporate governance not "deal breaker" if** PE investor makes good decisions on owners/managers

  **"After price paid for deal, it's all about management, management, management. When we get it wrong, people mistakes are the single largest driver." (PE fund manager)**

- **Key factors for success:** (i) Management **willingness to change** traditional practices, and (ii) PE investor **empathy**…

– **Most never raised 3rd party capital**; no knowledge of fund raising process/investor information requirements

– **Understandably suspicious, fearful of "outsiders"** demanding major changes to traditional business practices

– **Key challenge for PE investor: gaining management trust**

# PE Investment Criteria: The Optimal Candidate

**“For every 100 investment proposals we review, we do due diligence on about 10, and fund 1.”** (PE Fund manager)

**<u>What is the optimal PE Candidate?</u>**

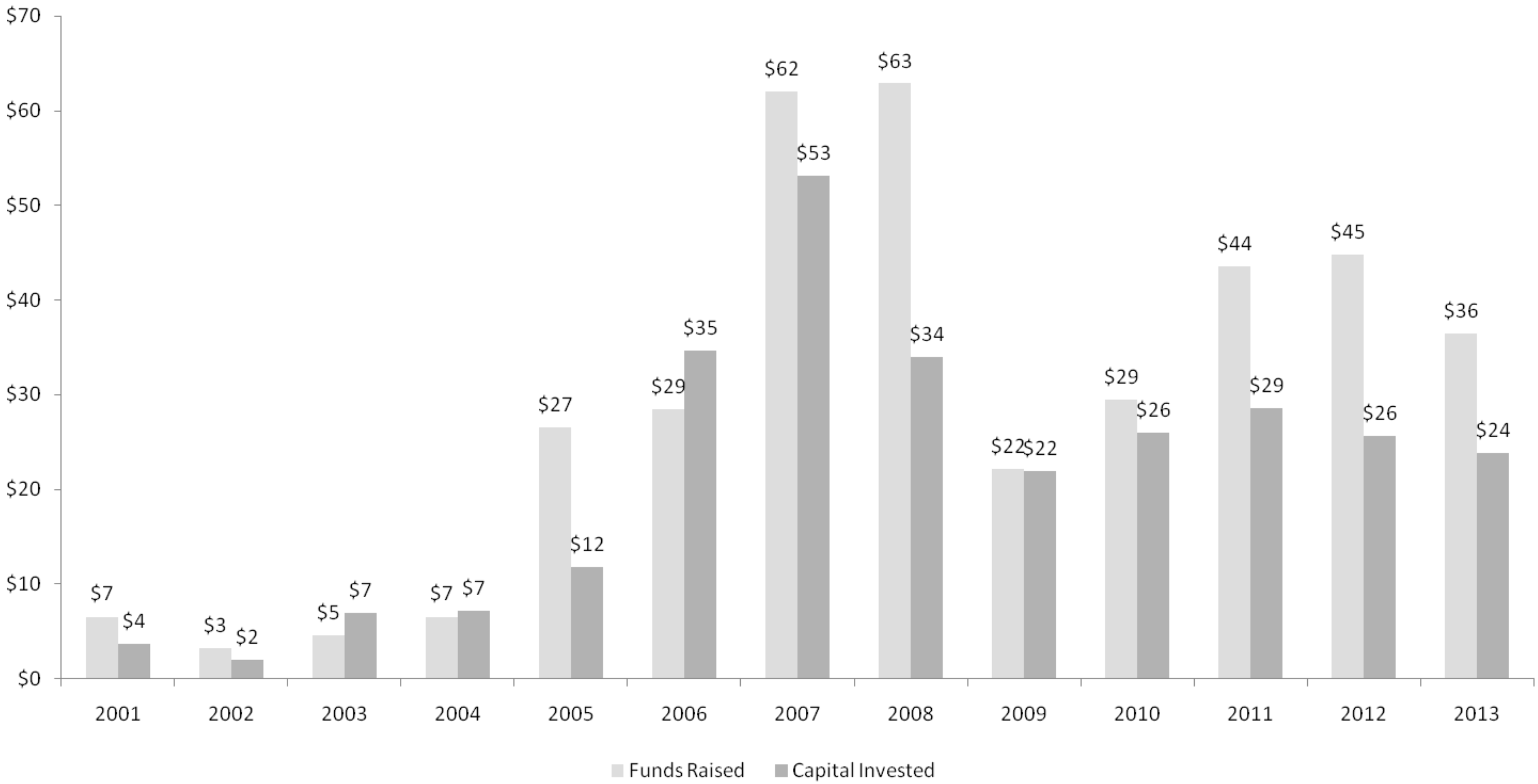
- **Experienced management team**-successful track record; integrity; willingness to accept outside investors
- **Attractive sector dynamics-**growth trends; competitive landscape; **fragmentation = scale opportunities**
- **Market leader-**identifiable competitive strengths; clearly defined value proposition
- **Willingness of management to implement acceptable corporate governance-**accounting & auditing standards, independent board
- **Alignment of interests with management on value enhancement strategy & timeline**
- **Clear exit strategy,** w/ high real return potential

