



Making additions

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DEAL OF THE WEEK



The right medicine

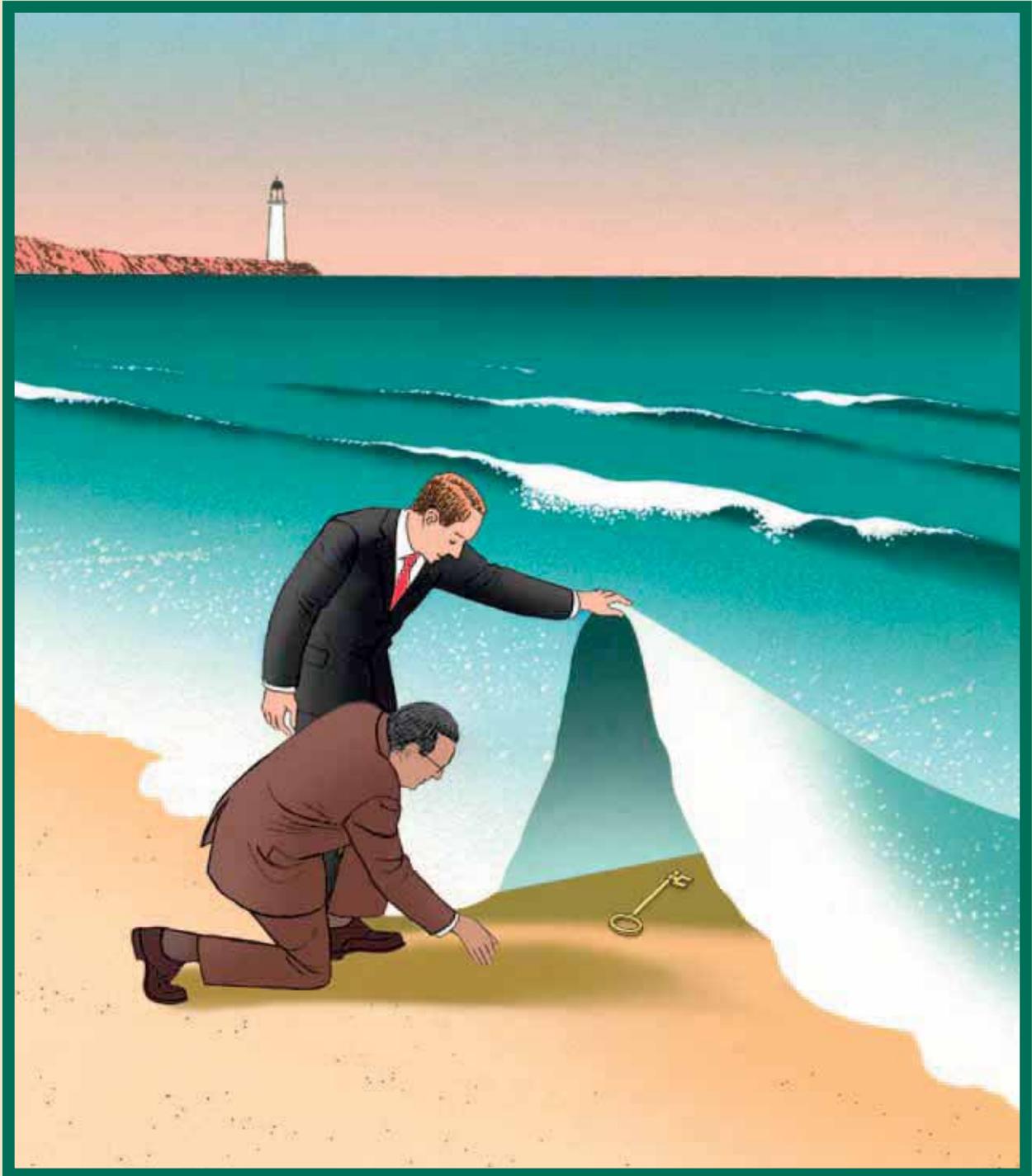
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Cautious optimism in Taiwan

"WE HAVE PREPARED A STATEMENT IF YOU want it." Within minutes of a panel concluding at the AVCJ Taiwan Forum in September, a piece of paper landed in my lap from the American Chamber of Commerce In Taipei's (AmCham) private equity committee, which has coordinated industry lobbying efforts to get more clarity on the treatment of foreign buyouts.

The panel in question featured three senior regulators and included a discussion on what might trigger an investment review.

The AmCham committee's view was that it "continues to see a disconnect between the government's stated desire to increase foreign investment and the statements from regulators on its role in receiving investment based on subjective criteria such as 'national security' and 'investor rights' without any clear definition on those terms."

After first Taiwan's minister of economic affairs had stressed that the government sees private equity as an important contributor to local economic development and then a commissioner with the Financial Supervisory Commission said the territory was very much open to "long-term investors," this was a sobering reminder of how much work remains to be done.

It is in this context that we should consider the recent proposed amendments to Taiwan's Business Mergers and Acquisitions Act.

As part of a broad package of measures, the proposals include raising the level of shareholder support required for a take-private transaction to go through to a two-thirds majority. As it stands, approval is granted if a straight majority of shareholders representing at least two thirds of the outstanding shares vote in favor. The two thirds majority only applies when the extraordinary general meeting is attended by voters representing half the total outstanding shares.

While the amendment is intended to protect minority shareholders' interests and could make it more difficult for a private equity investor – working in partnership with company management – to complete a privatization, industry participants value clarity above all else. Given the choice between a higher threshold and consistent application to a lower threshold

and arbitrary rulings on deals, they would opt for the former.

Past experience show that application has been anything but consistent. For example, a KKR-backed management buyout of Yageo in 2011 received more than two thirds support from shareholders but the government still intervened and nixed the transaction for reasons that have never been fully explained.

Subsequent private equity activity in Taiwan – a total of \$56.9 million was invested in 2012, putting Asia's seventh-largest economy 16th in the regional PE rankings – shows what happens when an industry loses confidence in the regulatory apparatus intended to guide it.

The AmCham private equity committee has put forward suggestions as to what would improve investor sentiment by creating a more transparent approvals process. These include published guidelines on investment criteria, the release of a list of sectors and companies in which foreign PE investment is unwelcome, and detailed explanations from the regulator as to why particular transactions are being rejected.

The Ministry of Economic Affairs responded by forming a taskforce to coordinate between different government agencies with a view to clarifying the criteria on which transactions are assessed by regulators. But what made the panel at the AVCJ Taiwan Forum frustrating was the absence of clarity with which the regulators present discussed their approach.

A change in policy is therefore only as effective as those tasked with executing it. While it is of course unfair to judge multiple regulatory bodies on the basis of a few remarks at a conference, the private equity industry requires reassurance that its attempts at advocacy and education are getting through.

An indication that the authorities are willing to set down rules and apply them consistently is indeed cause for optimism. But cautious optimism.

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AUSTRALASIA

Crescent's Cover-More to raise \$475m in IPO

Crescent Capital Partners-owned travel insurer Cover-More Group is targeting a A\$521.2 million (\$475 million) IPO on the Australian Securities Exchange. The company will sell up to 260.6 million shares at A\$2 apiece.

Blackbird leads round for Australian bitcoin start-up

Blackbird Ventures has invested A\$250,000 (\$227,645) to lead a A\$500,000 round of funding for Melbourne-based CoinJar, a bitcoin wallet and exchange provider. Angel investors in the round include RetailMeNot founders Guy King and Bevan Clark and game developer Rob Murray.

AMP buys Australia schools project from RBS

AMP Capital will acquire a 100% interest in a portfolio of school buildings in Melbourne from Royal Bank of Scotland (RBS). The purchase is being made via the AMP Capital Community Infrastructure Fund, which invests in public-private partnership-style social infrastructure.

Archer consortium scraps Abano Healthcare bid

A consortium of investors including Archer Capital has scrapped its bid for New Zealand's Abano Healthcare Group. The group cited a downgrade in the company's forecast profit revealed at its annual meeting last week. It became the target of an takeover bid by the consortium - which collectively owns 20% of Abano - in September after Archer obtained a five-month standstill agreement with shareholders.

GREATER CHINA

Sailing Capital launches cross-border RMB fund

China's Sailing Capital and its subsidiary Shanghai Sailing Industrial Capital have launched a RMB5 billion (\$821 million) buyout fund, in a bid to facilitate cross-border transactions. The fund will eventually leverage its size to over RMB20 billion through bond issuance, loans and equity investments, according to China Securities Times

China to resume IPOs in 2014 – CSRC

The China Security Regulatory Commission (CSRC) plans to re-open the IPO market in January. About 50 firms are expected to pass the regulator's review and become the first batch to list.

Domestic stock exchanges have been closed to new listings for more than a year. There are more than 760 firms in the queue waiting for IPO approvals and it will take about one year to complete an audit of all the applications, the CSRC said.



"After this announcement, it would take about one month of preparatory work before any firms list," the regulator said in a statement. The move comes as the CSRC unveiled a long-awaited IPO reform plan on Saturday, advocating a market-driven system to help boost market transparency.

The initiative was released two weeks ago following a meeting of the Communist Party's Central Committee. Under the registration system, the regulator will limit its influence in approving the IPO applications, while IPO sponsors, law and accounting firms will bear more responsibility for ensuring listing candidates' financial information is accurately disclosed.

Orchid-backed Autohome sets terms for US IPO

Autohome, a Chinese online automobile marketplace in which Orchid Asia is an investor, plans to raise up to \$125.9 million through an IPO on the New York Stock Exchange. The private equity firm will not be exiting any shares through the offering.

Highland leads Series A round in takeout site

Highland Capital Partners has provided approximately \$10 million in Series A funding to Etaoshi, a Chinese online food ordering and

delivery platform. Several undisclosed domestic venture capital firms also participated in the round.

