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Stuck in the middle

Are investors missing out on opportunities in China's middle-market? Page 9

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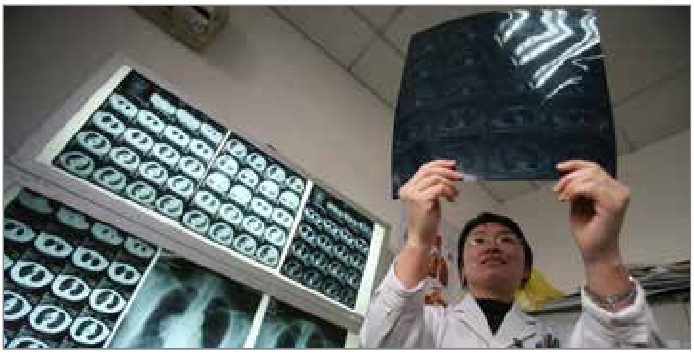

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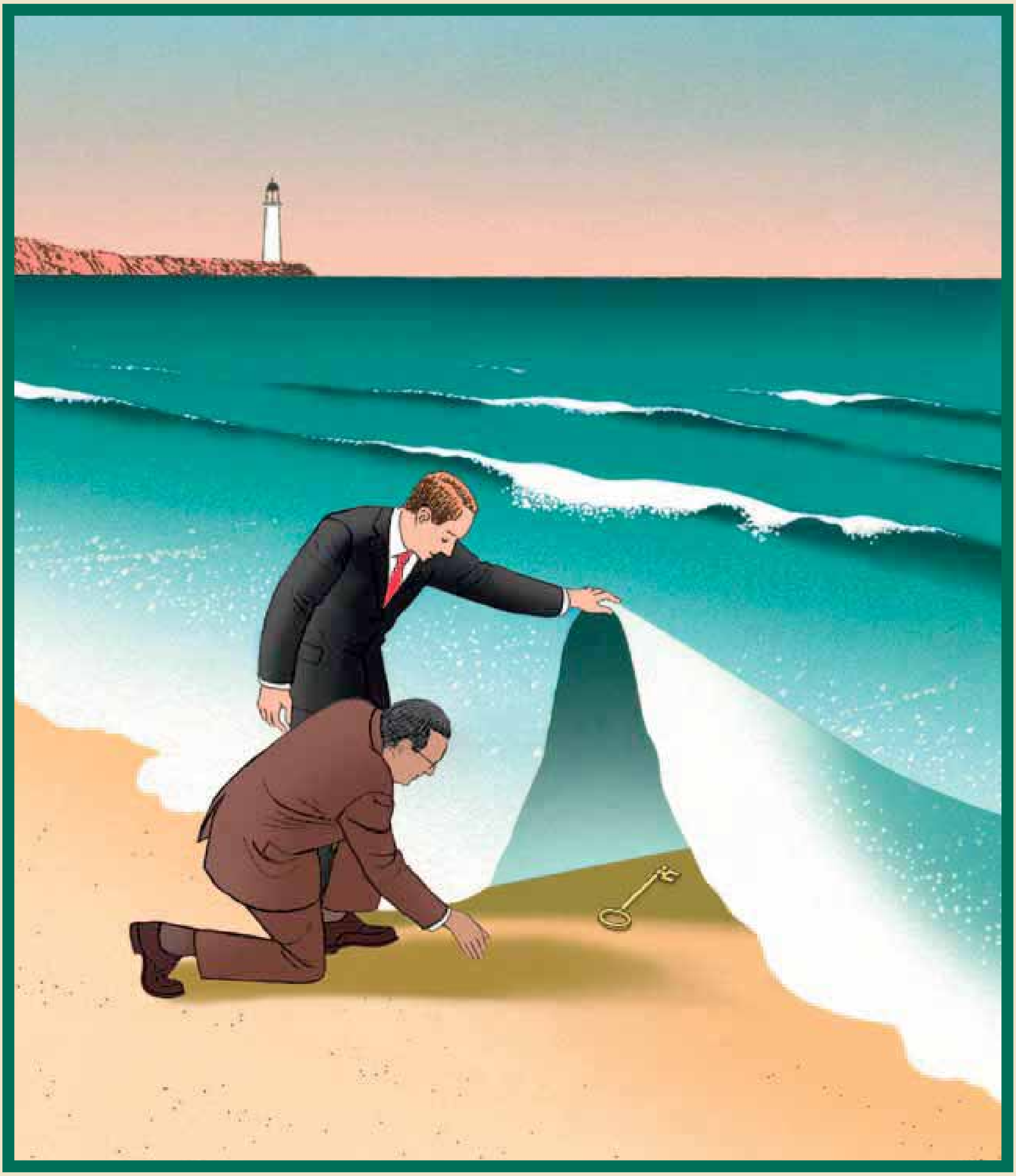
PRE-CONFERENCE ISSUE AVCJ PRIVATE EQUITY AND VENTURE CAPITAL FORUM CHINA 2015



EDITOR'S VIEWPOINT

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Changing China

THE PHRASE "NEW NORMAL" HAS BEEN used so frequently with regard to China's economy in recent years that one wonders when it might reach its sell-by date.

In a macroeconomic context, China's new normal is incremental stopping points on the path from fixed-asset investment and export-driven growth to a reliance on services and domestic consumption. But the phrase could equally be applied to the country's private equity industry. Changes in the economy and demographics signal a new genre of deals.

So far in 2015 investment is on a par with the past two years but there is been a significant shift in the nature of deal flow. Information technology has emerged as the driving force with substantial transactions involving entertainment listings and group-buying site Dianping ($850 million) and mobile-based taxi-booking platform Kuadi Dache ($600 million, prior to its merger with rival service Didi Dache).

There is a similar dislocation in fundraising, with the government-linked RMB30 billion ($4.8 billion) Green Ecological Silk Road Investment Fund dominating the rankings. It threatens to obscure true institutional activity, with CITIC Private Equity and Sequoia Capital raising their latest vehicles. Banyan Capital, a spin-out from IDG Capital Partners, also made a sizeable contribution, closing its second fund at $362 million and then raising a $100 million co -investment fund. It is worth noting that all three of these GPs are very active in the technology space.

The new normal also preoccupies global investors, who consider both the macroeconomic ramifications as well as the impact on private equity. It is a recurring theme at industry conferences – including AVCJ's own events – often followed by observations that China private equity has lost its shine in the eyes of some LPs, last year's uptick in exits notwithstanding.

For example, I was recently in Washington D.C. for the emerging markets-focused Global Private Equity Conference organized by the International Finance Corporation and our friends at EMPEA. A few years ago, this event was full of delegates from China but the 2015 iteration featured just a handful. By contrast, there were a huge number of Indian delegates.

Indeed, some attendees speculated aloud that China has fallen from favor. It is difficult to draw definitive conclusions – if anything, as the global LP community becomes more familiar with China, people forming their own opinions rather than going with the herd. Overall, there still seems to be strong interest, based on the conversations I had on my trip.

An interesting development is that a number of firms are looking at new ways of addressing the China market. A senior partner of a top US-based buyout house told us about a partnership his firm has formed with a successful Chinese renminbi-only manager that wants to expand into the US dollar fund space.

The new normal is not necessarily a concept to be feared. It emblematic of a market that is undergoing a significant transition and the opportunities it presents are different from what we've seen in the past.

Allen Lee
Publishing Director
Asian Venture Capital Journal

Largest China PE deals, 2015 year to date

Date	Size (US$m)	Financing Stage	Investee
Apr-15	850.0	Growth	Dianping.com
May-15	668.4	Buyout	Jiangxi ZhongJiang Group
Jan-15	600.0	Growth	Kuaidi Dache
Jan-15	484.3	PIPE	Guangzhou Baiyunshan Pharmaceutical
Mar-15	483.7	Growth	Lufax
Jan-15	350.0	Growth	Ele.me
Mar-15	309.1	Growth	GF Securities
Mar-15	254.3	PIPE	China Traditional Chinese Medicine
Apr-15	209.9	PIPE	Shanghai Bailian Group
Apr-15	200.0	Growth	Panshi Information Technology

Source: AVCJ Research

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GLOBAL

TPG, PAG-owned DTZ agrees $2b bolt-on

DTZ, a property services provider owned by TPG Capital, PAG Asia Capital and co-investor Ontario Teachers' Pension Plan, will buy industry peer Cushman & Wakefield for $2 billion. Investment firm Exor, n investment company controlled by the Agnelli family, founders of automaker Fiat, will receive $1.28 billion for its 75% holding in Cushman & Wakefield. The combined entity will be one of the largest real estate services companies in the world.

ASIA PACIFIC

Neuberger Berman appoints Asia PE head

Kent Chen, a former manager at the Hong Kong Monetary Authority (HKMA), has been appointed managing director at Neuberger Berman and head of the firm's Asia Pacific private equity efforts. Chen will be based in Hong Kong. His duties will include advising local clients and implementing the firm's investment strategies in the region. Chen has worked at the HKMA since 1998. His positions within the organization have included deputy chief representative at the New York office and advisor to the IMF's executive director for China in Washington.

AUSTRALASIA

EMR serves as cornerstone for Highfield placement

Australian resources-focused investor EMR Capital has served as cornerstone investor for listed mining company Highfield Resources' A$120 million ($96 million) share placement. The potash developer is offering just over 56 million shares at A$1.80 apiece. Proceeds will provide the equity component of $256 million in pre-production capital for the company's flagship Muga Potash Project in northern Spain.

Venture to benefit from Australia visa reforms

The Australian government has finalized changes to its significant investor visa (SIV) program, which will see more capital funneled into domestic venture capital. The SIV program is designed to attract overseas investment and provide a streamlined pathway to permanent residence in Australia for business people. Individuals become eligible after four years' residency, conditional on deploying at least A$5 million ($4 million) into approved assets such as government bonds and managed funds.