# Bad Deals-Common Mistakes?

- Selection of **wrong management team**
  - Too trustworthy (e.g. transparency, disclosure)
  - Miscalculate professional competence
- **Over-valuation** due to
  - Underestimate changes needed to make deal work (both pre- and post-investment)
  - Excessively optimistic assumptions about future growth & financial performance
- **Realistic downside case** not adequately evaluated
  - Inflated optimism about **legal protection**
  - Under estimate **country/fx risks**
  - **Overestimate exit timing & value**

# Emerging Markets Private Equity: Recent Trends & Performance

# EM PE Fundraising & Investment, 2001-2013

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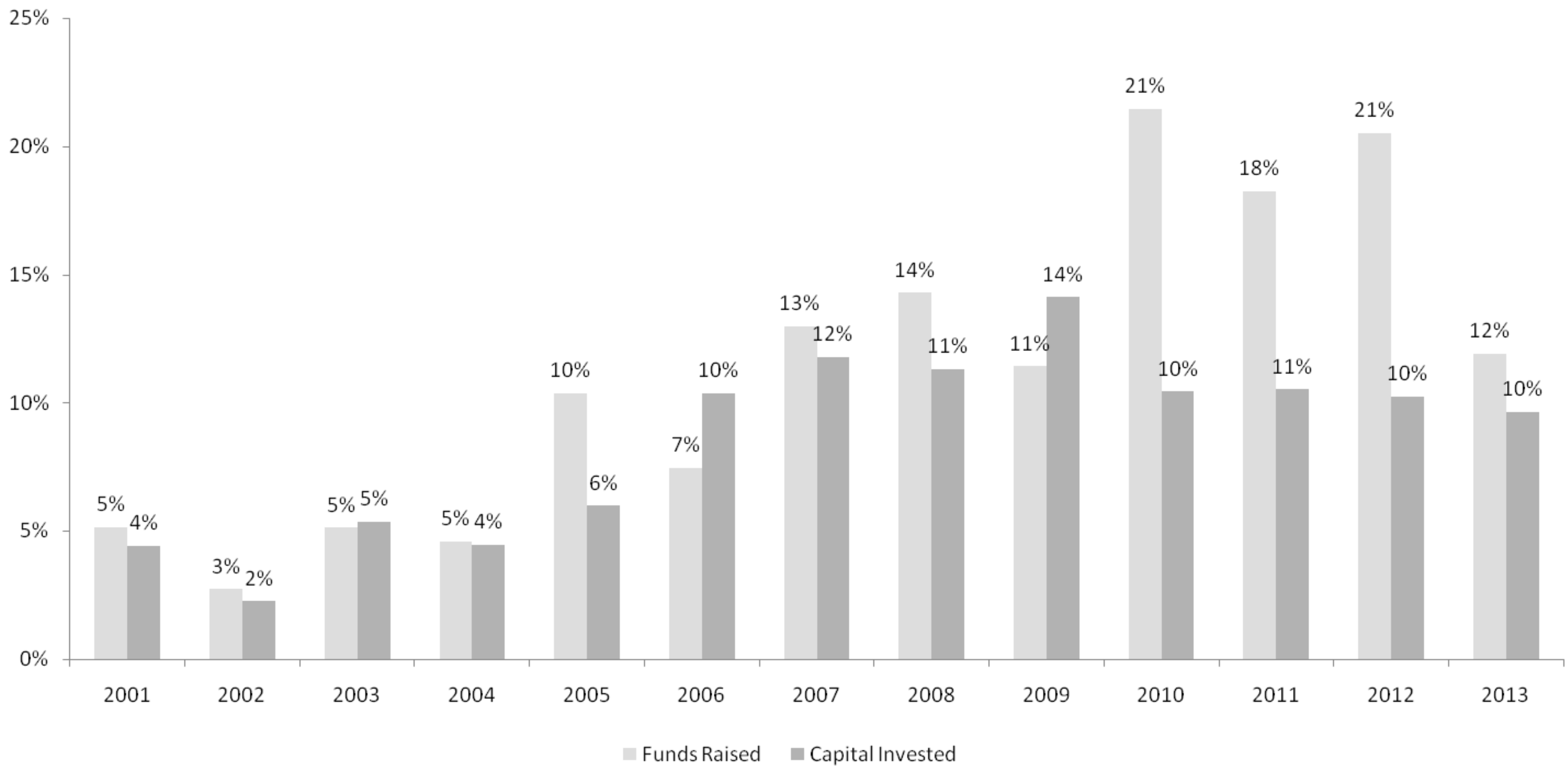
# EM PE Fundraising and Investment as a Percent of Global Total, 2001-2013