PE-backed Jintian Pharma eyes \$273m HK IPO

Jintian Pharmaceutical Group, a Chinese pharmaceutical retailer and distributor backed by CVC Capital Partners and SEAVI Advent Private Equity, is seeking to raise as much as \$273 million through a Hong Kong IPO. CVC holds 16.1% of Jintian following a restructuring earlier this year, while SEAVI Advent owns 5.74%.

Northern Light backs analytics firm TalkingData

Northern Light Venture Capital has provided \$10 million in Series A funding to TalkingData, a Chinese mobile data analytics provider. The company plans to use the new capital to enhance its product offerings in mobile gaming, advertising, e-commerce and financial services and exploring overseas markets.

China insurers' investment scope to further relax

China Insurance Regulatory Commission (CIRC), the Chinese insurers' regulator, is looking to raise the cap on industry players' exposure to private equity to 20%-30% of total assets. Currently, insurers are allowed to put up to 10% of their total assets into private equity following a decision to raise the cap from 5% last year

Sequoia leads \$25m round for online takeout service

Sequoia Capital China has led a \$25 million Series C round of funding for ele.me, a Chinese food ordering service. This latest round - which also includes existing backer Matrix Partners - values the company approximately \$100 million.

NORTH ASIA

Itochu, Mizuho back Japan restaurant finder app

Itochu Ventures and Mizuho Capital have led a JPY330 million (\$3.2 million) Series B round of funding for Retty, the Japanese start-up behind the restaurant app of the same name. GREE ventures, NTT investment Partners and Mitsubishi UFJ Capital jointly invested JPY100 million in the company in October last year. Prior to that it raised JPY22 million from Cyber Agent Ventures.

Advantage to exit Japan's Nissen for \$22.8 million

Advantage Partners, the Japanese mid-market buyout firm, is to exit its stake in catalogue and web-based retailer Nissen Holdings to Seven & i Holdings, the Japanese parent of 7-Eleven and the Ito Yakado supermarket chain, for JPY2.36 billion (\$22.8 million). Seven & i is looking to acquire up to 50.74% of Nissen and will make its investment through its subsidiary Seven & I Net Media.

MBK Partners sells Japan-based Invoice to Lone Star

MBK Partners has fully exited Invoice, Japan's largest telecom bill aggregation service provider, to Lone Star Funds. The sale price was not disclosed but sources close to the deal said the North Asia-focused private equity firm had generated a 2.5x money multiple and an IRR in excess of 50%.

INCJ commits \$100m to Global Brain Fund V

The government-backed Innovation Network Corporation of Japan (INCJ) will commit up to JPY10 billion (\$98.7 million) to Global Brain No.5 Investment Limited Partnership, the latest vehicle launched by IT-focused VC Global Brain Corporation. The fund will receive additional commitments from strategic investors bringing the total fund size to JPY15 billion.

SOUTH ASIA

CPPIB targets office market with \$200m JV deal

Canada Pension Plan Investment Board (CPPIB) will commit \$200 million to its first real estate venture in India. In partnership with the Shapoorji Pallonji Group, it will acquire income-producing office buildings in Indian cities. CPPIB has an 80% stake in the joint venture. The investment comes as reduced demand for office space in India has lowered rents in Mumbai, New Delhi and its surrounding National Capital Region by 20-40%

Accel, Ventureast invest \$7.6m in Portea Medical

Accel Partners and Ventureast have contributed INR480 million (\$7.69 million) in Series A funding for Indian home healthcare provider Portea Medical. Portea will use the funding to expand into a further six Indian cities.

L Capital acquires 40% of 2XU, Lazard sees 2x return

L Capital, the private equity firm backed by luxury goods conglomerate LVMH, has acquired a 40% stake of 2XU, an Australian sports apparel brand, for a reported A\$75 million (\$68.3 million). The transaction - which had been a pro-rata sell down by all shareholders - represents a partial exit for previous backers Lazard Australia Private Equity generating a 2x money multiple and a 50% IRR.

Founded in Melbourne in 2005, 2XU is a maker of high performance sports clothing catering to the technical sportswear market for runners, swimmers, cyclists and triathletes. The firm has a global distribution network covering



more than 50 countries and claims revenue growth in excess of 40% per annum over the past five years.

The investment was made through L Capital Asia 2, which reached a first close in September at the hard cap of \$950 million after less than six months in the market.

Lazard acquired a significant minority stake in the business for an undisclosed sum in 2011 via Lazard's Corporate Opportunity Fund 2.

ICICI Venture invests \$22.4m in BTI Payments

ICICI Venture has committed INR1.4 billion (\$22.4 million) for a significant stake in BTI Payments, an ATM and point-of-sales (POS) services contractor. BTI Payments is a subsidiary of Australia's Banktech Group.

Espirito Santo, Dabur's Burmans to launch PE fund

Portuguese financial group Espirito Santo plans to launch a private equity fund in partnership with the Burman family - the promoters of India's Dabur Group - to invest in medium and small-cap companies. The fund will have a corpus of EUR100-250 million (\$135-\$340 million) with a launch planned sometime next year.

India's Girnar Software raises \$15m from Sequoia

Sequoia Capital has invested \$15 million in a first round of funding for Girnar Software, which owns the automotive marketplace Cardekho.com. The funds will be used to support the marketplace's expansion plans.

Temasek buys stake in India's Eros International

Temasek Holdings has made its first foray into India's Bollywood movie industry by acquiring a stake in local film distributor Eros International through Fullerton Fund Management - a unit of the Singapore sovereign fund. Fullerton now holds an 8.7% stake in Eros.

Blackstone RE Partners to exit Synergy Property

The Blackstone Group's Real Estate Partners unit is in the process of exiting its 35% stake in Bangalore-based project management consultancy Synergy Property Development Services in a deal valued at INR2.6 billion (\$41.7 million). Blackstone invested INR600 million in Synergy in 2008.

Hitachi acquires Sequoia-backed Prizm

Hitachi will acquire all issued equity of India's Prizm Payment Services from Sequoia Capital, Axis Bank and other shareholders. Financial terms were not disclosed. Sequoia invested \$10 million in the company in 2008, followed by another \$8 million round in 2011.

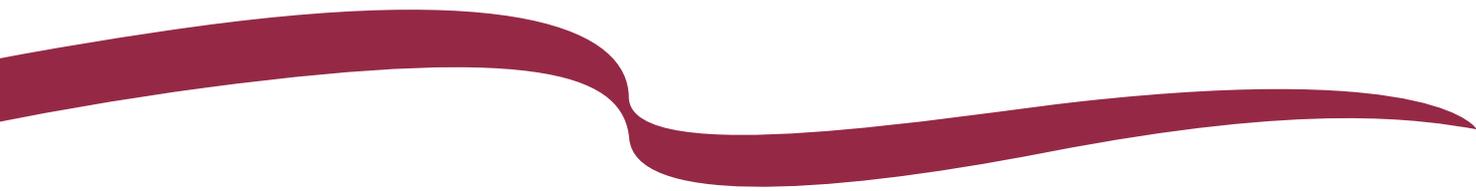
SOUTHEAST ASIA

Singapore's Coda Payments gets Series A round

Carrier billing provider Coda Payments has raised \$2.3 million in Series A funding from GMO Global Payment Fund, Rakuten Ventures, CyberAgent Ventures, and return backers Golden Gate Ventures and Skype co-founder Toivo Annus.

KV Asia buys Singapore skin care brand

KV Asia Capital has agreed to acquire Singapore-based Derma-Rx International Aesthetics (DIAL) from Indian skin care company Marico Kaya Enterprises. DIAL is a subsidiary of Marico's Kaya Skin Clinics.



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Adding extra

Private equity firms are exploring various strategies to help Chinese companies expand overseas. Bolt-on acquisitions are a proven approach in some markets, but that doesn't mean they work for corporate China

“WE DEFINITELY WILL SEE MORE

PE-backed Chinese companies to do outbound acquisitions. Local champions are ambitious to become the top in the world,” says Ally Zhang, managing director at Siguler Guff. “They’re looking for premium brands and advanced technologies that are considered complementary to what they have now – low manufacturing costs.”

With Chinese entrepreneurs looking for additional levers to drive growth, and ease their dependency on domestic markets, overseas expansion has emerged as a critical theme. However, it also poses a challenge to private equity firms as to whether they are willing and able to help companies achieve these goals.

Promises of potential synergies with fellow members of a global portfolio have long formed part of the foreign private equity proposition in China. Opinions are mixed as to whether these promises have been delivered upon, but it is generally accepted that if an investor is serious about realizing cross-border expansion plans early action is required.

“These international opportunities – be they M&A, expansion or just market improvement because they are there but not necessarily working as well as they should be – you have to go after them early on because they take time,” says Scott Bookmyer, Asia head at Capstone, KKR’s operating unit. “You need it to be something that people feel good about dedicating their resources to and making a reality within the reasonable horizon of the investment.”

The bolt-on acquisition is a classic means of boosting a company’s market share inorganically and quickly, and it can be repeated in different markets. But the strategy only works where the private equity firm has sufficient influence that it can guide the acquisition platform through fragmented markets, picking up majority stakes in smaller businesses along the way.

As a predominantly growth capital market, bolt-ons might seem anathema to China, but versions of the strategy are apparent in the venture capital space. Consolidation in certain segments of e-commerce, where scale means survival, has seen VC-backed operators absorb competitors. Group-buying is a classic example, with Tencent Collaboration Fund earlier this year engineering the alliance of Ftuan.com and

Gaopeng.com, the latter being a joint venture between Groupon and Tencent.