Australia backs crowdfunding scheme

The Australian government has allocated A$7.8 million ($6.2 million) in its latest federal budget to develop crowd-sourced equity funding (CSEF) and offered tax breaks for start-ups. The fund will allow the Australian Securities & Investments Commission (ASIC) to spend the next four years implementing and monitoring a new set of crowdfunding guidelines.

PAG targets $3b for second Asia fund

PAG Asia Capital is looking to raise $3 billion in its second pan-regional fund. A hard cap has yet to be set for the new vehicle. The first investment is likely to be South Korea-based Young Toys, which Headland Capital Partners is understood to have agreed to sell for around $200 million.

PAG targets buyouts, control deals and structured investments in sectors that leverage private consumption, including retail, food and

beverages, and healthcare. It typically invests at least $100 million per deal. The firm's first fund launched in late 2010 and closed at $2.5 billion in 2012. LPs include California Public Employees' Retirement System and California State Teachers' Retirement System.

Seven of the nine portfolio companies in Fund I are China-based, and there have been three exits, resulting in distributions of about $1 billion. Fund I is said to have so far generated a multiple of 1.5x and a gross IRR of 25%. Asia-focused private equity funds raised a total of $18.5 billion in the first four months of 2015, according to AVCJ Research. This compares to $65.5 billion for 2014 as a whole.

GREATER CHINA

Yunfeng, Wanda back sports channel

Yunfeng Capital and conglomerate Dalian Wanda Group have led a Series A round worth RMB800 million ($129 million) for sports channel LeTV Sports. Shenzhen Fortune Link and Prometheus Capital also participated alongside several high-net-wealth individuals. The financing round values the company at RMB2.9 billion.

Mizuho, China Merchants launch $250m growth fund

Japan's Mizuho Securities and China Merchants Group have reached a $20 million first close on their China-focused growth equity fund, which is looking to raise $200-250 million. Contributions came from MHSC, CMC, the Japan Bank for International Cooperation (JBIC), and several undisclosed corporations.

Greenland to take majority stake in Rundong

China's Greenland Holding Group will buy a controlling stake in KKR-backed Chinese car dealership Rundong Auto for HKD1.55 billion ($200 million). The firm will raise its current 3% stake to 30% through purchasing newly issued shares, and combine with Rundong Fortune's 30% for a majority position. KKR's 280 million shares will not be affected.

China Renaissance unit targets $150m fundraise

Huaxing Capital, the principal investment division of investment bank China Renaissance, has launched its latest fund, Huaxing Associates GP II, with a target of $150 million. Fundraising should be concluded by next May.

Baozun sets terms for US IPO

Baozun, a Chinese e-commerce platform solutions provider with strategic and private equity backers, has set terms to raise up to $177.1 million through a US IPO. The company will sell 11 million American Depository Shares at $12.00-14.00 apiece, to rise to 12.65 million shares if the underwriters exercise their over-allotment option in full. The proceeds will be used for sales and marketing, investment in R&D and technology, and warehousing and fulfillment infrastructure expansion.

NEWS

Alibaba's Ma leads HK brokerage investment

A consortium led by Alibaba founder Jack Ma has acquired 81% of Hong Kong-listed brokerage Reorient Group. Yunfeng Financial Holdings – an investment vehicle which is 40% owned by Ma – and four other investors participated in a private placement of shares priced at HK$2.00 apiece. The Hong Kong Stock Exchange says Yunfeng acquired about 1.34 billion shares in Reorient for HK$2.68 billion.

JHL Biotech raises $45m Series C round

Taiwan-based biopharmaceutical company JHL Biotech has raised a $45 million Series C round led by an unnamed investor. Existing backer Milestone Capital and newcomers Sungent BioVenture and Liwick Investment Management also participated. JHL will use the funds to expand its facilities, grow its therapeutic portfolio and complete development on two new compounds.

BeiGene raises $97m from PE investors

BeiGene, a Chinese company that develops drugs to combat cancer, has raised a RMB600 million funding round led by Hillhouse Capital and an undisclosed US-based public investment fund. BeiGene will use the new funding to support development of its oncology drug candidates, expand its global clinical development team, and strengthen product manufacturing.

Primavera leads round for online ad platform

Primavera Capital has led a $50 million Series D round of funding for Chinese big data company Miaozhen Systems, which specializes in advertising services. The funds will be used to develop new technology and scale up the business.

GEMS invests $20m in East China Sea energy player

GEMS, a natural resources-focused PE firm, has subscribed to a $20 million convertible bond issued by Primeline Energy Holdings (PEH) to support development of its East China Sea oil and gas interests. The bonds will be issued in two $10 million tranches. The term is three years, extendable for up to two years; the coupon is 7% per annum, of which 4.5% will be paid in cash and the rest in shares.

Macquarie-led group to buy telecom tower business

A consortium led by Macquarie Infrastructure & Real Assets (MIRA) has agreed to buy Crown Castle International's Australia telecom towers business for A$2 billion in cash. Other consortium members include domestic pension fund UniSuper and UBS Global Asset Management.

Crown Castle Australia (CCA) is the country's largest independent owner of mobile communications infrastructure with approximately 1,700 wireless communications towers nationally. Its largest customers are the three major mobile network operators, which account for approximately 85% of revenue. For

the year ended December 2014, CCA generated $151.1 million in net revenues - around 4% of the parent company's global total - and net income of $29.2 million. Projected EBITDA for 2015 is $97-102 million, with net income expected to reach $41-67 million.

This is the second major Australia telecommunications infrastructure deal involving private equity in the last couple of years. In 2013, Ontario Teachers' Pension Plan (OTPP) bought Leighton Holdings' Australian assets, which include one of the country's largest fiber-optic cable networks.

NORTH ASIA

Japan Industrial Solutions backs beleaguered Sharp

Turnaround specialist Japan Industrial Solutions (JIS) has invested JPY25 billion ($208 million) in ailing electronics group Sharp as part of a JPY225 billion bailout led by creditors Mizuho Bank and Bank of Tokyo-Mitsubishi UFJ, who will pay JPY200 billion for 200,000 Class A shares. Sharp will sell JIS 25,000 Class B shares for the same price. Sharp plans to cut 10% of its global workforce to recover from a JPY222 billion net loss for the year ended March 2015.

SIMI's Arora appointed COO of SoftBank Group

SoftBank Corp. has named SoftBank Internet & Media (SIMI) CEO Nikesh Arora its new president and COO. Founder Masayoshi Son will step down as president, although he will continue to act as CEO. As part of this restructuring, the company will change its name to SoftBank Group Corp.

SOUTH ASIA

TPG sells Shriram City Union stake to Apax

TPG Capital has sold its 20.37% stake in Indian non-banking finance company Shriram City Union Finance (SCUF) to Apax Partners for around INR23 billion. This represents a full exit for TPG, which took a stake in the business in 2013.

Indian state to form $31m start-up fund

The Indian state of Maharashtra has paired with the Small Industries Development Bank of India (SIDBI) to set up a INR2 billion ($31.1 million) venture fund for micro, small and medium enterprises (MSMEs). The state will contribute INR750 million, with the rest coming from banks and other financial institutions. The fund will aim to invest up to INR250 million per deal.

Housing.com CEO transfers shares to staff

Rahul Yadav, the CEO of VC-backed property listing platform Housing.com, says he will transfer all his shares in the company to its 2,251 employees. Yadav owns a 4.57% stake in the business and claims his shares are worth as much as INR2 billion. Earlier Yadav had issued a resignation letter calling the company's investors "intellectually incapable." He later apologized and was reinstated as CEO.

SOUTHEAST ASIA

SCPE invests in Indonesia electronics business

Standard Chartered Private Equity (SCPE) has invested $42 million in Singapore-based TT International's (TTI) retail electronics business in Indonesia. SCPE will a take a 45% stake in a joint venture that has acquired the majority of TTI's Indonesian retail electronics stores under the Electronic Solution brand.

This announcement appears as a matter of record only.

April 2015

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Filling the void

A clutch of China GPs now manage funds of $1 billion or more, leaving the traditional middle market space underserved. Those that remain must convince LPs they can deal with a changing opportunity set

THE FIRST TIME CDH INVESTMENTS backed Fujian Nanping Nanfu Battery in 1999 it was a minority deal completed while the team was still part of China International Capital Corp. Three years later the newly independent GP acquired Nanfu in full, putting $17 million to a deal involving a handful of co-investors.

CDH is once again owner of the business, having acquired it from Procter & Gamble last year at an enterprise value of around $600 million. The PE firm's equity contribution was $200 million. The investment came from CDH's fifth US dollar-denominated fund, which has a corpus of $2.5 billion. Fund I, raised in 2002, was worth $100 million.

The private equity firm made its name taking minority stakes in Chinese companies and helping them restructure offshore with a view to going public, mainly in Hong Kong. Now, though, the average equity check size has risen from below $50 million to more than $100 million. Buyouts like Nanfu are more CDH's style.

"The interesting question is did the strategy change or did the market change? People see the increase in investment size and assume we are doing something different, but we're not. What really changed was GDP growing at 10% a year for 10 years – the same company is now 10 times the size," says Stuart Schonberger, managing director at CDH. He notes that in 2002 Nanfu was, as it is today, China's largest manufacturer of alkaline batteries; but output and revenues have grown enormously.

Up-sizing

CDH is one of a handful of China-based PE firms – including but not restricted to Hony Capital, CITIC Capital and Orchid Asia – that have seen a marked increase in fund size over the past decade. There are also a select few younger GPs that have started out big. FountainVest Partners and CITIC Private Equity, for example, each raised around $900 million for their debut funds and have since followed up with second vehicles of more than $1 billion.