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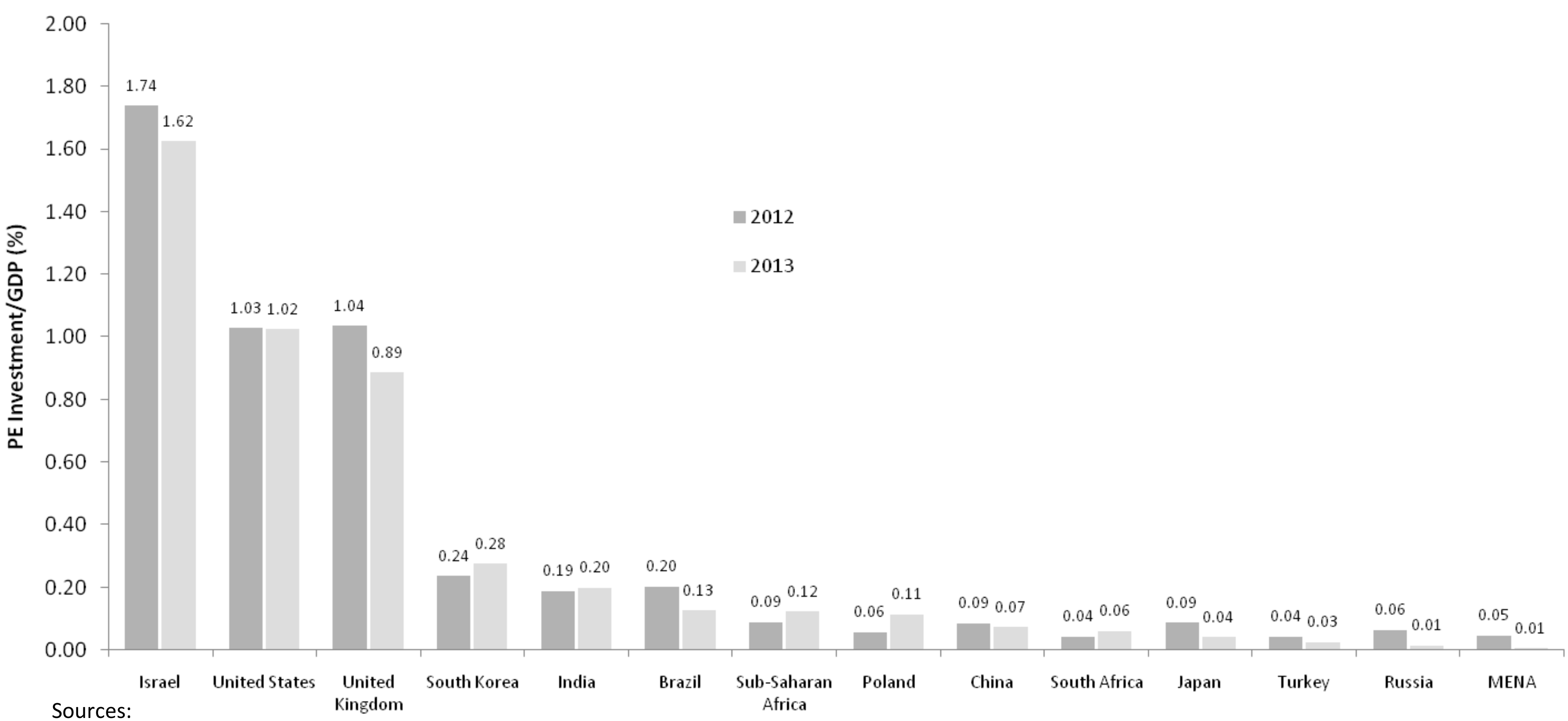
# Global Private Equity Penetration, 2012-2013




Sources:

- Emerging Markets – EMPEA's proprietary database
- United Kingdom – Centre for Management Buy-Out Research
- United States – PitchBook
- Israel – Israel Venture Capital Research Center
- Japan – Asia Private Equity Review
- All GDP data – International Monetary Fund

Methodology: Annual private equity investment divided by annual gross domestic product.

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# Comparative End-to-End Returns by Region (as of 30 September 2013)

| Index | One Year | Three Year | Five Year | Ten Year |
|---|---|---|---|---|
| Emerging Markets | 9.51 | 8.07 | 9.47 | 11.84 |
| Emerging Asia | 10.51 | 8.45 | 11.08 | 12.05 |
| CEE & Russia | 17.70 | 13.37 | 6.18 | 16.52 |
| Latin America | -1.15 | 1.89 | 6.84 | 12.46 |
| Africa | 7.22 | 6.16 | 6.68 | 11.58 |
| MSCI Emerging Markets | 1.33 | 0.00 | 7.56 | 13.16 |
| US VC | 15.09 | 14.38 | 7.51 | 8.58 |
| US PE | 17.19 | 15.66 | 10.95 | 14.21 |
| Western Europe VC | 17.11 | 13.17 | 4.94 | 5.59 |
| Western Europe PE | 16.09 | 12.31 | 6.38 | 16.77 |
| S&P 500 | 19.34 | 16.27 | 10.02 | 7.57 |

Source: Cambridge Associates LLC Proprietary Index: pooled end-to-end returns, net of fees, expenses and carried interest.