Strategic incursion

However, from a cross-border perspective, roll-up acquisitions by Chinese PE-backed companies are a rarity. Where transactions do happen, they tend to be better defined as strategic cross-border deals.

“If you’re talking about international bolt-ons, they have to be in markets that are fragmented. In this context, I wouldn’t say Shuanghui International’s take over US-based Smithfield Foods is a bolt-on acquisition because it is very strategic and transforms the original business in its entirety, rather than adding on small pieces,” an Asia Pacific-focused LP tells AVCJ.

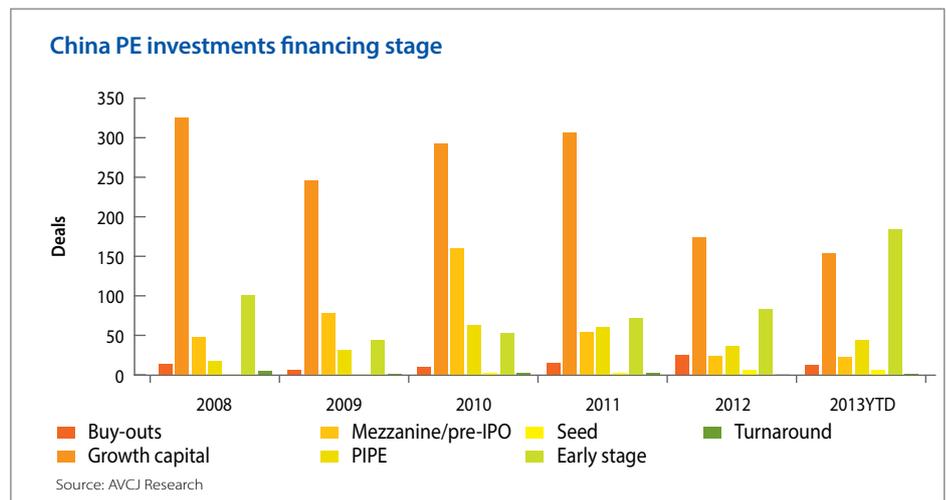
Leading Chinese meat processor Shuanghui is on course to buy Smithfield, the world’s largest pork processor and hog producer, in a deal

which has a 33.7% stake and first invested in 2006, played a key role in securing the deal.

Fundamentally, though, the main differentiator between a bolt-on acquisition and a strategic investment is outright control. This is particularly apparent in Australia, arguably the most developed buyout market in Asia. According to AVCJ Research, a total 60 PE-backed companies – all are with at least 30% private equity ownership – have completed outbound M&A transactions since 2005. These deals are worth \$2.36 billion.

Pacific Equity Partners (PEP) has almost 100 to its name – approximately 80% of which were in Australia and New Zealand, with the rest in the US, Europe and Asia. The GP estimates that 10-15% of total equity value creation over time has been through bolt-on strategies.

David Grayce, a managing director at PEP, says that merging two large companies can be



worth \$7.1 billion, including debt. The acquisition is expected to deliver process innovation, accelerating the Chinese company’s efforts to vertically integrate its business and improve efficiency, quality and food safety.

Shuanghui is unusual in the level of PE ownership, with investors including CDH Investments, Goldman Sachs, New Horizon and Temasek Holdings controlling around 45% of the company. This should translate into greater influence and industry sources suggest that CDH,

risky due to differences in business culture and strategy. Smaller bolt-on style acquisitions, on the other hand, are often lower-priced and less risky. But the overarching question is whether or not the bolt-on is supportive of the acquirer’s business strategy.

“The objective could be augmenting a sales channel, securing a new technology, or acquiring a low-cost manufacturing base,” Grayce says. “Once the strategic intent is clear the next question is whether a bolt-on is the best way to

achieve the desired outcome. Often alternatives like organic investment in building the capability internally or partnering with another player is a higher return path. We have done each of those in different circumstances.”

For example, it made sense for movie theater chain Hoyts to buy AMC Cinemas Queensland to complete its national coverage of Australia and New Zealand. Similarly, AST bought Canadian Stock Transfer to extend share registry services across North America and Canada, while Energy Developments acquired EnGen from Wesfarmers to build scale and capability in remote off-grid generation.

When it comes to offshore expansion in food businesses, however, PEP’s portfolio companies have often found it more effective to partner with local distributors rather than buying or building networks. Current investments Griffin’s Foods and Peters Ice Cream have all had occasion to address that issue. In an Australian context, part of the reason is the best food distributors tend to be very big, which means a full acquisition would be high risk.

Poles apart

Needless to say, experiences in Australia differ from China, where large corporates – with or without private equity support – are all too willing to pursue sizeable assets in the food space. Not only is the government encouraging them to go overseas, but it is also promulgating policies concerning food safety.

The Shuanghui-Smithfield deal is a case in point, but at the same time it is exceptional in that the transaction is likely to go through; most falter much earlier on in the process.

“Chinese strategic players generally lack international experience, and the cultural gap is so big,” Yichen Zhang, chairman and CEO of CITIC Capital, told the AVCJ Forum in Hong Kong last month. “You could probably count the number of true Chinese multinationals on one hand. There are a lot of failures among overseas acquisitions, so there are a lot of risks.”

Hony Capital and CITIC Private Equity have participated in outbound deals with portfolio companies and plenty of other PE firms express a willingness to try. However, this doesn’t necessarily mean such strategies are appreciated by LPs. The concern is that M&A involving companies that lack scale at home or don’t have some degree of international expertise will be too difficult and timely to consummate.

“It’s a challenging model,” says Tony Zhu, head of the emerging markets program at Munich Private Equity Partners. “The reason is it takes time for two companies to strategically merge together. Or if you want to expand in a new market, it takes time to generate financial

improvements through that exposure. It’s also difficult for fund managers to build up strong teams on both sides.”

Indeed, the Hony and CITIC PE deals are the only two sizeable outbound M&A transactions in which Chinese private equity firms have participated and taken a stakes in the target company.

Last January, Sany Heavy Industry paid EUR360 million (\$475 million) for Putzmeister, a German manufacturer of high-tech concrete pumps. Sany paid EUR324 million while CITIC PE took a 10% stake for EUR36 million. The Chinese firm was not previously invested by CITIC PE.

Four years earlier, Sany’s state-owned rival Zoomlion bought Compagnia Italiana Forme Acciaio (CIFA), supported by Hony, Goldman Sachs and Mandarin Capital Partners. Zoomlion bought its 60% stake in the Italian company for EUR163 million (\$215 million), also seeking advanced technologies in concrete pump manufacturing.

Hony first invested in Zoomlion directly in 2006 and then it, Goldman and Mandarin took equity stakes in the Zoomlion-CIFA joint venture that resulted from the deal. Mandarin’s particular role was to assist with on-the-ground deal sourcing.

In each case the Chinese GP was a minority investor trying to support a portfolio company in overseas expansion. This value-add came in the form of capital and M&A expertise.

And for both Zoomlion and Sany, the deals were structured in a way that offered the PE firms downside protection. Their capital commitments went into offshore acquisition entities, not the domestically listed parent companies, so there was no need to bring money onshore. And they had pre-agreed share buyback arrangements with the Chinese partners.

“It’s important to structure deals to mitigate investment risks, asking the Chinese company to provide downside protection, such as a buyback agreement,” says Munich’s Zhu.

At the end of last year, Zoomlion offered \$236 million for the 41% stake to its private equity partners held in the CIFA joint venture, generating an IRR of about 15%. Sany, meanwhile, paid \$54.9 million for CITIC PE’s holding in Putzmeister within six months of the acquisition, implying an IRR of 12%.

Back to local

Chinese companies will continue to look for acquisition opportunities overseas. However, success depends on management teams’ ability to execute and, where there is PE involvement, how much influence the investor can bring to bear in M&A situations. “For cross-border deals, international GPs are more experienced and

are in better position to facilitate these kinds of transactions,” says Lindsay Chu, head of Asia Pacific financial sponsors at HSBC.

These private equity firms have global teams, strong networks in multiple markets and, most importantly, considerable experience in dealing the various stakeholders in a transaction, be they unions, politicians, the media, customers or suppliers. They may also be among the first to hear when suitable assets come up for sale in different areas.

Making it work, however, is a time and labor intensive process. And it comes back to the question of whether an international GP is equipped to deliver.

“Placing a few phone calls and putting people in touch is one thing but having that as part of your thesis – that we are going to dedicate resources outside of the home country and help the company really achieve outsize growth in that other market – is pretty hard to do,” KKR’s Bookmyer says.

In addition to helping portfolio companies expanding overseas, some GPs, including Hony, CITIC PE, Fosun International and CDIB Capital, are trying to work it the other way around – acquiring overseas businesses with a significant China angle and developing them domestically.

Fosun has been particularly aggressive in this regard, adding a string of overseas luxury brands to its portfolio. The company bought a 35% stake in Italian luxury menswear manufacturer and retailer Caruso in September and has invested in Greek jeweler Folli Follie Group and upscale US knitwear maker St. John Knits. It is also involved in a take-private bid for France-based vacation resort operator Club Méditerranée in association with Axa Private Equity.

Comparisons can be drawn between Fosun’s approach and typical bolt-on strategy: the Chinese company is itself the acquisition platform, scooping up a collection of international assets that could in theory be rolled out synergistically in China.

However, HSBC’s Chu asks whether this approach is a good fit for the target market. A PE firm may see lateral acquisitions as the best way to drive growth for an Australian company, but its Chinese counterpart operates in a very different commercial environment.

“In more mature markets, the underlying scenario is these companies are likely facing slower growth prospects. In these cases, bolt-on acquisitions can help achieve inorganic growth which should help to build equity value for these sponsor-backed companies,” he says. “In faster growing developing markets such as China, though, a sponsor-backed company may not necessarily need to execute that kind of M&A strategy to pursue growth.” ▀



Can you bolt-on a reputation?