While Schonberger claims CDH has moved with the market and follows a similar investment thesis but on a larger scale, there is arguably a dearth of quality participants in the middle market space it and others have vacated. Are investors missing out on an opportunity?

"There are very few firms left in the middle market, or at least very few that can raise funds," says Kallan Resnick, managing director at placement agent Park Hill Group. "The middle market has been a difficult place for fundraising in the last couple of years. Where we have seen activity is in TMT [technology, media and telecom], healthcare-focused ventures and then at the larger end of the market."

A total of 1,185 China-focused private equity funds have achieved a final close since 2005, according to AVCJ Research. Three quarters of these are renminbi-denominated vehicles, most of them dating back no more than four years. Between 2001 and 2008, five US dollar funds raised in excess of $750 million. The remaining 140 or so closed on $600 million or below. Since 2009, the number of funds that have raised at least $750 million stands at 17, including nine of $1 billion or more.

Of the 100 other China-focused vehicles reaching final closes, 41 sit in the $250-749 million sweet spot generally acknowledged as being middle market or lower middle market. However, more than half of these are venture capital funds. Of the approximately 40 final closes since the start of 2013, around 60% have been by VC managers. In the $250-749 million space the share is over 70%, such is the appetite for exposure to the high-growth technology space.

This is in part an LP problem. The trend in PE globally is for institutional investors to consolidate GP relationships and deploy more capital with a smaller number of managers. At the same time, many of the larger LPs are forced to overlook smaller managers due to minimum check sizes and rules preventing them from accounting for more than 10% of the overall fund size.

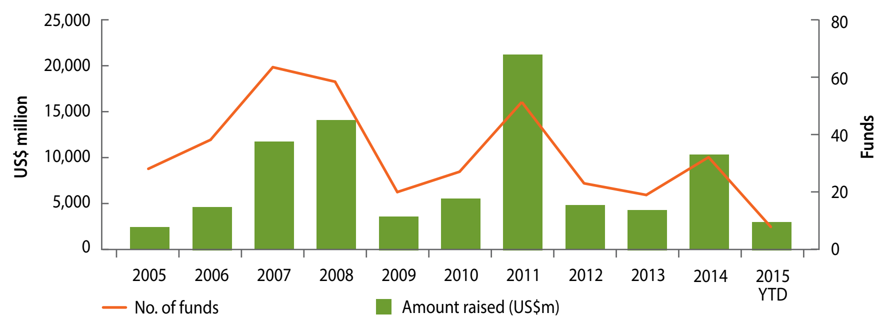
"There is a disconnect between the opportunity set, the LP universe and the GP universe. More and more money is going into $1 billion-plus funds," says Myron Zhu, a partner at FLAG Squadron Asia, speaking a personal capacity. "Sovereign wealth funds and large pension funds are increasingly coming to Asia but they are can't commit less than $100 million per fund so they are gravitating to the more institutionalized platforms."

Although the headline US dollar fundraising numbers, including incremental and final closes, for 2007 and 2014 are similar – $11.6 billion versus $10.3 billion – the number of GPs receiving capital fell by nearly half. Between 2001 and 2008, average fund size was $155 million. For 2009 to the present, it is $292 million, as larger vehicles tip the balance.

"Right now it's easier for a pan-Asian fund to raise $3 billion than it is for a China fund to raise $500 million," adds one GP. "If you want $500 million then it is $25-50 million a time, 10-20 times. If you are raising $3 billion you get $100-200 million at a time from a bunch of state pension funds, and it usually goes through the gatekeepers."

Several middle market firms are currently

China US dollar fundraising



Source: AVCJ Research

fundraising. Lunar Capital is said to be seeking up to $500 million for a consumer sector buyout fund, while Ascendent Capital Partners and Bull Capital Partners have are expected to set hard caps of $650 million and $500 million for their latest vehicles. Trustbridge Partners is at the upper end of the space, having targeted around $750 million, and then the likes of Abax Global Capital and Capital Today are also in the market, the latter for an evergreen vehicle.

There is choice, but anecdotal evidence of strong demand for a small number of managers in the space suggests that LPs are not getting as much choice as they want. "It's not the case that there are no firms in the middle market or lower middle market, it is more about the quality of the players," says Doug Coulter, a partner at LGT Capital Partners. "A lot of good managers in China are chasing early-stage TMT deals or they have raised a lot of money and are going after $50-100 million checks."

Park Hill's Resnick notes that size in itself is not enough of a differentiator: GPs have tried and failed to raise funds on the back of the notion that, with many PE firms now raising funds of $1 billion or more, there is a need for groups in the middle-market hole. "You need to have a good track record or at least something that is differentiated in the strategy," he says.

The new normal

The middle market space is stigmatized in the eyes of many by an association with minority, often passive, participation in pre-IPO deals – the idea being that the GP would provide expansion capital and then exit via the public markets at a valuation multiple substantially higher than the one at which it invested. With GPs having limited influence over business operations or the timing of exit, a number of these deals floundered.

At the same time, riding on the coattails of industry growth is no longer a relevant strategy in many cases. Chinese middle market companies face an array of challenges, including a tougher commercial environment, cross-border expansion or domestic consolidation imperatives that are beyond their current operational and financial resources, and transferring ownership to a younger generation within the founding family that can't operate the business alone or perhaps doesn't want to operate it at all.

"After the global financial crisis growth wasn't happening and so it made no sense to do growth investing – helping a company build a new factory and double capacity. The second factor was the IPO market became very tight and middle market companies weren't going to get that multiples pick-up on listing," says Kyle Shaw, managing director at Shaw Kwei & Partners. "Now the pool of opportunities is driven by demographics, low interest rates, and the lack of growth. A lot of guys are struggling to stay where they currently are. They appreciate that they must do something different with their business."

Shaw Kwei is currently investing its third fund, which has a corpus of $450 million, and most of the capital has been going into turnarounds and succession planning situations. Rather than putting in new capital to accelerate growth, it is buying people out and addressing particular problems. To get traction on these deals, the seller needs to be convinced of the buyer's ability to engineer a transformation.

"Domain knowledge is important. Entrepreneurs have become more sophisticated and they are not only looking for capital – it is now a commodity to a certain extent – the strategic angle you can provide is going to make the difference," says FLAG Squadron's Zhu. "We have seen GPs secure deals at 20% discounts to the market price because they are perceived to be able to add value to the company."

Sector specialization is the most obvious example of how a GP can bring domain knowledge to bear. It is very much a characteristic of the middle market in the US and China appears to be moving in the same direction, albeit gradually. Shaw Kwei concentrates on high-end manufacturing, which often necessitates dealing with companies that have operations in multiple countries. Lunar, meanwhile, targets branded consumer goods businesses that rely on domestic demand.

Both GPs are control-oriented and both are excited about succession planning. Derek Sulger, managing partner at Lunar, notes there were $12 billion worth of consumer buyouts completed in China last year, most of them small- and medium-sized enterprises (SMEs) that meet the firm's investment criteria of being sub-listing in size and generating $100-150 million in annual revenue.

"Only 2% of those consumer buyouts went into private equity hands but that pool is growing dramatically because China has a massive succession problem," Sulger says. "It is a huge opportunity but it is very largely overlooked. I think this is because a lot of people don't have the ability or desire to run these companies and manage them through this transition. It is a very labor-intensive process."

> **"It is a huge opportunity but it is very largely overlooked. I think this is because a lot of people don't have the ability or desire to run these companies and manage them through this transition"**
> – Derek Sulger

Resources management

This issue of labor intensity gives some LPs pause for thought. When deciding whether or not to back a GP, the first consideration is usually the quality of the team and the track record of individual members. If that box is ticked, the question becomes whether the approach is suitably focused and differentiated from the rest of the market. Furthermore, can this strategy be executed and is its competitive advantage sustainable?

A buyout strategy requires industry knowledge, operational expertise and relevant business networks. For many middle-market China managers it is unknown territory and LPs are not convinced that the bench is deep enough to make the transition from growth deals.

FLAG Squadron's Zhu says he has seen numerous instances of private equity firms enjoying success with one buyout and then seeking to raise a larger fund in order to do more such deals. "We say to GPs, 'You are doing great on this but look at how many resources it is occupying – it is the single largest deal in the portfolio.' We need to be cautious about the significant additional resources required to replicate this model,'" he explains.

The general view is that minority transactions will continue to account for the bulk of deals in China's middle market. Indeed, Bull Capital is one of a number of GPs not looking to attain control of businesses.

"The best deals are generally state-owned enterprise (SOE) spin-offs and we are not the best positioned to capture those opportunities," says Guillaume Dry, managing director at the firm. "And we are not yet geared or prepared to do transactions where you need real operational knowhow and the ability to change management if needed. We could do it but we would need to add resources."

Bull Capital is looking for opportunities in the industrial sector, where companies want to upgrade their operations and accumulate new technology and expertise, and also in business-to-business services, which is expected to benefit from companies outsourcing non-core functions such as human resources of facilities management. The firm ensures its minority voice is heard by only investing as the lead participant in a round and insisting on a board seat.

Ascendent is also typically a minority investor in deals but makes brings its influence to bear through a merchant banking-style approach to private equity, providing companies with capital in conjunction with advice and solutions. The firm's value-add is strategic rather than operational, but Kevin Zhang, one of the co-founders, told AVCJ last year that this is good fit when working with established industry leaders.

"A food packaging business doesn't need us to come in and explain how to make a metal can at lower cost. But they might need us to advise on how the company can reposition itself as a multi-product food and beverage packaging company," he says. "They might have identified an acquisition target and need help on the transaction, or they might want us to look at their capital structure, not only to lower financing costs but also to match assets and liabilities in order to reduce potential risks."