The index is an end-to-end calculation based on data compiled from 497 global emerging markets private equity and venture capital funds (includes funds investing primarily in Africa, Asia/Pacific–Emerging, Europe–Emerging, Latin America & Caribbean and Middle East–Emerging) including fully liquidated partnerships, formed between 1986 and 2013. The Asia Emerging Markets Index consists of 281 funds, the Europe Emerging Markets Index consists of 56 funds, the Latin America & Caribbean Index consists of 49 funds and the Africa Index consists of 45 funds. Please note that the Global Emerging Markets Index contains 66 funds that do not fall into these specific regions stated above. A Middle East index is not calculated because of insufficient sample size.

# Chinese Private Equity: Recent Performance

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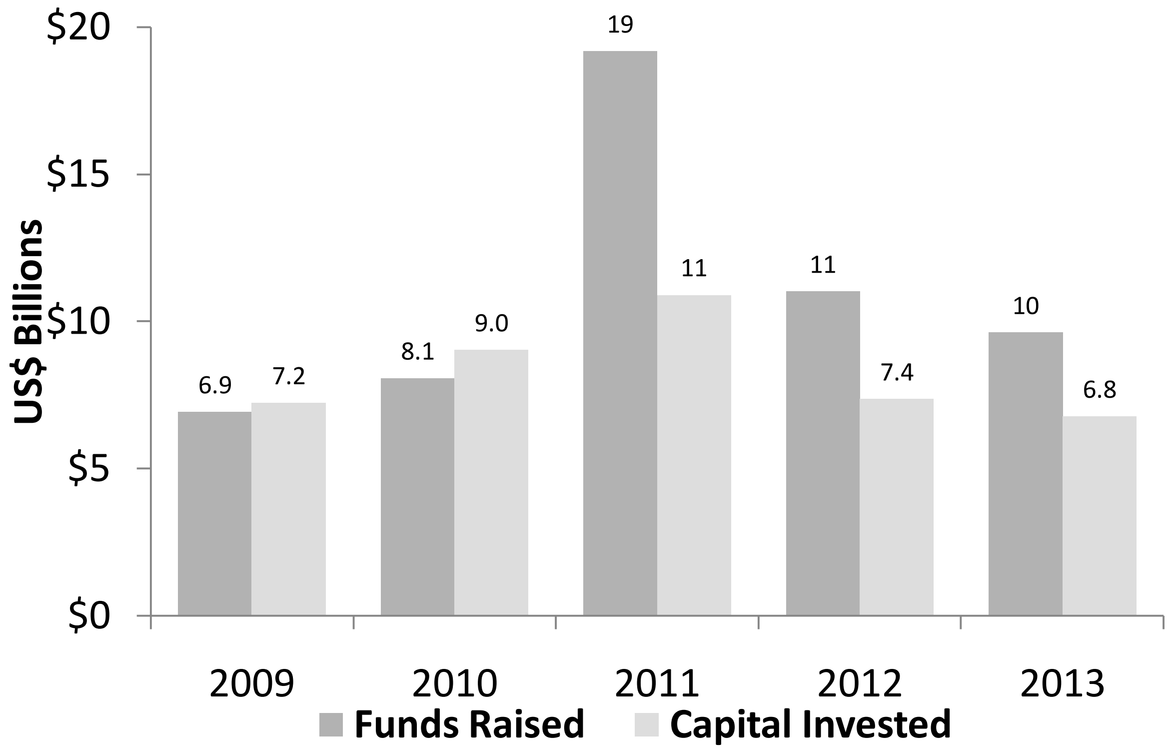
# CHINA PE FUNDRAISING & INVESTMENT: 2009-2013




Source: Emerging Markets Private Equity Association. Data as of 31 December 2013. Published 17 February 2014.