As we look into 2014, many of last year's problems for China-focused private equity firms remain. IPO markets are still largely closed, while the region's biggest economy is again stuttering – and in the process threatening to leave holes in carefully constructed company growth stories.

To avoid being left on the shelf when the new issues window does re-open, PE firms are busy finding ways to bolster the attractiveness of investee companies. One option being considered anew is outbound bolt-on acquisitions.

In theory this can deliver scale by opening up new markets and customers to create a more robust investment story. Other strategic assets frequently coveted by acquisitive Chinese corporates include natural resources, brands, products or technology that can reinforce a platform and bring valuable intellectual property.

Of course, the reality is venturing overseas to make acquisitions has been a steep learning curve for mainland companies in recent years, where reputations can make or break a deal.

In a competitive bidding process it requires a sophisticated communications “soft sell” to win over a myriad of interested stakeholders – not just investors but also government bodies, media, employees and professional organizations, to name a few.

Since the Chinese government officially announced the “going out” policy in 2006, the list of successful overseas M&A is still a relatively short one. More often it's been a story of hard knocks and culture shock.

Can this be reversed by bringing PE deal-making nous and an international perspective to smooth over some of the cross-cultural rough edges? The likelihood is it should help, yet what is essential is a strong stakeholder communications plan for any proposed acquisition – private equity-backed or not.

To start with, it is important to understand the vested interests of all potential parties in a transaction from employees, unions and politicians to news media, customers and suppliers. Through a stakeholder mapping exercise, a strategy to deal with the likely reactions of each party can be put in place.

We always advise Chinese companies to engage in a “charm offensive” to build relationships, so that they are a known, rather than unknown quantity. A vacuum is dangerous. In the absence of information and relationships, detractors will use a script about you that won't serve you well.

The reality is Chinese companies on the international stage start with a reputation deficit, meaning they must work harder. China Mobile may have 700 million-plus customers in the mainland but its name would likely draw a blank with consumers in most parts of the world.

In fact, considerable effort must be made to overcome a range of unfavorable perceptions of Chinese companies in international markets. This can range from Chinese brands



and companies being little known, to being too secretive. Or that “Chinese” simply equates to being cheap and that the intention post acquisition, is merely to asset strip and cart jobs, IP and equipment back home.

Quite often Chinese corporates are simply culturally unaware of the multiple stakeholder groups that need to be engaged when operating in overseas countries. Or that public opinion can play a pivotal role in a politically sensitive decision making process.

Recent controversy over the close links between the Chinese government and giant telecom vendors Huawei and ZTE has underlined that greater openness is needed to allay potential misperceptions.

But in some cases, the communications challenge requires more than just increased transparency.

For instance, in Africa, Chinese companies have been on the receiving end of a catalogue of negative press about energy and infrastructure-related investments where there have been reports of worker mistreatment. This tends to result in a case of everyone being tarred with the same brush – fairly or not.

Chinese investment is now effectively non-grata in some African nations.

Badly conceived acquisitions can also be costly. State-backed CITIC Pacific looks no closer to profitability after its US\$2.47 billion investment in an open-cut iron ore mine in northwest Australia blew out to over \$8 billion. Part of this can be put down to cultural miscalculations. The project has been beset by various missteps from understanding Australian labor laws, to contractual treaties.

Yet amid all these missteps in Africa and Australia, some Chinese investors have proved resilient and found a new bolt-on path. Rather than going direct to Africa, they have taken an opportunistic detour to buy African mines through Australian miners as share prices succumb to weakness. Australia's Discovery Metals, Anvil Mining and Sundance Resources have all been subject of bids from Chinese entities. This is one way of trying to sidestep potential reputational problems.

But of course, most of the time there is no short cut to getting a deal done. The lesson today is that successful outbound acquisitions by Chinese companies are no longer just about the hard issues of valuation and the legal framework. They must also pay equal attention to getting the soft issues of stakeholder engagement right.

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Asia Awards: The winners



Firm of the Year – KKR

PE Professional of the Year – Michael Kim (MBK Partners)

VC Professional of the Year – Richard Liu (Morningside Technologies)

Exit of the Year – Matahari Department Store (CVC Capital Partners)

PE Deal of the Year – Panasonic Healthcare (KKR)

VC Deal of the Year – Tujia (Lightspeed China/CDH Investments/Qiming Venture Partners/GGV Capital/Ctrip/HomeAway)

Fundraising of the Year – KKR Asian Fund II (KKR)

Operational Value Add – Yonghui Superstores (Headland Capital Partners)

Special Achievement – Shangzhi Wu (CDH Investments)

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Firm of the Year – KKR

KKR closed its second pan-Asia fund at \$6 billion and announced investments of \$1.8 billion and distributions of \$1.2 billion for the year to September. Capstone, the firm's operating unit, was a factor in each area

THE INVESTMENT DOCUMENT KKR

presented to Panasonic when bidding to carve-out the conglomerate's healthcare division outlined how the PE firm thought it could help develop the business over the next five years. It was also imbued with experiences of the preceding three years: the operational progress KKR had made with Intelligence Holdings – a Japanese recruitment firm acquired from Usen Corporation in 2010 and sold to Temp Holdings in March – and the Asia-wide additions to its operating team.

"We were certainly comfortable approaching another carve-out from a larger parent. We have done it many times globally but Intelligence was the first time we had done it in Japan," says Scott Bookmyer, Asia head of KKR Capstone. "We were also comfortable in our underlying assumptions as to how to make the company more valuable. There were actual values attached to operational improvements we thought could be achieved in partnership with management."

With more resources available up front and on the ground in Japan, Capstone was able to participate fully in the due diligence alongside KKR's global healthcare unit, making it easier to establish relationships with Panasonic Healthcare's management. But perhaps more importantly, the team was just better versed in forming partnerships with Asian companies.

The acquisition of an 80% stake in Panasonic Healthcare for JPY165 billion (\$1.66 billion) – agreed in September and still pending final regulatory approval – was KKR's largest buyout in Japan to date.

Making waves

However, the transaction is also significant in a broader sense. KKR closed its second pan-Asian fund earlier this year at \$6 billion, the largest PE pool ever accumulated in the region. Deploying this amount of capital over a 5-6 year period means completing some significant leveraged buyouts and Joe Bae, the firm's head of Asia, has made no secret of the fact that he expects to be more active in Japan, South Korea and Australia.

Panasonic Healthcare is an early statement of intent.

From a Japanese perspective, this is the first time a leading conglomerate like Panasonic has sold off a profitable business to a PE investor. According to Hiro Hirano, CEO of KKR Japan, assets were previously deemed non-core because they were losing money. Panasonic concluded that because it didn't have a global healthcare network, a third-party investor would be better equipped to take the business forward.

The parent is also retaining a 20% interest in the healthcare unit, potentially marking out

be 18-strong, with five in Hong Kong and the rest deployed around the region.

This expansion also involved the recruitment of senior people in each market. Sakae Suzuki, formerly of McKinsey & Company and Gateway Japan, was the principal addition in Tokyo. He was a prominent participant in the Panasonic Healthcare deal from the outset.

Bookmyer describes the ideal Capstone recruit as possessing a general manager's judgment plus an analytical mind capable of thinking quickly about the major issues confronting a business. Pure industrial experience is often not enough; those offering a consultancy or professional services background as well tend to be most adept at helping existing management teams bring about change as opposed to leading it themselves.

With Intelligence, this collaborative approach was very important. A joint working team comprising KKR and company management drew up a list of potential improvements, including the development of operational key performance indicators (KPIs), implementing sales representative support and enhancing the IT infrastructure. Capstone spent 18 months helping implement these changes, which saw revenue per

sales rep rise 50% in the first two years while the number of job placements per career consultant jumped by 30%.

The challenge was persuading the management team of the validity of practices it had not yet witnessed. Sub-teams were set up in the sales and consulting divisions to run pilot programs with narrowly-defined targets intended to prove the operational thesis. But a degree of trust was required to get this far.

"There was a fear that if it didn't work it would reflect poorly on the management," says Bookmyer. "We had to make clear that we were all in this together and if it didn't work then we were just as accountable as them; that we would learn from the experience and try something else. You must have the willingness to try and this can be one of the bigger obstacles. But once we got past it we gained tremendous momentum to expand the programs more broadly and rapidly."



KKR team members (second left to right) Steve Okun, Joe Bae, Clifford Chiu and Sharon Yang

a path for others to follow. "The deal is unique in that Panasonic can share in the uplift of the business and help to some extent," says Hirano. "We have done this with Phillips and Siemens in Europe but I think it can be positively received by Japanese companies."

The caveat is that a positive reception is conditional on the prospective buyer being able to add value to the target business. It is an increasingly prevalent theme across Asia, whether negotiating carve-outs with Japanese corporates or securing minority positions in Chinese family-owned businesses.

Capstone, by extension, is placed in an interesting context. When Bookmyer arrived in Asia in 2010 the nascent team comprised eight people – six in Hong Kong and two in Beijing. This hub-and-spoke model was soon jettisoned in favor of hiring local people for each market in the region. By the end of the year the team will

Should the forces driving Japanese corporates to reassess their strategies hold true, this could become the norm rather than the exception.

The need to branch out overseas, tapping new sources of consumer demand in response to flat-lining domestic markets, is well established. Hirano argues that the principal contribution of Abenomics has been to place corporate failings under the microscope. A combination of the stronger public markets and a divergence in performance between good and mediocre companies has forced management teams to pay more attention to stock prices.

Beyond this are longer term considerations such as an easing of the restrictions that remain on foreign capital entering Japan. But just as important, perceptions of private equity are also moving away from the financial sector restructuring that characterized the early 2000s.