When working with smaller companies, much rests on a manager's willingness and ability to contribute in areas that can be time-consuming and relatively mundane. Firstly, a typical middle-market company with less than $200 million in revenue is likely to be lacking in back office administration. The accounting department may be weak on cost controls, there may be no enterprise resource planning (ERP) system and no Big Four auditor, and bank relationships could be poor.

Sales and marketing is another area with plenty of scope for improvement. It is not uncommon for middle-market companies to have gained traction through a couple of key sales executives who have strong ties with key clients. This is not a long-term solution and so institutional sales force management is required.

"Then you get into things like rationalizing production facilities, perhaps in areas that made sense once upon a time but don't any longer, and no one wanted to take the hard decision to lay people off," says Shaw of Shaw Kwei. Only once these basic goals have been achieved can the business move forward, drawing up plans for capital investment in new equipment or altering the positioning of brands.

CITIC Capital also pursues a buyout strategy, although with a fund of $925 million it sits at the upper end of the space. Large, relationship-based deals – often club transactions in which the firm gets a piece by virtue of its connections to state-owned CITIC Group – sit alongside SOE restructurings and a handful of middle market companies in the portfolio.

Eric Xin, senior managing director for China private equity at CITIC Capital, explains that smaller deals come into focus in areas where the firm has particular expertise. The GP also finds limited availability in the upper middle market, defined as companies with annual sales of at lesat $80 million, because they are often just waiting for an IPO. At the same time, there is a reluctance to go too small, for the reasons outline above: it means engaging with companies that are generally poor on compliance and have weak management systems.

"It is not practical for us to buy small companies," Xin explains. "For businesses with RMB100-200 million ($16-32 million) or so in sales, we sometimes ended up spending more time on them than on Focus Media [CITIC Capital participated in a $3.5 billion privatization of the display advertising business]. Management teams in these companies generally struggle to think strategically so they need all the help you can give them. You have to get your hands very dirty."

Judgment day

China funds get raised for all kinds of reasons that aren't necessarily tied to track record: a perceived princeling connection that promises access to premium deal flow; a principal who previously worked for a large institutional player and carries with him the goodwill of LPs plus the odd anchor commitment; ties to a domestic brokerage that can tap pre-IPO opportunities; or just maybe an articulate manager with a good story.

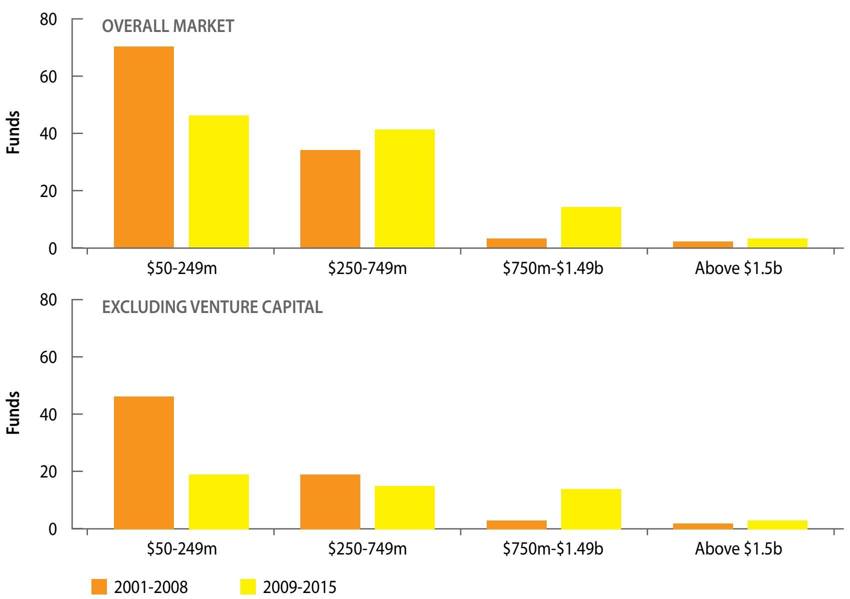
The current generation of middle-market funds will ultimately be judged on their ability to generate exits, an area in which some of their forbears fell short. If the strategy plays out and the minority investor is able to guide portfolio companies to new markets and technologies and the buyout deal serves as a platform for an M&A spree, there should be sufficient scale or value to secure decent returns. It helps that entry valuations in the space are said to be reasonable by China standards.

Just as important, these GPs are not wholly dependent on the whims of a narrow set of public markets. According to Schonberger, CDH became wary of listing middle market companies because of the regulatory road blocks on mainland exchanges and risk of a weak reception, and consequent illiquidity, in Hong Kong. He is now much more bullish on the prospects for these companies in the A-share market.

If that doesn't work, those same private equity firms that vacated the middle market to go up-scale are now ready and willing buyers, as are numerous strategic players. Consolidation is a prevalent theme at all levels of China's economy in response to slowing growth.

"If you back a great company and it continues to grow then you can list it on the A-share market. If it's a decent company and you get it a bit wrong then you can still exit to an industry consolidator," Schonberger says. "That middle market does look a lot more interesting than it once did, and it is underserved."

China US dollar fund final closes, by size



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Complicated prescription

Private equity investors see huge opportunities in China's hospital space on the back of healthcare reforms. But valuations are high, doctors are in limited supply, and regulation can be a headache

DELTA HEALTH, A BRAND NEW HOSPITAL group controlled by Fidelity Growth Partners Asia (FGPA) and its affiliates, will open its flagship facility – Shanghai Delta Hospital – within six months. It has taken nearly seven years to design, construct and commission this cardiovascular healthcare unit.

Located in Qingpu District, five miles from Shanghai Hongqiao Airport, the 50,000-square-meter facility currently holds 230 beds and provides end-to-end service for cardiovascular diseases, from early diagnosis, to prevention, intervention and rehabilitation.

"We spent significant capital and it has taken many years to come to fruition. The reason why we want to own and control this ambitious initiative is because we are committed to controlling our destiny and making certain we create something of the absolute highest quality," says Daniel Auerbach, managing partner and senior managing director of FGPA, and chairman of Delta Health.

The firm works with stakeholders including The Shanghai Health Bureau, the Qingpu District Health Bureau and several specialist public hospitals, as well as Columbia University with a view to providing international standard services. Moreover, FGPA has plans to obtain additional land and licenses to expand into a comprehensive service provider.

In Auerbach's view, Delta Health cannot be classified as a traditional venture capital or private equity investment; FGPA has something longer-term in mind. It wants to participate in Chinese healthcare reform over the next two decades, working with stakeholders throughout the system.

"We have the capital and we have the patience, and we will indeed have patients," Auerbach adds. "We have very little interest in rolling up or consolidating assets with a view to a quick public listing."

The Chinese government has introduced policies encouraging private capital to play a role in improving healthcare services, and financial investors, including private equity, are looking at potential opportunities with interest. There are numerous possibilities in the hospital space: building new facilities or consolidating existing ones, entering the general hospital segment or focusing on specialty hospitals and clinics. However, the overriding concern remains whether investors can turn a profit from healthcare service delivery.

"There are two questions around foreign private equity investment in hospitals. First, why does China need foreign money? It has a lot of money, but there is a need for foreign expertise. Second, is the private equity investment horizon long enough to allow hospitals to become profitable?" says Benjamin Shobert, managing director of healthcare consultancy Rubicon Strategy Group.

The door opens

Moves to liberalize China's healthcare service industry were announced in late 2013. Last August, the Ministry of Commence further opened up the space by allowing 100% foreign direct investment in hospitals in seven cities and provinces, including Beijing, Tianjin, Jiangsu, Guangdong, Hainan and Fujian. Public hospitals currently account for over 90% of the national medical services delivery market, but FGPA expects the private sector share to reach 25-30% over the next few years.

The successful IPO of iKang Healthcare Group, China's largest operator of medical examination and disease screening centers, last year suggests that public market investors are buying into the growth story. IKang raised $150 million through its public offering, facilitating partial exits for NewQuest Capital Partners and GIC Private. It is currently trading up 20% on the IPO price at a valuation of $1.1 billion.

On the private investment side, a total of $607.2 million was deployed 10 deals in the service provider space last year, the most since 2010, AVCJ Research shows. While these include some investments in general hospitals, the bulk of the capital has focused on privately-owned specialist clinics and hospitals.

Last April, Fosun Pharma teamed up with TPG to buy Chindex International, operator of United Family Healthcare hospitals and clinics, a chain that specializes in female health and child care services, in a deal worth more than $450 million. A few months later Hony Capital made invested in privately-owned Shanghai Yangsi Hospital, and the GP has indicated there will be more acquisitions to come.

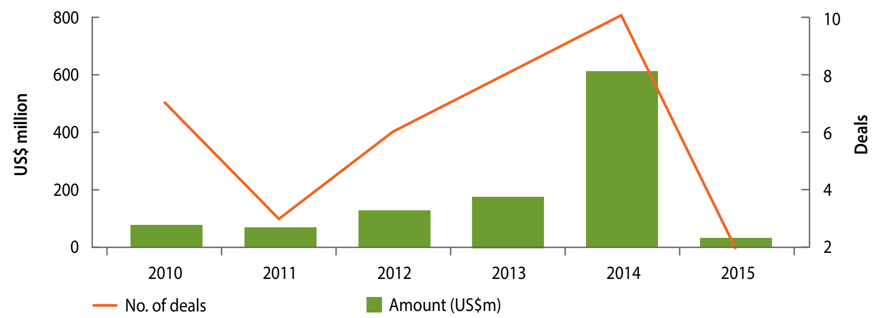
"In the early wave of investments, most financial investors focused on a repeatable type of retail format, such as healthcare check-up centers or dental chains," says Vikram Kapur, a Hong Kong-based partner of Bain & Company.