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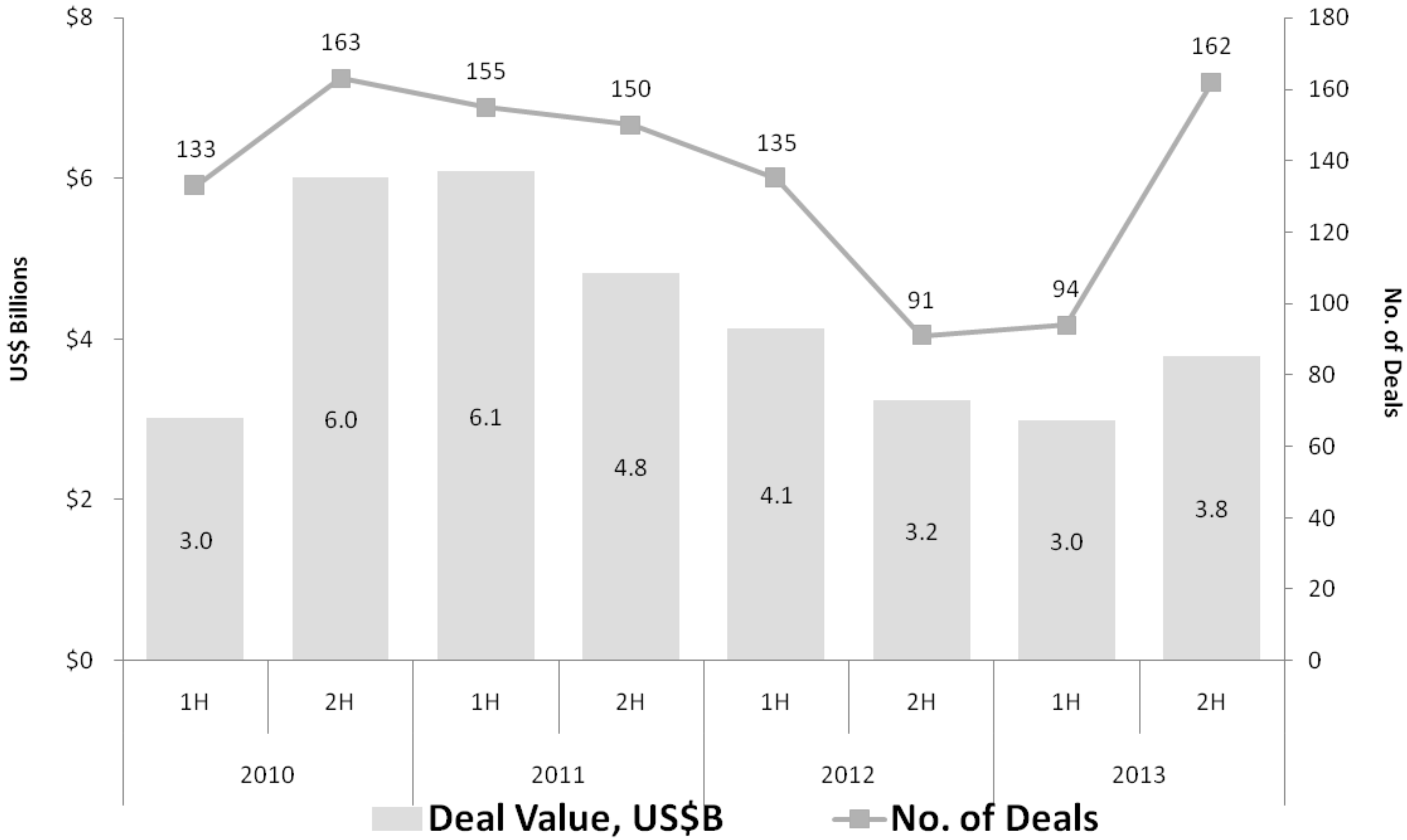
# CHINA PE INVESTMENTS:2010-2013