"There is a greater willingness to do

operational improvement on top of financial improvement," says Hirano. "And then company CEOs and boards are changing – not dramatically, but they are moving in the right direction and starting to understand that they must work in the interest of shareholders. With market sentiment changing as well, we hope the PE business environment is getting better."

Relationship management

An operational value-add thesis is only as strong as the relationships that facilitate its execution and the due diligence process is an opportunity to assess potential partners. This is equally true for control transactions like Intelligence



Hiro Hirano



Scott Bookmyer



David Liu

and Panasonic Healthcare as it is for minority investments such as Chinese home appliance manufacturer Qingdao Haier or Malaysia-based Weststar Aviation Services.

An added quirk is the amount of time Capstone spends on the ground with portfolio companies in Asia. While China Modern Dairy required two years of work, with many investments the heavy lifting takes six months and might involve a comprehensive infrastructure build-out, introducing KPIs, HR management and incentive systems, organizational structures, and financial planning and analysis processes.

Of the eight situations Capstone is involved in at present, three are approaching 24 months on the ground and two are 6-12 month projects. The rest are reasonably young but he estimates that some will be reasonably light touch.

This is in part a function of deal type. Growth investments often need more of the enterprise infrastructure build-out support, but the private equity investor's ability to reshape these companies in the event of a market downturn is also limited. There might be agreed upon contingencies – Capstone's preferred arrangement is to be invited in as a resource for management to draw upon – but when an investment is not going according to plan it can place a strain on the relationship with the entrepreneur.

"You look for overlapping areas of consensus and hopefully those are the most important. If that overlap doesn't hit the key issue you bring to bear as much influence as you can without blowing up the relationship," explains Bookmyer. He adds that differences often come down not to strategic intent but time horizon, with the majority shareholder taking a 10-15 year view on an issue while KKR sees swifter action as better for ultimate value creation.

As such, in minority deals there is more pressure on the investor to get the industry and macro thesis right. It is also important to pick the right kind of entrepreneur and make sure he knows what he is getting himself into. "You have to be transparent with your majority shareholder as to how you can help them and make sure they agree and that is what they would want in their business," Bookmyer says. ▀

Strategic evolution

The trends in KKR's China investment strategy can be traced back nearly two decades to when the present China team was at Morgan Stanley Private Equity Asia (MSPEA). They include a tendency to move along the value chain in tried and tested industries in search of new growth.

Earlier this year the firm partnered with CDH Investments to commit \$140 million to Asia Dairy, a greenfield farming joint venture with China Modern Dairy that will supply premium raw milk to downstream dairy products manufacturers. Five years ago the team invested in Modern Dairy, another milk supplier, and in 2002 it backed China Mengniu Dairy, the country's leading dairy brand and as of May a significant shareholder in Modern Dairy.

"The industry has consolidated significantly and the top 2-3 players control about 60% of the market," says David Liu, CEO of KKR Greater China. "The room for growth is still there but it's not as great as it once was. That's why we moved upstream to milk supply. We think this is the next wave of growth because the upstream dairy farming business is so fragmented and there is a lack of expertise and scaled players to provide the high-quality raw milk supply that Chinese consumers demand."

A similar pattern is apparent in financial services. In 1993-1994, Liu's team invested in Ping An Insurance, which at the time was a fraction of the size of market leader China Life Insurance, and helped the business grow. In 2009, KKR was among the first PE firms to enter the financial leasing space, backing Far East Horizon, a specialist in lending to small- and medium-sized enterprises.

Liu adds that the investments also track evolving consumer preferences in China. Modern Dairy and Asia Dairy address food safety concerns, water treatment business UEL is an environmental play, and blood bank China Cord Blood benefits from increased spending on healthcare.

"People are moving towards a higher quality of life in general," he explains. "Ten or fifteen years ago, the consumer businesses we invested in put food on the table and met basic consumer needs. These days we are moving beyond that. People aren't satisfied with just having milk to drink or food on the table, they demand better quality goods as living standards improve."

KKR's acquisition of a 10% stake in home appliance manufacturer Qingdao Haier for \$552 million – its largest investment in China to date – arguably represents another step forward, with the private equity firm expected to help facilitate expansion both at home and overseas.

Scott Bookmyer, head of Asia for Capstone, KKR's operations division, identifies supporting global expansion or the improvement of existing international businesses as one of the key emerging themes in his work. "If you want outsize returns you have to find additional paths to profitable growth and we think the ability to help people span the region or the globe is going to be a critical part of that in the next 5-10 years," he says.

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PE Professional of the Year – Michael Kim

MBK Partners closed its North Asia-focused fund in September and also completed four of Asia's largest buyouts of 2013. Michael B. Kim, the firm's founding partner, looks back on a busy 12 months

Q: MBK reached a final close of \$2.7 billion on Fund III very quickly, despite a difficult market. What helped you?

A: We reached the hard cap in less than a year, and it was a revised hard cap. Three factors worked in our favor. First, a differentiated strategy: we do buyouts only, for the most part, and in North Asia only. Of our 21 investments, 19 have been for control and all of them have been in China, Japan or Korea. Second, we have a stable team: five of our six partners have been investing together for over 14 years. Third, track record: LPs seek consistent, high IRRs and now that every major GP is on Fund III or IV there is a substantial and meaty track record to point to. We had a high re-up rate – 80% of our LPs also invested in Fund II. There is a group of LPs who have been with us from the beginning and they have been central to our franchise.

Q: Do you feel the market is bifurcating? A few GPs can raise large sums at short order, while others are struggling...

A: I do think there is a flight to quality. It is a natural evolution at this stage in the development of private equity in Asia. Twelve years ago it was the Asian financial crisis and everyone made a bunch of money. Nine years ago people were raising funds on an idea. Now the thesis that you can make money investing in private equity in Asia has been proved and LPs are looking for the winners. The advantage will increasingly go to local GPs. I don't just mean Korean GPs in Korea or Japanese GPs in Japan, but also global players that are able to fully execute on localization. They will have the best deal flow; they will have the most constructive dialogue with sellers, intermediaries and regulators; and they will know all the potential buyers on the exit side.

Q: In which markets will you be most active?

A: Our target allocation is 40% Korea, 30% China, 30% Japan. Given the relative sizes of these economies, it is a bit unusual in that Korea is our largest target market but as a buyout market it is more dynamic. For the last 10 years Japan has been a bit like Microsoft whereas Korea is like Google. Having said that, I think Japan is changing thanks to Abenomics. It has

been a boon to the economy in general but it has also been a disruptive force: corporates that would typically not be sellers are thinking of selling and corporates or financials who would not be aggressive buyers are looking to buy. The question is will Abenomics be sustainable or is this a window of opportunity?

Q: Why is Korea so dynamic?

A: It has to do with the corporate landscape. The chaebols dominate Korea and as they go through a change in ownership, the second and third generation owners – who are

expect to see more of these?

A: There will be some secondaries in the deal flow. Again, it is a natural part of the evolution of private equity in Asia and a function of there being too much financial sponsor capital in the marketplace. But we don't think this is a major trend and we don't think it can be tied to the challenging exit market. The capital markets in China have slowed down, but Korea is up slightly and in Japan the Nikkei has risen 65% in the last 12 months. The buoyancy in Japan is facilitating capital market exits; we are working on one right now.



“As the chaebols sell out of non-core businesses while being acquisitive in core areas, they are becoming a dominant source of deal flow for us but also our takeout”

Western-trained – are learning to focus on their core businesses. They want to expand horizontally, meaning overseas, rather than vertically, meaning into related industries. As they sell out of non-core businesses while being acquisitive in core areas, they are becoming a dominant source of deal flow for us but also our takeout. The other factor driving deal flow is the privatization of government-owned businesses.

Q: MBK has completed four large deals this year: Coway, NEPA and ING Life in Korea, plus Komeda Coffee in Japan. ING Life was a competitive process – what was the clinching factor?

A: We are almost unique in having both requirements for this deal. We are a domestically registered GP, and by that I mean for a non-industry player to gain control you had to be domestic and this knocked out all the big global sponsors. And it was a \$1.7 billion deal so you need to be able to write a big equity check, and of the local players, we are it.

Q: Komeda was a secondary buyout. Do you

However, we have made seven exits and most of them have been trade sales – these are preferable because you get out at one shot and you get a control premium. The third leg is leveraged re-cap dividends and they remain a viable source of exits in Japan and Korea.

Q: How has the trade buyer universe evolved?

A: Seven years ago it was dominated by global players, but today you see a much larger Asian strategic presence and one of the most important trends we are seeing is the emergence of North Asian buyers. Chinese and Korean companies will look at a Japanese business, and the Korean and Japanese companies will look at a Chinese business.

Q: Presumably they are also competitors for deals...

A: The chaebols are our most important deal source as well as our most important exit destination in Korea. They are also in some instances our most formidable competitors. They are sophisticated – they know we can be on the same side of the table one day and on the other side the next day. ▾

Operational Value Add – Yonghui Superstores

Headland Capital Partners invested in Chinese supermarket chain Yonghui Superstores in 2007 and helped turn the regional player into a sector outperformer with a national footprint

AS IT GREW AT A RAPID PACE, YONGHUI

Superstores, a Chinese supermarket chain backed by Headland Capital Partners, had to prove itself in battle against a bigger rival. It had a store literally next door to French retailer Carrefour in Chongqing, separated from its rival by just a wall. "Everyone was saying 'This will be the Waterloo of Yonghui,'" says William Shen, senior partner and head of Greater China at Headland. "They're doing well but it's a domestic chain."

But Headland was confident Yonghui would win. The firm had recently agreed to increase its stake in the company, from 20% to 24% at three times the previous valuation, on the very day that Lehman Brothers collapsed in 2008.