"Recent liquidity events have given people confidence and they're seeing the value creation opportunity. There is growing interest in specialty hospitals and clinics, as well as to 'take-privates' of public hospitals with a view to restructuring them."

Several private equity firms want to acquire hospitals as part of a roll-up strategy. Hony has formed a dedicated platform, called Grand Accordia Healthcare, which is intended to acquire a dozen local hospitals in the next three years from both private and state-owned sellers.

"Shanghai Yangsi Hospital was privately-

PE investment in China healthcare service providers



Source: AVCJ Research

owned and we wanted to buy it to serve as base – or a training ground – to make sure that we understood all the nuances before we scale up. The deals we have in the pipeline are a mix of small regional hospitals, owned by private founders, and others owned by the state in one way or another. These deals are complicated because in addition to the difficulties of running a hospital, you also have to deal with historical owners," John Zhao, Hony's CEO, tells AVCJ.

Morgan Stanley Private Equity Asia (MSPEA) is adopting a similar strategy. Earlier this year it paid $38 million for a minority stake in Baijia, China's second-largest private sector maternity hospital operator. The firm also completed two control deals for hospitals in Nanjing, Jiangsu province, operating through a joint venture with Sihuan Pharmaceutical, a longstanding portfolio company.

While Baijia is a classic growth deal, the joint venture platform is a dedicated acquisition vehicle. The plan is to absorb 6-12 hospitals, exploit scale and operating synergies, and ultimately take the platform public. A total of RMB1.24 billion ($200 million) went towards the two purchases in Nanjing, one of which was already under private ownership while the other was obtained from the local government.

CDH Investments also been active in the space, completing 8-9 transactions out of its renminbi-denominated fund from 2005 onwards, including Ciming Health Checkup Management and Angel Women's and Children Hospital. There is a single hospital deal in the GP's most recent US dollar fund and a plan to create a chain a smaller clinics and hospitals, but progress has slowed due to rising valuations. Stuart Schonberger, managing director at CDH, notes that success is not easily won.

"If PE investors can find assets at the right valuation then it's a very attractive market – there is unlimited demand and very poor or limited supply in China's healthcare sector," he says. "Everyone sees the opportunity, but how do you build out a chain with all the regulatory constraints? How do you find the right doctors?"

Doctors and patients

The level of unmet demand in China's healthcare system is best expressed in doctor numbers: there are only 2.7 million serving 1.4 billion people compared to 2.2 million in the US, which has a population of 300 million. Every year 600,000 students graduate from medical training schools and universities, but only 100,000 of these go on to become fully-fledged doctors. The rest take lower-skilled jobs in small clinics and check-up centers, according to Shan Fu, managing partner at Vivo Capital.

The elite gravitates to the large public hospitals where they are better paid and have a clearer path to promotion. Many public hospitals also have ties to universities, and this presents teaching opportunities as well as the possibility of getting government funding for research.

The lack of supply has led some investors to target greenfield facilities, where they can build high-quality brands from scratch. This is often done in partnership with foreign healthcare groups, combining their domain expertise with the PE firms' local knowledge. Last year Hillhouse Capital Group formed a joint venture with US-based Mayo Clinic, while Trustbridge Partners drew on the consulting services of Boston-based hospital group Partners HealthCare International for its general hospital in Shanghai.

The $500 million Shanghai Jiahui International Hospital is due to be completed in 2018. The specialty private facility aims to hire Chinese doctors from the US and establish strong ties with academy schools and medical institutions in order to train and retain staff, according to Gilbert Mudge, president and CEO at Partners HealthCare International.

"We've been approached by real estate entrepreneurs who want to build the hospitals but they have a little understanding about the complexity of running a hospital," says Mudge.

Public hospitals: Tough targets

China's healthcare system suffers from a resource and demand imbalance, largely due to large hospitals that have a monopoly on the system – about 95% are public hospitals controlled by the government.

Last year Beijing opened the door to private investment in public hospitals and more opportunities will come as assets are sold off with a view to improving the quality of healthcare. For example, last December China Resources Healthcare Group announced the acquisition of Huaibei Miner Hospital Group, which operates a total of 17 public hospitals.

Private equity investors are less likely to follow suit. "First, we think the government will introduce a lot of policies in this sector in the long run and we don't know what they will be," says Shan Fu, managing partner at Vivo Capital. "Second, there is limited number of public assets that are available for private equity firms to look at."

Of the 600,000 students who graduate from medical training schools and universities in China this year, one sixth will pursue careers as doctors. Looking for higher salaries and a leg up on the comprehensive public sector promotion ladder, most will end up at the country's 20,000 sizeable public hospitals. These are concentrated in the cities of Beijing, Shanghai, Guangzhou and Chongqing.

"Most of these hospitals earn their income from drug sales," Fu says. "But the government has said a number of times that it wants to reform the revenue structures so that medical institutions aren't excessively reliant on drug sales from their in-house pharmacies. When this policy is implemented, net profit for these hospitals will probably be cut a half. If you were a private investor, you might compensate by hiking treatment prices instead, but this would create tension with the public."

In terms of availability, these public assets must go through a formal sale process and it can be difficult for private investors to get transactions done. Among the key criteria are the welfare of existing employees and the patient populations, as well as the stability of tax contributions to the local government, Homer Sun, CIO at Morgan Stanley Private Equity Asia, previously told AVCJ.

In this context, the background and operating credentials of the acquirer are subjected to intense scrutiny. It is not unknown for doctors, nurses and other professionals to submit objections.

"Employees in public hospitals are concerned about their future job security, the for-profit drive of private owners and their career development. As a result, there have been a number of cases in which employees have gone on strike when private investments into public hospitals were considered," says Jenny Yao, a healthcare partner at KPMG.

Other factors taken into consideration by prospective private equity investors include the healthcare management capabilities of the target institution, potential synergies with other hospitals on the same platform, and opportunities to collaborate with leading foreign and domestic healthcare groups. If a PE firm can secure the right asset at the right valuation with the right management, hospitals are highly attractive.

"What we like a lot about this sector is the barriers to entry are high if you are well positioned. The cash flows are stable and very defensive," Sun said.

"The complexity is first in the politics: who is going to get the land? Then it is a question of the institution interacts with existing hospitals and medical schools in the community. Trustbridge is very committed in designing healthcare services in the long run."

Despite steps taken by the government to relax restrictions on acquisitions, securing land remains a pressing challenge for greenfield operators – the best plots are often being used for other purposes. "That's a real problem for hospitals because they are all about providing localized services within a metropolitan area," says Rubicon's Shobert.

He has seen some existing buildings, such as hotels, re-purposed as hospitals or medical care centers, offering ready access to patients. At the same time, other industry participants question the importance of location, noting that patients are willing to travel for high quality services.

Who pays?

The real problem is payment, observes Jenny Yao, healthcare partner at KPMG. Creating a universal health insurance program is part of the government's reforms and three schemes – the mandatory urban employee basic healthcare insurance scheme, the voluntary urban resident basic healthcare scheme and the voluntary new rural co-operative medical scheme – cover over 95% of the population.

Private hospitals are keen to participate but local governments, conscious of the need to protect public hospitals, are reluctant to extend coverage. Indeed, the application procedure alone for private hospitals is incredibly complicated. As a result, the 11,000 private hospitals in China miss out on mass-market basic care. Even for services that go beyond what is covered by the insurance reimbursement program – and there are still holes in the system – private facilities are too expensive for most users.

> "We have very little interest in rolling up or consolidating assets with a view to a quick public listing" – Daniel Auerbach

The emergence of a middle class with higher disposable incomes and an ability to pay for private insurance cover are only part of the solution. Long-term reforms are required across the healthcare delivery system, from hospital ownership to regulation of medical practitioners.

In this regard, there has been some progress. Traditionally, doctors have been subject to close controls but now those working in public hospitals are encouraged to work part-time in the private sector. Although predominantly a practical measure to help address the shortage of qualified staff, it also represents the beginnings of a free market for talent.

Another recent development is the government's decision to allow public hospitals to sell franchises to private sector operators in order to give patients access to a wider range of services. Anzhen Hospital and Beijing Children's Hospital each plan to build new medical centers with private capital. This could be the short-cut that many PE investors are looking for. While they are supplying capital, the public hospitals provide reputation, brand identity and trained doctors, essentially covering areas in which fully independent facilities fall short.

"With the well-known brands, patients already recognize them so there is built-in demand," says KPMG's Yao. "It is actually setting up a new mechanism for patients who are willing to pay higher prices for better services in new hospitals. I think that's a good opportunity because it won't take 10 years before you see a return on investment."

Building for buyouts

Hony Capital CEO John Zhao expects to see more control opportunities arising from domestic succession planning, cross-border expansion and restructuring. He explains how his firm is preparing the ground

Q: What progress have you seen in terms of buyout opportunities?

A: As China continues to mature we see three sets of buyout opportunities. One is the growing number of privately-held companies where the owners want to sell the business because there is no successor to take over. The majority of entrepreneurs pass their businesses on to their children but a large number will cash out. Second, as China becomes more global there will be more buyouts by entities like Hony that want to exert control over products and services that better serve the Chinese market. The third set will be restructuring opportunities. On the succession planning side, we led a consortium of that spun out the medical equipment business of IT services provider Neusoft Corporation. We have formed management groups targeting buyouts in two focused – but very large – sectors: branded fast food franchises and community hospitals. Finally, we have participated in take-private deals for online game developer Giant Interactive and drug developer Simcere Pharmaceutical, both of which were US-listed. We consider these to be cross-border control deals, as was our acquisition of Pizza Express.