## Deal activity increased in the second half of 2013 with 162 deals

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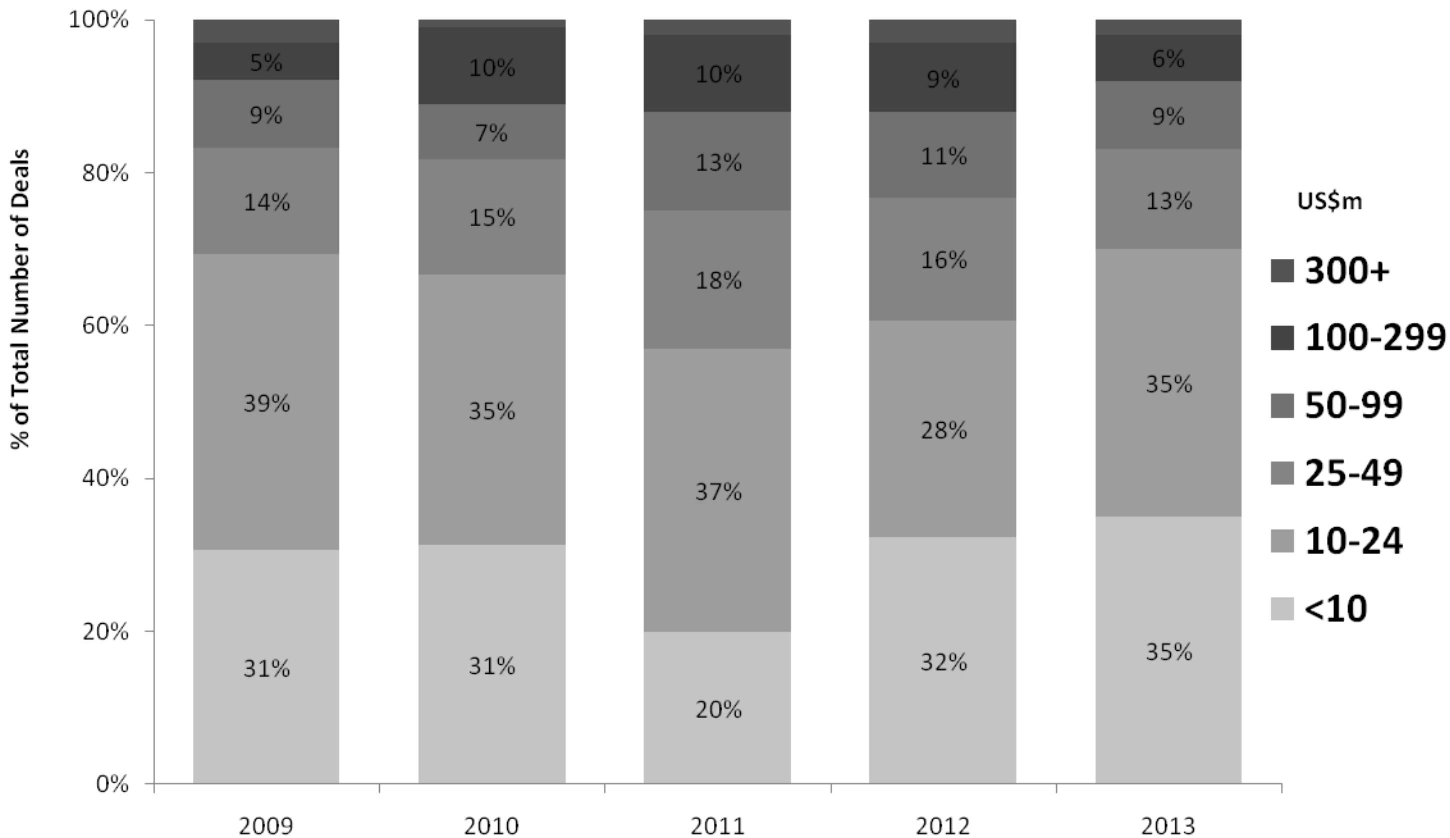
# CHINA PE INVESTMENTS BY SIZE: 2009-2013

## (70% of deals were less than US$25 million)

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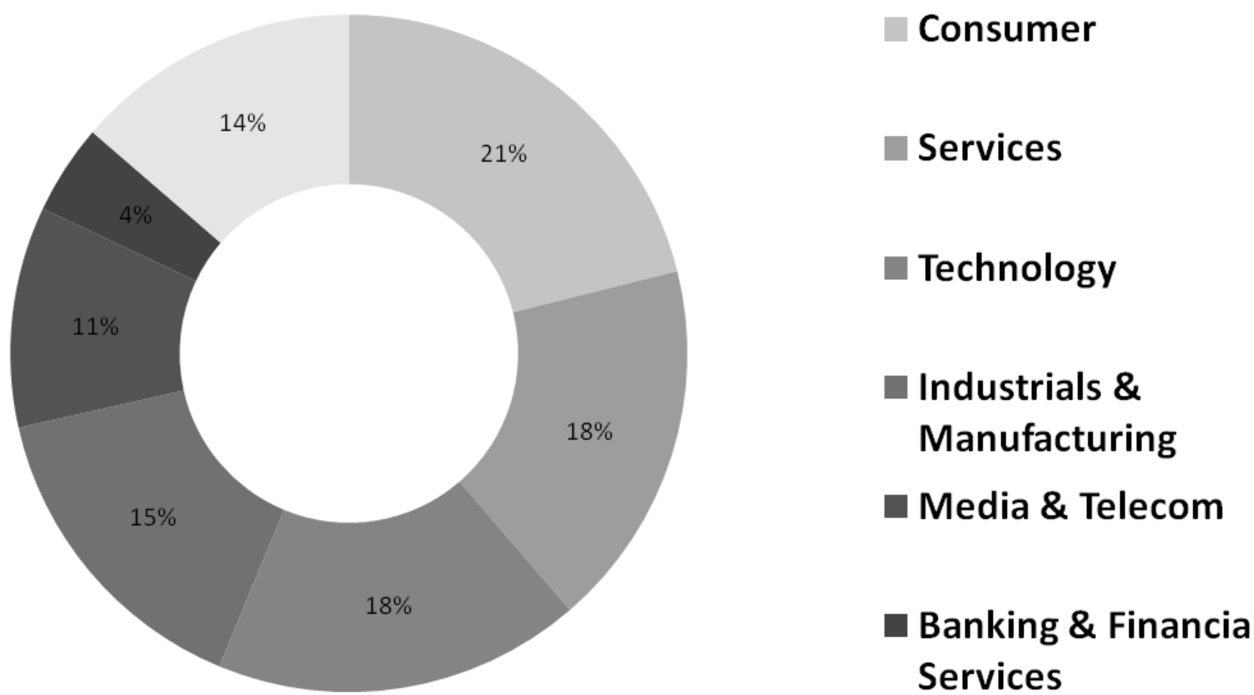
# CHINA PE INVESTMENTS BY SECTOR: 2013 (% OF TOTAL DEALS)