The confidence came from the company's strong focus on fresh produce, which attracts a high volume of foot traffic. "It's important because people buy it every day," Shen explains. "If a customer comes into a store to buy fresh produce, he will pick something up else as well."

Yonghui's revenue jumped from RMB3.7 billion (\$607.2 million) in 2007 to RMB24.7 billion in 2012, a compound annual growth rate of 46.4%, as it rapidly accumulated market share. EBITDA increased six-fold to RMB1.3 billion over the period as the company rose to become the seventh largest grocery retailer, moving up from 26th place.

Of this income, 45% derives from sales of fresh produce compared to 15-25% for most other supermarket chains. When Headland first invested almost \$40 million in the company in 2007, 80% of fresh produce in China was sold through wet markets – establishments that not only present hygiene issues, but also start early in the day, which means most goods are sold by the time white-collar workers shop in the evening.

However, change was imminent. In most mature markets, 70-80% of fresh produce is sold through modern retail channels and the government in Fujian province, Yonghui's primary market, was already offering financial incentives to transform wet markets into supermarkets. Headland saw potential in this transition, and Yonghui's fresh produce section was set up to replicate the product range of a wet market, but in a clean environment.

"Yonghui was the pioneer in creating best practice for this wet market transformation, partly because all the founders come from humble roots in the countryside," Shen says. "They

understand the importance of fresh produce, and how that helps draw foot traffic, but also how to sell it at a competitive price compared to wet markets."

The competitive pricing came from direct sourcing – instead of relying on an existing supply chain, Yonghui went straight to the farmers. It created an entire logistics infrastructure, with agents paying cash to source the best available fresh produce at the best available price.

The direct approach

This helped reduce input costs, but that was only one part of Yonghui's value equation – the other being direct operation.

"Even if Yonghui and a competing store get the same input price, Yonghui will be able to

core competencies and pursue a timely, cross provincial expansion strategy to turn the company into a national player. It managed to drive margins and sales up while pushing into new markets.

When the PE firm invested in 2007, Yonghui had a dominant market share in Fuzhou, the capital of Fujian. It operated 54 stores in the province and had just set up four outlets in Chongqing. Instead of expanding quickly into multiple provinces, the company worked on establishing a sizable and sustainable business in Chongqing and then moved into Beijing, Anhui and other markets. As of June 2013, the chain had grown to 259 stores across 17 provinces.

Yonghui was the only domestic player that managed to build a national presence through pure organic growth. One of the reasons for this is supply contracts for fast-moving consumer goods (FMCG). Wal-Mart, Tesco and Carrefour have national sourcing contracts with companies such as P&G and Unilever and can lower costs by placing larger orders across provinces. When a domestic company launches in a new province, it has to deal with the provincial or even local distributor, paying a higher price than the dominant local player which sources the same products at higher volume.

In addition, it might use discounts to attract customers but the dominant player can discount further because of its lower buying price. The new entrant will lose money, so it is difficult for a domestic player without national supply contracts to expand across

China. Yonghui does not need to discount daily necessities to attract foot traffic because its fresh produce draws customers in.

However, although sales rose from RMB3.7 billion in 2007 to RMB8.5 billion in 2009, when daily necessities as a proportion of revenue also grew, gross profit margins were not increasing. The company responded by negotiating national FMCG supplier contracts.



Headland Capital Partners' William Shen (left) and Marcus Thompson

get a higher margin than the rival, because it has very detailed in-store operating standards," Shen explains. A lot of retailers use a concession model for fresh produce, recruiting vendors or merchants and charging them a monthly lease or share of the revenue. But it becomes difficult to control wastage, so all of Yonghui's stalls are operated by its own employees.

Headland wanted to stay focused on these

“Before listing in 2010, though Yonghui was well established and enjoyed a great deal of reputation in Fujian, we were not well known and recognized by multinational suppliers,” says Xie Xiangzhen, director and general manager of Yonghui’s FMCG department. “The procurement channels were fragmented, and we had to negotiate with suppliers in different regions, resulting in higher procurement costs and negative impact on our cash flow and profit.”

Since the retailer now had a footprint across three provinces and could benefit from economies of scale, Headland leveraged its connections to offer Yonghui access to executives at world-leading suppliers. Coca Cola was the first to sign on in 2009, its contract including different subsidized promotions for which special packaging was launched.

“When other suppliers saw that the Coke deal was a success, they also came in to sign contracts,” says Raymond Wong, principal at Headland. “P&G, Unilever and Kimberley Clarke also came on board.” By the end of 2013, 38% of Yonghui’s total FMCG sourcing is expected to be through national contract, significantly reducing costs.

Willing landlords

Another hurdle to organic growth is real estate. Wal-Mart and other foreign supermarket used to be welcomed by government officials with tax credits and receive 3-5 year rent free holidays from property developers because their stores attract customers. But when Yonghui moved into a new province they needed to work hard to convince the leading developer to work with it.

Headland helped put together data from property developers in Chongqing to demonstrate that the supermarket was doing really well in the regions in which it operated. They asked questions about the impact of the store opening on real estate – how fast other commercial property could be leased out, whether there was a positive impact on sale and purchase agreements for residential units.

Once the developers visited the stores, they were convinced. When the company listed on the Shanghai Stock Exchange in December 2010, to raise RMB2.64 billion, there was more traction. Headland sold its holding down to 20.56% for an 8.8x return multiple in the process.

The chain’s Bravo premium supermarket format was also instrumental in helping form alliances with major developers. In order to differentiate Yonghui from the Carrefour next door, Headland suggested adding sections such as a bakery and wine cellar to attract new consumers.

“When we opened the first true Bravo store in a Wanda mall, it really impressed the chairman,”

says Shen. “We didn’t realize at the time that this could be a make or break to get Wanda on board. We just thought it was important to experiment with this format so that we understand how to attract premium shoppers and some of the learning could be applied in our regular stores.”

Wal-Mart had a deal with the developer for space in every Wanda mall but now Yonghui takes one third of all Wanda new mall openings. The supermarket chain also has strategic alliances with Longfor and Wanke, among other developers.

The company’s rental expense is expanding dramatically as it opens new stores but that is offset by rental income. The retailer launched new stores in the hypermarket format in 2010, the key benefits being additional income from subleases to specialist retailers such as McDonald’s or KFC, better brand presence when

store operations and the FMCG section, the GP has looked at opportunities to further strengthen the fresh produce section. When Shen chanced upon a possible arbitrage in growing imported varieties of produce locally, the firm discussed launching private label products at Yonghui.

Food quality and safety are major concerns in China, so it made sense for a trusted brand such as Yonghui to sell an own brand product similar to high-priced imports. “I can see huge room for higher-income category to pay a premium for this,” says Shen. “It just shows that even when the company is strong, there is room for fresh ideas.”

Taking stock

According to Goldman Sachs, Yonghui could become one of the top three supermarkets in China. Retail has been in a down cycle in the country since the last quarter of 2010 due to a

“They understand the importance of fresh produce and how that draws foot traffic, but also how to sell it at competitive prices”

– William Shen

entering new provinces and stronger negotiation power against suppliers.

Rental income covered 32% of rental costs in 2012, and this is expected to reach 40% in 2013.

To further improve revenue and margins, Headland started work on category management last year, with an in-depth category management analysis of the underperforming FMCG division.

In order to optimize the product mix offered to customers, the study divided products into four categories to distinguish the star performers, which attract foot traffic and also generate significant margin, from the foot traffic builders, which do not have much margin. The other two categories are margin contributors, which do not generate foot traffic, and complementary products, which do not bring foot traffic or margin, but a store needs to stock.

The second step is price bands – does the store offer enough representation in the high, mid and low-end band to match the targeted demographic of the store?

Usually 80% of sales are generated by one quarter of stock keeping units (SKUs) in a store. Yonghui is using technology to track which items are selling so that it can get rid of the slow categories and free up space for high-end or fast-moving products. As a result, the company managed to release more than RMB400 million of cash flow from operations in the first half of 2013. The gross margin return on inventory has increased by 30% over the past year.

While most of Headland’s work has been on

weak economy, supply-demand imbalances, cost pressures, and e-commerce. However, despite the macro environment Yonghui’s same-store sales growth was well above peers in 2012, and it posted strong year-on-year growth in the first quarter of 2013.

Meanwhile, its foreign rivals are still in the trenches. Carrefour’s top line growth in China was almost zero last year, Wal-Mart has decided to close 9% of its store network, and Tesco is merging with state-controlled China Resources Vanguard.

Rising rent and labor costs have put pressure on the bottom line. The average hourly wage for an employee of a foreign-invested enterprise was RMB55 last year, compared to RMB30 in 2007, according to government statistics. Property rental prices have gone up eight-fold in the last 10 years, making China one of the most expensive commercial real estate markets in the world.

On top of this, the sweetheart deals local governments and property developers offered to foreign investors have been withdrawn. Even the national sourcing contract advantage is leveling out as more domestic players such as CR Vanguard and Yonghui develop direct relationships with suppliers.

The Yonghui store next door to Carrefour in Chongqing is the company’s top performing outlet in the city in terms of revenue and operating profit, Shen adds. By contrast, Carrefour is struggling. ▽

Exit of the Year – Matahari Department Store

TWO SUBSTANTIAL PARTIAL EXITS THAT can be seen to justify the Indonesia investment thesis for global PE firms were among those nominated for Exit of the Year: TPG Capital and Northstar Group's agreed sale of more than 30% of Bank Tabungan Pensiunan Nasional to Sumitomo Mitsui Banking Corp. and CVC Capital Partners public placement of shares in Matahari Department Store.

Matahari prevailed with the voters, much as it has with investors since the March offering. The stock is trading at IDR11,050, up marginally on the sale price, and has held steady during a period in which the Jakarta Composite Index dropped by as much as 25% on concerns about the slowing economy.