Q: Did you set up the fast food and hospital platforms largely because you expect to do a lot of rolls ups?

A: Yes. We only do this in sectors where we think there is going to be increasing demand in the lower- to mid-tier segment of the market, which is highly fragmented. We target sectors

> **"The majority of entrepreneurs pass their businesses on to their children but a large number will cash out"**

where a roll up is an effective strategy, but it is not template for all buyouts.

Q: How competitive is the hospital sector and what does this mean for deal access?

A: It really depends on the specific strategy. There have been a lot of control investments in specialty chains, whereas our strategy is to target community hospitals covering basic services. We are the first ones to try and do this. It is a difficult because it requires good sector insight in different regions, and then a lot of resource aggregation. What makes it attractive to us is the fact that there is a lot more consumption and demand for services in the mainstream. The sooner we crack the code, the easier it will be to target future opportunities.

Q: In terms of bringing foreign brands into China, which sectors are particularly attractive?

A: When bringing brands to China we want to make sure we can amass the necessary resources, in addition to the capital, to aid expansion. Where we don't have a management group we want to work with an existing portfolio company that has a strong China presence. A case in point is Shanghai Jin Jiang International Hotels, which we helped acquire Louvre, the France-headquartered European hotel chain. In this instance the thesis runs both ways. We can help Louvre penetrate the Chinese market, because it has Europe-based clientele wanting to come to China, and then Chinese tourists want to utilize hotels in other locations around the world.

Q: Does STX Entertainment come under the cross-border strategy category?

A: Absolutely, we have invested heavily in media and entertainment sector. We previously bought into Shanghai Media Group and that served as the basis for plans to expand into Hollywood. STX has also secured a three-year financing deal with Huayi Brothers Media Corp

Q: You have also backed online TV provider PPTV. Is there an effort to create an integrated entertainment consumption channel in China?

A: Given that intersection between internet media and content creation segment is so hot, there will be a lot more demand for content there will be more ways to disseminate that content to consumers via mobile internet. PPTV is at a critical spot in this intersection. We are actively developing our business while entertaining proposals or movements in the markets. Anything can happen there.

Q: What impact did the suspension on new share listings in the domestic market have on Hony?

A: When we raised our first renminbi-denominated fund in 2008 alongside the US dollar fund, we decided to put more emphasis on domestic stock exchanges. So we started to construct our portfolio, for both funds, with a view to doing a lot of onshore exits. When the IPO door was shut, it had a huge negative impact on the industry. Luckily the market and has now reopened and there is a lot of pent up demand.

Q: What do you make of the move towards a disclosure-based IPO approvals system?

A: It is a great move. The new third board is adapting advanced concepts that have been practised in Hong Kong and New York for a long time. Although the new third board is small, it can make a huge impact on China's capital markets. The way they are structuring the disclosure requirements so they are more market-driven is the right way to think about this.

Q: The regulators also want more tech companies to list domestically. What does this mean for the US route?

A: I hope there will be more options for China-based tech companies; that is better for the market in the long run.

Chasing unicorns

Capital is flooding into China-based internet companies, with PE firms, family offices, hedge funds and strategic players all-too-willing to support large, late-stage rounds. Not everyone will emerge a winner

THE WORST CASE SCENARIO FOR investors in Dianping, a Chinese entertainment listings and group-buying platform, is Tencent Holdings buying the business. Already a significant shareholder, Tencent is understood to have made numerous proposals to Dianping as it looks to add e-commerce functions to what is primarily a social media platform.

The best case scenario is a merger with Meituan, the company's direct domestic rival – replicating the recent unification of Didi Dache and Kuaidi Dache, which between them rule the mobile taxi-booking space. Dianping and Meituan have each raised new capital in the past few months at valuations of $7 billion and $4 billion, respectively. A single, dominant player would be worth far more.

This was how one investor described the risk-reward debate surrounding Dianping, which has now raised six rounds of funding. The most recent of these saw Tencent Holdings, FountainVest Partners, Temasek Holdings, Xiaomi, Wanda Group and Fosun Group pumped $850 million into the business. Even for late-stage entrants, the best case scenario – culminating in an IPO – could deliver a 2-3x return.

However, the investor warns against doing any deal at any price. "We must be very careful about what we work on – there must be very little downside," he adds.

Investors of all description are pouring into China's technology, media and telecom (TMT) space, pushing up valuations and creating a pack of "unicorns" worth $1 billion or more. With the financial stakes so high, never has selecting the right company been more important. It is not only question of whether the market leader today will still be there tomorrow, but whether the existing market dynamics can be sustained.

"The challenge from an investor perspective is you have to pick the ones you want," says Julian Cheng, a managing director at Warburg Pincus, which has made a number of TMT investments. "If you invested in every single Series B company out there you wouldn't do very well. If you invest in every single public company you wouldn't do very well either."

Expansion time

Until 2014, China's TMT space had seen no more than seven disclosed investments of $100 million in a single year. Last year, there were 17 as a record $6.8 billion flowed into the space across nearly 400 transactions. There have been 20 to date in 2015 out of 160 deals in total and $4.7 billion in capital deployed. Investors in the those 20 rounds include 19 VC firms, 16 PE firms, seven internet companies, one government-backed investment fund, and a handful of general strategic players and hedge funds.

Following the most recent round for Dianping, an LP with a portfolio that features both Qiming and FountainVest would have exposure to the same company twice. The same could be said of investors in Sequoia Capital and CITIC Private Equity's latest funds after both participated in a $350 million round for food-ordering platform Ele.me. As it happens, Dianping committed capital to that round as well.

> "The challenge from an investor perspective is you have to pick the ones you want" – Julian Cheng

"We have seen some of this double exposure to portfolio companies, especially in later rounds," says Myron Zhu, a partner with FLAG Squadron Asia, speaking in a personal capacity. "I am less concerned by this because some of these companies are reasonably mature and there is less early-stage risk. What I am concerned about is valuations. Are they sustainable and for how long?"

The argument against that the pace of growth in the internet sector to some extent justifies the premiums investors are paying is well established. Unlike the dotcom bubble era, the internet is delivering actual revenues rather than the possibility of revenues. The user base, which has grown exponentially, has been monetized and the sector is underpinned by an e-commerce infrastructure. At the same time, companies are going public later, which means they are more mature and stable.

John Lindfors, managing partner at DST Global, cites internal research showing that the market capitalization of the internet sector globally is $2 trillion, up from just under $1 trillion five years ago. Over the coming 10 years this figure is expected to exceed $5 trillion. Capturing just 1% of the five billion people using smart phones a few years from now and persuading 5% of that group to pay for a service translates into 2.5 million customers – a target that few offline businesses reach.

"China alone is a massive market," Lindfors adds. "The other important consideration is that a lot of these technologies leapfrog developments in the West. E-commerce penetration, for example, is higher in China than in the US. There is a significant amount of concentration of value in the top few players in a segment but I think there is room for many."

The trend of many category-leading internet companies going public at a much later stage than before has allowed DST to carve out a significant niche. It invests globally, taking minority stakes in late-stage internet companies. The average check size is around $200 million and in a select few cases it has committed a lot more. Significant China investments include JD.com, Alibaba, Xiaomi and Didi Dache.

Getting comfortable

Ozi Amanat, founder of K2 Global, a VC firm that also focuses exclusively on pre-IPO rounds, has ventured into China's tech space just once. It was also the deal through which he made his name.

Working for a family office in the US, Amanat secured allocations in Facebook and Twitter in 2012 for a small club of investors, making a 7-8x return within 18 months as the companies went public. His next stop was Singapore, seeking backers for US data-mining specialist Palantir Technologies. One HNWI asked for a stake in Alibaba and Amanat obtained $35 million worth of shares. Palantir doubled in value around the same time and Asian family offices began to get interested.

K2 Global is in the process of raising a $100 million fund but the real firepower comes from the LPs' appetite for co-investment. The firm tends to get access to shares through founders and early investors looking for a liquidity event. Avoiding expansion rounds means lower valuations – Amanat claims to get sizeable pricing discounts on target companies' previous

rounds. The firm only backs start-ups that have at least $1 billion in revenue and are cash flow positive. The portfolio includes Uber, Spotify and Airbnb.

"We decided we would go with the most mature, well-known names in the world and they are predominantly in the US. Alibaba was the exception," Amanat explains. "The only other Chinese name that popped up was Xiaomi but interest fizzled away pretty quickly. We have some institutional interest but it's mainly on the family side and they gravitate towards big names."

Industry participants note that they see limited participation from HNWI and family offices in China technology deals. Indeed, club deals brokered by trusted intermediaries are often the only way entrepreneurs who can choose their investors would tolerate Chinese HNWIs (family offices are viewed differently). This is due to concerns about a lack of sophistication: these investors are high maintenance, they ask silly questions, and they can't be trusted with sensitive information.

"We have seen entrepreneurs turning away this kind of money because it comes with strings attached," says James Lu, a partner at law firm Cooley. "They want PE houses with relevant experience. A lot of PE firms when they are pitching highlight their experience in similar industries with similar companies and that is very attractive to entrepreneurs."

A track record in the tech space also makes it easier for investors to get comfortable with the valuations being asked of them. DST focuses on companies that can disrupt existing markets or create new markets. When it backed Alibaba in 2011 the company was already generating significant EBITDA, so DST had to be sure that expected growth in China's e-commerce market – and Alibaba's position in this market – justified the valuation. As it turned out, e-commerce in China grew faster than anyone expected.

The investment in JD.com came the same year. DST was impressed by the commitment to providing value to customers, the delivery network that was being built out, and the founder, Richard Liu. Lindfors says a strong founder is often the clincher when deciding whether a company can consolidate its position in the long term.