**The consumer sector remained the most popular sector**




Source: Emerging Markets Private Equity Association. Data as of 31 December 2013. Published 17 February 2014.

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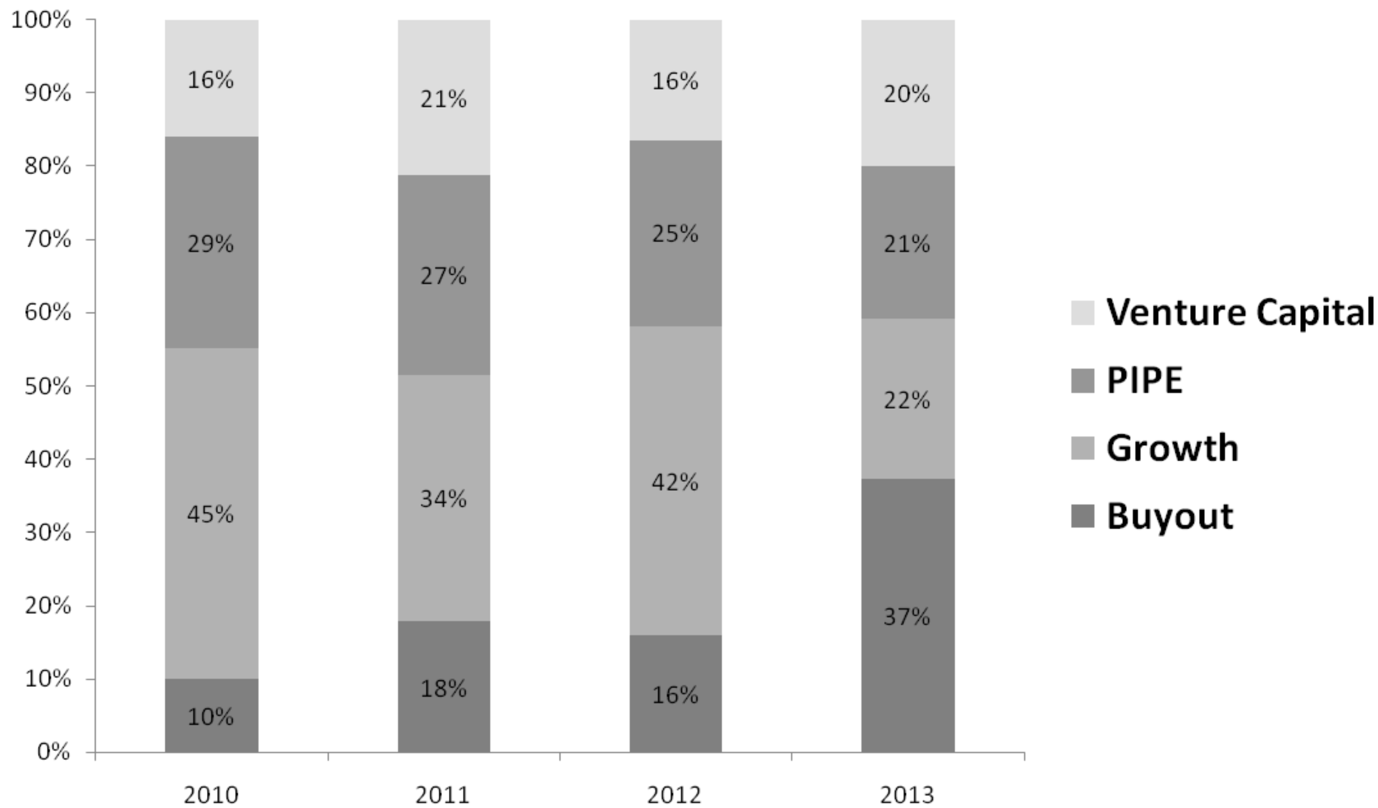
# CHINA PE INVESTMENTS BY STAGE: 2013
# (% of Total Capital Invested)

## Buyout deals represented 37% of total capital invested in 2013




Source: Emerging Markets Private Equity Association. Data as of 31 December 2013. February 2014.