"For any public marketing offering, you need to take advantage of the window. The timing was good with Matahari, but even with the recent sell down, the stock price is

holding up," Sigit Prasetya, managing partner for Southeast Asia at CVC, told AVCJ in November. "People see through the market volatility and recognize a good quality business with a high scarcity value because it is the leading retailer in Indonesia and probably in Southeast Asia as well."

CVC and Multipolar, a vehicle owned by the Riady family's Lippo Group, raised \$1.3 billion by selling approximately 46% of Matahari. The pricing of the share placement valued the entire company at close to \$3.3 billion, or 27x 2013 forward EBITDA.

It reflects an appetite for the Indonesia consumption story that Prasetya says holds firm despite the recent volatility. "If you look at the secular trends - Indonesia being a large population, a young population and a middle-income growing population - they are still there."

PE investors can be patient and take advantage of these swings, provided they can access the deals – and in

Southeast Asia large transactions remain few and far between. Prasetya estimates that, in the last five years, there have only been about 20 deals in the region with an enterprise value of more than \$200 million.

Matahari was a proprietary transaction, sourced through connections to the Riadys. CVC bought a 72.6% stake in the company from a Lippo-controlled entity in early 2010 at an enterprise valuation of \$892 million. CVC and Multipolar then set up an 80-20 joint venture which owned approximately 98% of Matahari.

It is one of eight CVC investments in Southeast Asia since 2007, of which only two came via auction.

"If there aren't many deals and everyone shows up to an auction, then whoever wins usually overpays for the asset," Prasetya added. "However, valuations are not everything. Most of the big investment banks have been active in Southeast Asia for a while now, so the level of intermediation is good. But in most cases, if a family or business group wants to sell, there is a reluctance to hire a bank and do a full auction for face considerations." ▀



Roy Kuan of CVC Capital Partners

AVCJ Special Achievement – Shangzhi Wu

CDH INVESTMENTS STARTED OUT IN 2002

with four LPs and \$100 million in capital. The team had been together for six years as the private equity unit of China International Capital Corp. (CICC), but the asset class was relatively unknown and unproven in China at the time.

Investments in the first fund included Shanshui Cement, China Mengniu Dairy and Li Ning, each of which ended up going public in Hong Kong. CDH seized on this momentum and has never looked back. The firm now has about \$8 billion in capital under management across PE, VC, real estate, listed equities and high-yield mezzanine. In recognition of this achievement, Shangzhi Wu, chairman and managing partner of CDH, won the AVCJ Special Achievement Award.

Wu was unable to attend the ceremony personally, so Stuart Schonberger, managing director at CDH, collected the award on his behalf. "I think it is quite representative of the firm and Dr. Wu himself, how low key and out of the limelight all of my partners like to be," Schonberger said. "But we truly are a Chinese firm and under Dr. Wu's leadership we strive to be a world-class institution."

Schonberger also stressed that CDH's strength is reflected in its stability, with the six original partners, who started working together at CICC in 1995, still in place. However, in other respects, the firm has moved with the times.

Speaking to AVCJ earlier this year, Wu contrasted the early years spent restructuring companies into red-chip offshore holding structures with the post-2007 era in which offshore restructuring became more difficult.

"The A-share market became the main route for IPOs and there are regulations defining how long it takes to restructure a company into a joint-stock company," he said. "If you are foreign-invested it takes even longer. There is the queue for IPOs and then the lock-up could be 1-3 years. This transition has made the pace of exits much slower, so IRRs come down."

With larger funds and bigger ticket deals – CDH's average commitment is now \$100 million and it is raising its fifth US dollar-denominated fund, with a target of \$2 billion, and last year closed its second renminbi fund at RMB8 billion (\$1.3 billion) – has come more manpower. The firm now has close to 50 investment

professionals and a seven-strong operating team.

As for diversification, it started out almost by accident. First, LPs wanted clarity on the asset class because Fund I covered the full gamut from venture capital to buyouts, and so the VC business was spun out. Then, one LP wanted to set up a listed equities platform but couldn't find the right people, so CDH did it instead.

Now, though, exposure to multiple asset classes is seen as integral to keeping CDH going for another 10 years and more. "Diversification is important for long-term stability," Wu said. ▀



AVCJ Pulisher Allen Lee and Stuart Schonberger

VC Deal of the Year – Tujia

LIGHTSPEED CHINA LIKES DISRUPTIVE

business models that build up traction online and then use the momentum to gain a foothold offline as well. This has worked to good effect with Meilele, an online furniture retailer that now has a network of 200 offline stores. Ron Cao, Lightspeed's co-founder, looks at vacation homes rental service Tujia in a similar way.

"One is selling furniture and the other is selling services but they are very similar in terms of the offline user experience, the complete consumer experience," he says.

Lightspeed came across Tujia in late 2011. The VC firm had identified travel as a key investment theme for the next 3-5 years and the Airbnb and HomeAway model – whereby travelers looking for holiday accommodation are matched with property owners with space to rent – was singled out as one to watch.

Tujia's founders already had start-up pedigree. Jun Luo, was formerly joint CEO of NASDAQ-listed China Real Estate Information, while Melissa Yang used to be CTO of Escapia, a US vacation rental platform bought by HomeAway. Thanks to their connections, Ctrip and HomeAway both

participated as in the Series A round in early 2012. This round, worth more than \$10 million, was led by Lightspeed, with CDH Investments also participating.

A second round followed 12 months later, taking the total raised to \$64 million. By this point, Tujia's business had grown to a nationwide platform featuring 400,000 rental properties in 65 Chinese cities and 45 foreign cities. The existing investors were joined by GGV Capital, Qiming Venture Partners and CBC Capital.

AVCJ understands that Tujia is generating meaningful revenue but has yet to turn profitable. Cao describes the company as "in growth mode," with consolidating its position as market leader and improving customer service the current priorities.

Interestingly, Tujia's long-term sustainability may lie in how it differs from HomeAway – and thereby embraces the online-to-offline model.

The US site allows the party listing a property to set the rental price and then takes a commission off the top. Tujia, meanwhile, has a property management business bolted on to its website. An individual with a holiday home in



Lightspeed China's James Mi and KPMG's Jon Parker

Sanya can appoint Tujia to maintain and rent out the property, with the company setting the price and splitting the revenue with the landlord.

In many cases, the owner doesn't list the property at all but relies on a local manager who posts it on Tujia in order to attract more custom. Cao argues that the third-party approach is appropriate given home rentals are still relatively new to China. "The Chinese aren't necessarily comfortable having other people stay in it," he says. "Tujia makes it more comfortable by taking responsibility for the property." ▀

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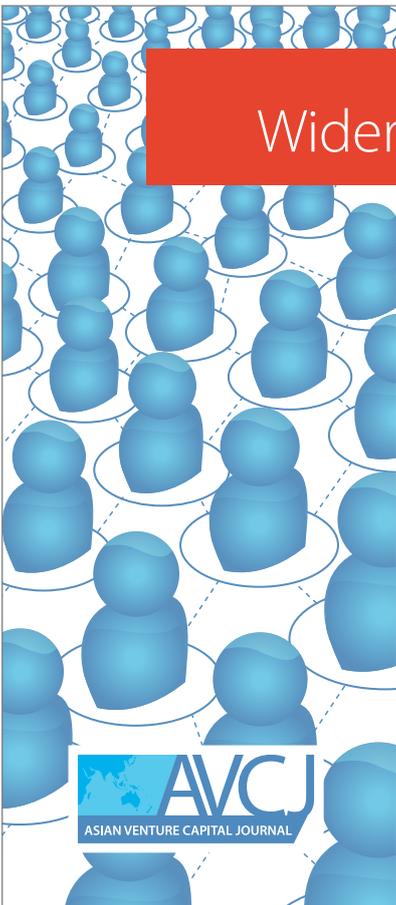
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VC Professional – Richard Liu

Richard Liu has spent 14 years investing in tech, media and telecom for Morningside Technologies. He has witnessed increasing competition, ups and downs in e-commerce, and the rise of the domestic super angel

WILL THE SNOWBALL MELT? IN JUNE

Chinese online financial information platform Snowball Finance received \$10 million in Series B funding from Morningside Technologies and Sequoia China, the latter having provided the first institutional round two years earlier.

The company, which operates news site iMeigu and social network Xueqiu, is one of a host of financial start-ups using innovation to remove sector inefficiencies that restrict the reach of services. In this sense, the internet is a democratizing force and Snowball Finance is ultimately helping drive information flow, bringing opportunities to small-scale investors.

“Deregulation is supposed to open up financial services to all private businesses and that is good news for everyone,” says Richard Liu, managing director at Morningside. “On the other hand, the sector has a problem in terms of a mismatch in the risk-return profile, so the internet is a means of providing more match-making opportunities. There are so many opportunities in online finance but ultimately it will be like e-commerce 2-3 years ago with all the hype. Only a few will survive.”

However, the transformation taking place in financial services does fit in with Morningside’s take on the evolution of internet businesses in China. The explosion of venture capital interest in physical goods-driven e-commerce is giving way to service-oriented e-commerce and from there it is penetrating all kinds of traditional industries, from travel to education to legal services.

Morningside also has an interest in the latter. In August it provided just under \$2 million in Series A funding to Legalsiri, investing alongside ZhenFund. The company draws its inspiration from LegalZoom, a VC-backed platform staffed by a team of lawyers that handles routine documentation online, offering a low-cost alternative to small businesses and individuals.

Then and now

Liu has been with Morningside for nearly 14 years, leading the firm’s tech, media and telecom coverage. In 2007-2008, his unit spun out from its family office parent and launched independent funds, although the Chan family, which runs Hang Lung Group and set up Morningside, remains the anchor LP. The first fund raised \$150 million in 2008 and the second closed at \$225 million three years later.