"That is one of the judgment calls you have to make as an investor – is this company really going to be a leader?" he explains. "In some situations you have more conviction."

There are various ways in which private equity firms can ensure an element of downside protection when going into these deals. Valuation ratchets, entitling investors to more shares if certain targets are not reached, and different liquidity provisions feature in some of these transactions. In a number of cases investors are also able to negotiate put options.

Additional comfort comes from tagging along into deals alongside strategic investors that may end up buying businesses or at least use their industry clout to engineer a favorable outcome. Several investors claim they were reassured about Didi Dache and Kuadi Dache due to the presence of Tencent and Alibaba, respectively, and the consensus that a merger would work best for all concerned.

In this case, there was a clear path to creating not just a category leader but a dominant force – a position from which the combined entity is much better placed to diversify its business and ensure long-term sustainable growth. In other segments of China's internet industry there is less clarity.

Dianping and Meituan have weathered the fierce competition that dominated the early days of group-buying when several thousand players fought tooth and nail for market share. A battle was fought and won. Food-ordering platforms and P2P payment platforms are still engaged in these skirmishes and on a different kind of terrain. Ele.me may have built up a commanding position, but new competitors are still entering the market and the service is very location-specific.

P2P platforms, meanwhile, will be challenged by offline players encroaching on the online space. "These companies will do well for a time but then banks will catch up and a lot of P2P players will disappear," says one industry participant. "You need to work with groups that have large offline businesses – like Alibaba or JD.com or Xiaomi."

Acceptable risk?

Yet PE firms continue to make investments even in these less mature areas, albeit not at the valuations seen for the likes of Xiaomi, Didi Dache and Meituan. They may make a convincing argument for an investment, citing extensive industry research, ideas for how the business can develop, and their past experience working with similar companies. At the same time, no one wants to miss out on the next big thing.

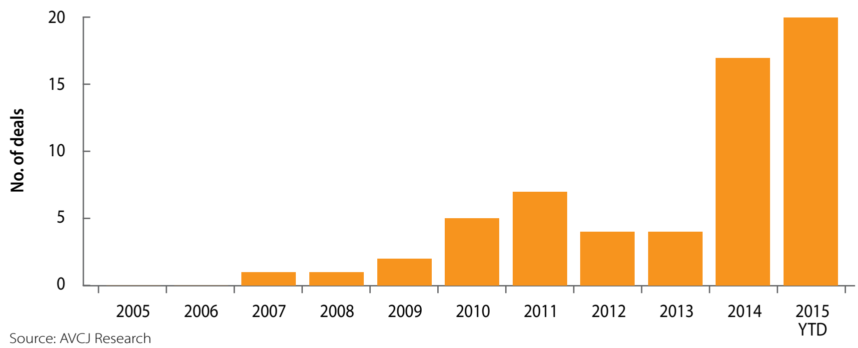
For example, CITIC Capital has profited from its investment in Alibaba, entering in 2012 at a valuation of $32 billion, which implies a more than 6x return at current prices. However, the deal was completed at holding company level, not through a fund. Even though the deal would arguably have been off-strategy, one LP expresses frustration that the firm never took the opportunity to the fund advisory board.

Given the groundswell in demand, few investors expect valuations to slow in the near term. Indeed, K2 Global's Amanat expects his business to turn on its head in the next couple of years and rather than connect Asian capital to Silicon Valley, he will be getting US and Asian investors exposure to Asia-based internet companies. At the same time, he notes that the market ebbs and flows; companies need to monetize their business models and those that fail will disappear. It all comes back to picking winners.

Once the market turns, LPs will have clarity as to which PE firms have been prescient and which have been taking venture capital-style risks – perhaps risks that have been taken in the same companies by VC funds in the same LPs' portfolios. Whereas the VC model is designed to accommodate a handful of write-offs because they are compensated for by a single home run, private equity needs its downside protection.

"There will be an inflexion point," says Cooley's Lu. "Eventually investors need to get liquidity and get out and there will be success stories and failures. When the failures come along they may be dramatic failures because of the amount of money involved. It's only a matter of time. Not everyone can be a success story."

Investments of $100m or more in China TMT



Source: AVCJ Research

Maker's mark

Best known as the go-to location in China for cheap electronics manufacturing, Shenzhen is now emerging as a Silicon Valley for hardware. Can these start-ups get traction with software-focused VCs?

FRANK WANG, THE 35-YEAR-OLD FOUNDER of Chinese drone manufacturer DJI, is a classic example of a "maker." He got his first remote-controlled toy helicopter at 16, crashed it, and started playing around with the parts inside.

DJI came into being in Wang's dorm room at Hong Kong University of Science & Technology in 2006. An electronic engineering major, his final-year project was building a mini-helicopter drone. He obsessed over the stabilized flight control system, skipping classes to perfect his design. The drone crashed during a test flight before the presentation, but his efforts weren't wasted.

Wang relocated to Shenzhen, the light manufacturing hub of southern China, and set about building his business. The flight control system was DJI's first product. By 2012 DJI had developed all the components for a complete drone, and the Phantom, a rotor-powered device carrying a high-definition camera, was released in January 2013. DJI is now the world's biggest consumer drone maker by revenue, with an estimated 70% of the market share.

Earlier this month the company received $75 million in funding from Accel Partners at a reported valuation of $8 billion.

"DJI is a great example of a Chinese company that's creating a new category. It is an innovator, coming up with the initial concept and starting the market," says Vasant Natarajan, a partner at Accel. "There are so many opportunities for the company because it is based in Shenzhen. It has access to local market resources in that manufacturing zone. Other global markets have yet to master this model."

Maker communities and incubators are sprouting throughout Shenzhen, tapping into the rich DIY culture. With the emergence of internet-of-things (IoT) technologies, it is hoped that the hardware talent found in these communities can translate into new prototypes, giving birth to a new breed of Chinese start-ups along the lines of DJI.

For venture capital firms that have long seen software as the key ingredient to their China investment thesis, Shenzhen is an opportunity but also a challenge. Are these investors able to adapt their strategies and become consistent and successful backers of hardware businesses?

Tech metropolis

A sprawling city of more than 15 million people, Shenzhen was China's first special economic zone. Foreign investment gave it head-start in manufacturing and the past 35 years have seen substantial progress. Assembly lines produce components and do final assembly for international electronics brands such as Apple and Samsung at a scale, speed and quality that still justifies the rising costs.

The evolution of the smart phone has also, to a certain extent, democratized hardware. Ten years ago, building small-form, high-performance electronic goods was a challenge. But the emergence of powerful sensors, mobile chip sets, and better battery technology has made production more cost-effective. Sophisticated hardware can be developed in a dorm room.

> **Almost any process you need to fabricate a product is within two-hour drive of Shenzhen, which facilitates the depth of design vocabulary available to a hardware start-up"** – Bunnie Huang

"Shenzhen is the ecosystem for hardware start-ups," says Bunnie Huang, a Singaporean hacker, who is also a mentor at Shenzhen hardware-focused accelerator HAXLR8R. "The existing supply network provides an extremely liquid supply of parts and services, which means free-market forces drive down prices for basic resources. Almost any process you need to fabricate a product is within two-hour drive of Shenzhen, which facilitates the depth of design vocabulary available to a hardware start-up."

The districts of Futian and Huaqiangbei are home to a massive components emporium where traders sell circuit boards, bolts and screws that are the foundation stones of electronic gadgets. A dozen multi-story buildings are filled with wholesale shops tied to different factories, enabling makers to find the components they need. In the online space, Seeed Studio sells more than than 700 open source hardware components to makers and inventors globally.

Cyril Ebersweiler, a partner of SOS Venture, founded HAXLR8R in Shenzhen in 2012, basing the model on different skill-sets drawn from traditional accelerators that could support hardware start-ups.

The firm, which recently rebranded as HAX, provides seed funding and 111 days of intensive prototype development and refinement. It helps start-ups sell products and raise capital through crowdfunding platforms such as Kickstarter and Indiegogo, as well as giving them the chance to pitch to potential investors from the US.

"Crowdfunding has been very important for start-ups, which wouldn't necessarily be able to raise VC funding due to investor ignorance. This was certainly the case 2-3 years ago but it's now's getting better," Eberweiler says. "Selling the products on Kickstarter can generate tens of millions in revenue without any equity dilution. Then they can take venture capital for further growth. In the early days, revenue is the best thing you can have as a start-up."

China's pirated goods purveyors, collectively known as "shanzhai," are also bringing benefits to the hardware start-up community. Entrepreneurs who learned their trade in large factories are trying to build their own brands and introducing supply chain innovations. They tend to focus on "appcessories" that extend a smart-phone's capabilities, robot technology ranging from vacuum cleaners to drones, and medical or healthcare-related apparatus.

The target market is typically business-to-business rather than business-to-consumer, although the likes of HAX do help start-ups broaden their focus in order to generate revenue from the consumer mass market.

This initial concentration on B2B is one of the reasons why venture capitalists have struggled to understand the space. Huang says he advises many hardware start-ups to shun VC funding because these investors do not grasp hardware's full potential and their motivations are not aligned with those of the entrepreneur.

"Hardware is a buy-and-sell business," he explains. "Nobody is going to acquire or invest in you because you have 10 million users but your product is underpriced and so you're losing $20 for every item you deliver. However, internet start-ups can get away with that – the actual cost to keep users is unclear. You might be acquired for billions of dollars if you can prove you've got the most eyeballs in a particular niche."

Jenny Lee, a managing partner at GGV Capital, agrees that hardware is a "tough space to invest" as it requires a deep knowledgeable of technology. This is especially important because hardware is capital intensive – VCs must be prepared to reserve more capital and help start-ups secure other forms of funding.