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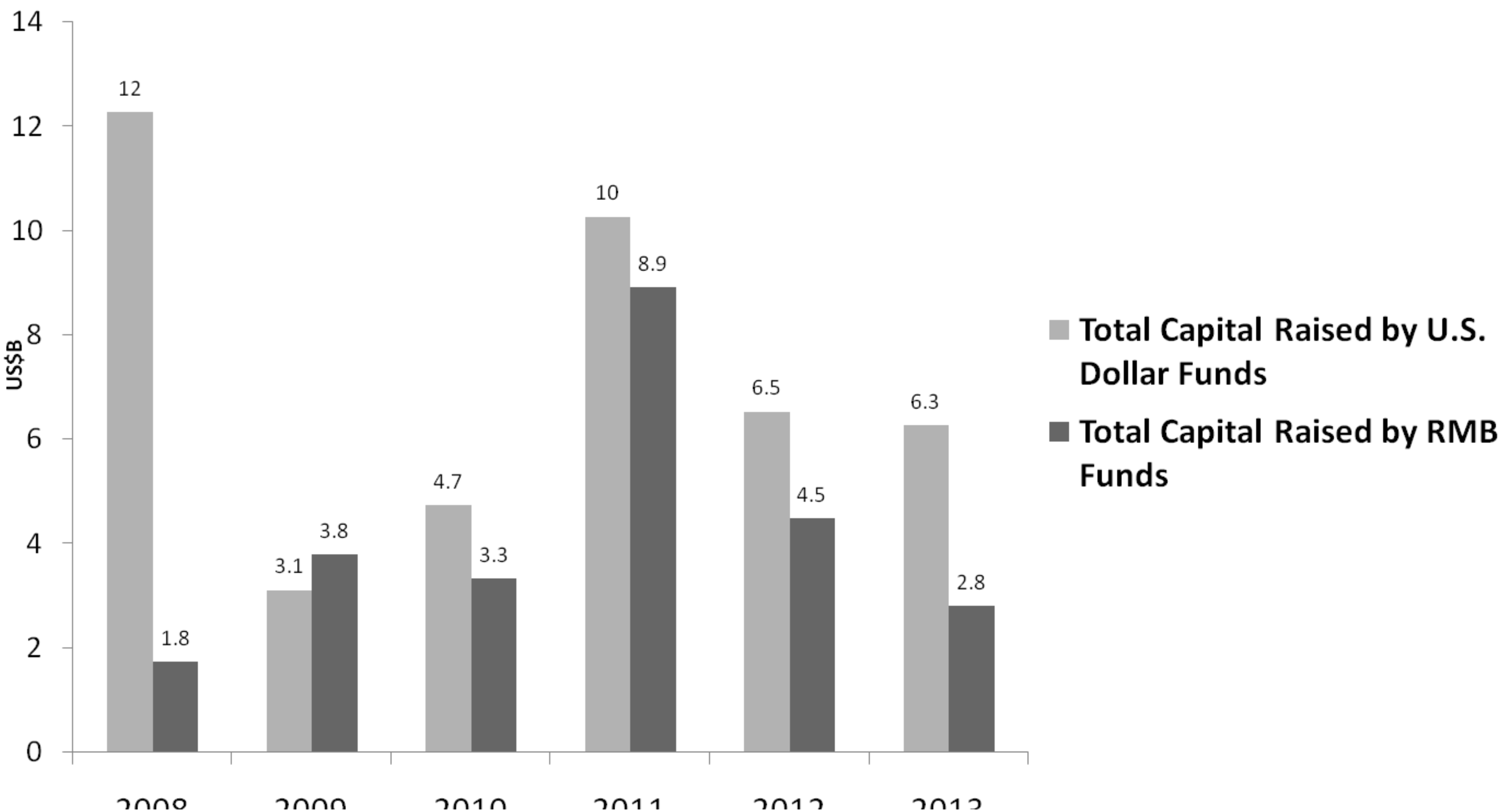
# China: USD and RMB Fundraising, 2008-2013

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# EMPEA 2013 LP Survey

## The Relative Attractiveness of China vs. Other EMs for PE investment– LP Views

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Sub-Saharan Africa | 1 | 5 | 7 |
| Southeast Asia* | 2 | 4 | 2* |
| Latin America (ex-Brazil) | 3 | 1 | 4 |
| **China** | **4** | **3** | **2** |
| Turkey | 5 | 7 | 6 |
| Brazil | 6 | 2 | 1 |
| Central & Eastern Europe | 7 | 10 | 8 |
| Russia/CIS | 8 | 8 | 10 |
| India | 9 | 6 | 5 |
| MENA | 10 | 9 | 9 |

*Classified as "Other Emerging Asia" in 2011, 2012.

# THANK YOU!

# DISCUSSION