"While the sector is considered hot, not that many companies get funded in the Series A to Series C rounds," Lee says. "The ones that secure financing tend to be larger-sized companies that already have products selling in the market, or are already are profitable."

Revenue is therefore a key consideration and a number of accelerators have been set up to help hardware companies commercialize their technology. Brinc, which is based in Hong Kong and has offices in Shenzhen and Guangzhou, focuses on connected hardware under IoT, encompassing wearables, smart devices and products for smart cities. It wants to support companies that not only make money by selling products, but open up platforms that form the basis for other technologies.

"People don't define connected devices and smart devices very well today. A 'connected' device is simply a device that connects to a mobile phone. This is what most of the manufacturers are doing in China. There is a Bluetooth or Wi-Fi chip that turns the device on and off, and does some basic data tracking. It's not really smart," says Manav Gupta, founder and CEO of Brinc.

Convergence point

For the likes of GGV, Qiming Venture Partners and Shunwei Capital Partners, the driving factor is the convergence of hardware and software. They are particularly focused on start-ups with products that play a functional role in a consumer lifestyle and appeal to those who are no longer impressed with the fact of the technology itself. Traditional industrial hardware technology is therefore not a target.

Qiming is about to close on three hardware-related deals, having already backed three companies – manufacturing drones, sport cameras and home appliances – in the past 12 months. Kuantai Yeh, an IT-focused partner at the firm, says the six companies are pre-revenue, but all have proven concepts in product designs of 3D printing. Those smart hardware companies have an operating system (OS) integrated inside, and also connect with the smart-phones.

Given the products have yet to launch, there is no desire to seek capital through online crowdfunding platforms. "The smart hardware business is very competitive. When you tell the whole world about your plans you give them an opportunity to copy your products," Yeh says. "If you want to sell a camera for RMB100, your rival would release a model priced at RMB49 with one more additional feature."

Shunwei has invested over 30 hardware start-ups since inception; one third are based in Shenzhen and the others are in nearby cities. The VC firm was co-founded by Lei Jun, who is also the founder of domestic smart phone maker Xiaomi. It often invests in Xiaomi affiliates in partnership with the parent company.

"We call them 'Xiaomi ecosystem investments.' Xiaomi provides a range of support to these start-ups, including on product designs, financial operations and marketing," says Tian Cheng, a partner at Shunwei. He cites iHealth, a healthcare electronics specialist, as an example.

> **"While the sector is considered hot, not many companies get funded in the Series A to C rounds"**
> – Jenny Lee

Qiming, GGV and Banyan Capital also dip into the Xiaomi ecosystem. GGV's firm recently invested in three Chinese IoT players, of which two – headphone designer 1More and portable battery maker Zimi – are affiliated to Xiaomi. Through this affiliation, the start-ups can not only create an enhanced user experience by integrating their hardware with Xiaomi's platforms, but also draw on a wealth of data.

"Xiaomi has built up a strong brand, a big installed base of users and this makes it especially suitable for products that can be easily connected, displayed or controlled by Xiaomi phones. This includes wearables and smart home devices, which can be sold in large quantities for a single model, leveraging Xiaomi's design and supply capability," GGV's Lee says.

Also as affiliates rather than captives, the likes of Zimi and iHealth are free to forge ahead as independent operators once they have expanded their product portfolios.

Several other Chinese technology giants, including JD.com, Alibaba Group and Baidu have joined Xiaomi in the hardware space. It has also become a target for traditional telecom devices manufacturers like Huawei, TCL and Midea. They have ambitions to create their own ecosystems, bringing together online and offline technologies in order to engage with consumers and create sustainable business models.

"Everyone wants to get into the hardware space as an ecosystem player. It is much easier for hardware start-ups to get funding in the wake of the IoT boom," says Junhao Hu, CEO and founder of Darma, which manufacturers smart cushions that monitors sitting posture and stress levels. The firm started out producing bed sheets but switched to cushions while in the HAX program. "As a hardware start-up, selecting the right products to manufacture is more important than how we manufacture them."

Crowded market

As makers get more traction on their products, the smart device market is becoming crowded, with dozens of new releases every day. Between 10 and 20 bracelets or smart watches with similar activity-tracking functions are currently available in China. The numbers are similar for robotics, smart cars and drones.

At the same time, the line between hardware and software is blurring – hardware captures detailed data from users and software is required to deliver the results in a form that can be monetized. This is encouraging the development of integrated start-ups, which in turn require management teams with a broader range of skill-sets. As such, barriers to entry will become higher.

"Ultimately when we look at the investments in the smart hardware companies, the core value is in their software technology, because they don't do the manufacturing or design integrated circuits. It is similar to Apple – they actually have a very low value on the manufacturing side, it's more in the software and service ecosystem," says Qiming's Yeh.

Intelligent hardware is still in its nascent stages and the market is still waiting for true leaders to emerge in various segments. In the drone space, for example, the range of applications is enormous, spanning consumer, industrial and military users. DJI may be the largest Chinese drone manufacturer, but it is not alone. In addition to Qiming's recent investment, Chengwei Capital Partners has XAircraft Aerial Solutions, while GGV supports EHang.

Focusing on their sweet spot – the nexus of consumer and technology – venture capital investors want to penetrate deeper into the hardware market, align start-ups with consumer audiences, and deal with regulators to secure approvals where necessary. The ultimate objective is mass adoption.

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Solving the value-creation puzzle

By designing a value creation plan early, focusing on execution and strengthening the organization, China GPs can make value-creation strategies work, say Bain & Co's Vinit Bhatia, Weiwen Han and Kiki Yang

THINGS ARE GETTING MORE COMPLEX IN the Greater China private equity (PE) market. The landscape is changing. Local GPs with access to proprietary deal flow and patient state-backed capital sources have become important players, finding ways to tap deals that others have trouble accessing.

In addition, sovereign wealth funds have returned to the market as buyers, leading many of China's largest deals of 2014. Holding periods are far longer than pre-crisis. Prices are trending high. In this context, PE funds have to rethink how they can create sustained value.

However, few Chinese players have been able to pull this off. Bain & Company's 2015 Asia-Pacific survey of PE funds or GPs in Greater China found that only half have a robust plan for creating value within six months for the vast majority of their portfolio companies, and 75% are hoping to put such a plan in place in the next three to five years.

What's holding them back? Minority ownership is one reason for the lack of value-creation plans. About 10% of deals (in value) over the past five years were buyouts. Our survey indicated, however, that about 70% of China PE funds are interested in seeking path-to-control mechanisms in minority transactions so that they can participate more fully in value-creation strategies and decision-making.

The most popular provisions now in place across the Asia Pacific region include board seats and veto authority over key decisions involving people, capital spending and M&A activity. During the past two to three years, about 20% of Chinese companies bought with a minority stake have included such path-to-control provisions, and surveyed PE funds expect this number to be as high as 30% over the next two to three years.

Talent is the other major contributing factor. PE professionals in China readily admit they operate with a limited talent pool – most say their companies have three or fewer people who focus exclusively on creating value for portfolio companies. But this is a clear priority and our survey found that they want to allocate more resources (namely, three to five people dedicated to portfolio value creation over the next three to five years for the median fund among those surveyed).

There is no single answer for how to structure a team devoted to portfolio activism. We find that all effective activist value-creation programs in China need three critical building blocks. None is sufficient on its own, but the firms that deploy these building blocks early and throughout the asset's holding period generate more value and are more likely to produce consistent, market-beating returns.

1. Design a robust value-creation plan in year one.

The best activist firms recognize that time is of the essence and step in immediately to help management assess a company's full potential and then develop an aggressive plan to get there. When launched early and formulated jointly with the portfolio company's management team, a strong value-creation blueprint can have a huge impact on deal success.

A study of 128 deals showed that rolling out such a plan in the first year of ownership produced a multiple of 3.6x invested capital – twice the industry average. These plans are so effective because they identify priorities, assign proper resources and secure strong alignment between the fund and company management around specific, tangible goals.

The best of them start with a clear view of where the business stands today and a bold vision of its long-term potential. They then take a long wish list of initiatives and whittle them down to the three to five that have the best chance of moving the needle within the firm's preferred five-year investment time horizon.

2. Execute on what matters most.

Only 25% of those GPs in our survey report that their value-creation plans deliver the intended results for a vast majority of their portfolio companies. Few firms systematically engage with each company in their portfolio, and still fewer do it consistently well.

To some degree, execution depends on how much control a PE firm has over key decisions and strategic moves. Value-creation plans drawn up by the best portfolio activists often involve setting up a program management office to oversee execution and defines the key metrics utilized to both track performance against the plan and to provide early warnings about what's not working. It is crucial, however, that the PE firm and management revisit and refresh their value-creation strategy at regular intervals and adjust appropriately to account for changing competitive or market dynamics. When it's time to exit, the firm can use the plan to build the economic case for the asset's sale and to identify future growth opportunities for the next owner.

3. Deepen the talent pool and build a high-performance organization.

Many GPs will tell you that grooming a portfolio company's management team – or putting in a new one – may be the most important factor in any deal's success.

It's no secret that Chinese PE firms lack the talent of their counterparts in other countries, but some have been successful at putting in strong CFOs, running CEO forums or establishing objective key performance indicators that link to compensation. They translate the value-creation plan into "big jobs" and make sure to fill them with "big people." They then align the rest of the organization to the value-creation plan and identify ways to overcome key execution risks.

Mastering these three steps will help Greater China private equity professionals thrive in a rapidly changing environment.

> "Only 25% of those GPs in our survey report that their value-creation plans deliver the intended results for a vast majority of their portfolio companies"

Vinit Bhatia and Kiki Yang are Bain & Company partners based in Hong Kong. Weiwen Han is a partner based in Shanghai. All are members of the firm's private equity practice.

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