But the change has been far more pronounced in the space in which Liu invests. When he started out, the market was limited from both a demand and a supply perspective: an entrepreneur looking for funding would travel to Shanghai, meet with the handful of VC firms present in the city and whichever ones were willing to take the risk got the deal.

Morningside’s early successes, such as web portal Sohu, travel booking site Ctrip and online games operator The9 all came this way, and each one ended up going public in the US.

“In the early days, you could cover all the investment opportunities by backing 20-30 companies. Today, the number of deals probably goes into the thousands,” Liu says. “You can’t



Richard Liu and Dorothea Koo of Baker & McKenzie

cover all of them. And the competition has become so fierce – US dollar funds, renminbi funds, institutions and angel investors, private equity, hedge funds.”

Deal sourcing is a product of Morningside’s top-down sector research with a peppering of direct approaches from entrepreneurs. A sign of how the market is maturing, the VC firm has been a repeat investor with a handful of these entrepreneurs. Morningside has partnered with Lei Jun, the Kingsoft CEO turned angel investor, no fewer than eight times and co-invested with Lei’s VC unit, Shunwei Capital Partners, in other start-ups on several occasions.

Xiaomi, a hugely successful smart phone brand, is the most famous example. Liu and Lei spent 12 hours on the phone discussing the business model one night in 2009. Morningside and Qiming Venture Partners provided seed funding the same year and then Xiaomi took off. DST Advisors led the Series C and D rounds in

2012 and 2013, which valued the company at \$4 billion and \$10 billion, respectively.

Liu notes there are other serial entrepreneurs with whom he has worked multiple times, such as Bob Xu, co-founder of New Oriental Education & Technology Group and founder of ZhenFund, and Hongyi Zhou, co-founder of internet security software provider Qihoo 360.

Competition issues

While competition from renminbi-denominated funds has dissipated with the slowdown in public market exits, it is debatable to what extent they were a rival to Morningside in the first place. Liu argues that US dollar and local currency funds are very different creatures: their ideal IPO candidates can be poles apart and a renminbi fund’s investment horizon is much shorter.

Interestingly, one area where Morningside does see post-crazy valuation opportunity is e-commerce. It largely steered clear of the space, concerned that firms were burning through capital in order to buy market share without creating sustainable value. Now, though, consolidation is taking place and this has eased pressure on the survivors.

“This year we realized most of our competitors have died,” says Liu. “I believe in the e-commerce model in the long run but in the past 2-3 years most of the businesses were not sufficiently innovative or sustainable. We will continue to explore the space but we want to identify platforms and communities that are differentiated from Taobao and the rest.”

This has also placed the onus on Morningside to provide more support to its portfolio companies. Entrepreneurs, though the driving force behind their businesses, are at times the principal obstacle to development once a certain scale is achieved. Assistance is required in terms of hiring additional talent and developing expertise in particular areas, as well as ensuring the firm retains focus and doesn’t spread its resources too thinly in pursuit of multiple strategies.

“We are usually the earliest institutional shareholder in our portfolio companies so we have the trust of the entrepreneurs,” Liu adds. “We are not an external investor so much as a partner and the cost of communication is low. When a guy calls you with a long list of problems it’s a good sign; if he says everything is great, it’s a warning sign.”

DEAL OF THE WEEK

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KKR agrees capital injection

BEFORE AGREEING TO INVEST \$200

million in India's Gland Pharma, KKR looked at a couple of opportunities in the injectable drugs space in the US and another in India over a period of several years. The PE firm has a long-standing interest in the industry but assets tend to get snapped up by strategic buyers.

This was never going to happen with Gland. "The promoter was very clear that he wanted to stay on and continue to grow the business," says Karan Swani, a principal at KKR. "Selling to a strategic investor wasn't an option because it would have meant giving up control."

The attractiveness of Gland lies in its cost advantage as an India-based manufacturer and its strong position in an industry struggling with product shortages.

According to the US Food and Drug Administration (FDA), there were 117 new drug shortages in 2012, of which 84 cases involved sterile injectable drugs. This is down from 2011, but shortages of older sterile injectable drugs persist. Discontinuations, production delays and limited raw materials are contributing factors,

but a number of manufacturers have also been shuttered after their facilities were found to be non-sterile.

"A lot of shortages can be linked to the complexity of the manufacturing process and facilities in the US having run afoul of FDA regulations," says Heramb Hajarnavis, a director at KKR. "This trend will continue for the next couple of years."

In 2003, Gland became the first Indian firm to receive FDA approval for pharmaceutical liquid injectable products and there have been no run-ins with the regulator. Gland's work in India on pre-filled syringe technology and Heparin technology has successfully translated into commercial sales in the US.

A partnership with Germany's Vetter Pharma, a global leader in pre-filled syringe technology, helped Gland introduce the right technologies and practices and the Vetter family retains a small minority position in the company. Swani adds that Gland benefits from being a vertically integrated producer. It makes many of the active pharmaceutical ingredients used in its drugs,

which allows greater control over the process.

KKR's investment – thought to be for a 35-40% stake and still pending final regulatory approval – will be structured in two parts: an infusion of fresh equity followed by the purchase of Evolve India Life Sciences Fund's interest in the business. The PE firm is expected to help the



Gland: Global leader

company grow its manufacturing capacity and expanding product registrations.

Following the acquisition of Agila by generic drug maker

Mylan for \$1.6 billion earlier this year, Gland is by some distance the largest pure-play injectables manufacturer in India. According to Research & Markets, the global market for these drugs will be worth \$43.3 billion by 2017, reflecting compound annual growth of 14% over the preceding five years. ▀

VCs to take Kingsoft across borders, platforms

HONG KONG-LISTED SOFTWARE

developer Kingsoft is not in desperate need of capital. It posted a net profit of RMB466.4 million (\$76.6 million) in 2012, up 39% year-on-year, and its cash reserves stood at RMB2.4 billion for the year. Furthermore, in July of this year, the company successfully tapped the debt markets, raising HK\$1.4 billion (\$180.5 million) through a convertible bond issue.

Inviting three external venture capital investors to provide \$50 million in funding to Kingsoft Office Software, the company's enterprise software subsidiary, was therefore about more than just money.

"If you are operating in the internet world it's not just capital and it even goes beyond the product as well. If you have a great product, the question in the mobile internet sector is how do you leverage your advantage," says Jenny Lee, a partner at GGV Capital. "They are thinking about what it takes to bring a product to the international market."

GGV is one of the three investors, alongside Morningside Technologies and Shunwei Capital

Partners. GGV and Morningside will both have representation on Kingsoft Office's board of directors and play an active role in developing the business' global strategy.

Shunwei already has a connection to the parent company. The VC firm's founder is Lei Jun, was a co-founder and previously CEO of Kingsoft. He is currently company chairman.

Lei is partly responsible for the creation of Kingsoft Office. In 2012, the subsidiary was spun-out through a management buyout – although Kingsoft remains the major shareholder – completing a restructuring of the parent company's three major subsidiaries. Its enterprise software, internet security software and entertainment software divisions now operate with greater independence.

A fourth arm to the business – cloud computing provider Kingsoft Cloud – is at a more nascent stage of its development.

For the newly empowered Kingsoft Office, the challenge is taking its longstanding battle with Microsoft Office for supremacy in China across borders and onto new platforms. The

business achieved new record sales of more than RMB195.8 million in mainland China and Japan in 2012, with monthly active users of its WPS Personal Edition rising to 43.3 million.

WPS Mobile Office – available as a free-to-download app for Android and iOS devices, with users paying for value-added services – had more



Kingsoft: Cross-border strategy

than 11.2 million global monthly active users, in 226 countries and regions, in 2012.

"We like companies that can change existing ways of doing

business," says GGV's Lee. "We would prefer to do everything on a tablet rather than a laptop but it's difficult to get a productivity software suite that allows you to work seamlessly on a tablet. You need experience working with different operating system and formats. That is what we are betting on with Kingsoft Office." ▀

The secondary network

Setter Capital's Secondary Link is the latest online platform intended to fill the information void in the secondaries market. Industry participants have mixed feelings as to its utility

IT IS ALMOST IMPOSSIBLE TO GET

accurate picture of activity levels in the traditional private equity secondaries space. Few disclosure requirements and a lack of publicly available data means that LP interests are often traded under the radar. The information that is available tends to come from intermediaries who brokered the transactions. However, even they are restricted to what they know about their clients.

One way the industry has sought to provide a better sense of what is going on – and therefore a sense of market liquidity – has been through online platforms where information on funds and deals can be traded directly between players.

Setter Capital, a Canada-based secondaries advisor, is behind the latest offering known as Secondary Link. It serves both as a platform for people in the industry to connect with each other and as means of gauging GP performance and fund liquidity.

While the site – which is being offered for free – clearly has its uses, it is unclear how much demand there is for the service and from whom, and by extension what impact it might be able to have on liquidity in the secondary market.

"Prior to the platform being set up, I can't say anyone ever said they needed it, most likely because they didn't know they needed it," says Peter McGrath, managing director at Setter.

He explains that the idea to set up Secondary Link was largely a reaction to the rapid growth of the secondaries market. Today the firm covers over 1,000 buyers of LP interests in funds who are active across several alternative asset classes, including private equity, real estate, infrastructure and hedge funds. This compares to around 250 four years ago.

"We just saw the market exploding and we had a theory that PE and other alternative funds were not nearly as illiquid as people have perceived them to be in the past," McGrath says.

Liquid or not

As such, the core feature of the platform is the liquidity rankings of the funds it features - of which there are 4,000. While private equity is generally less illiquid than it was in its early years, the degree of liquidity varies greatly from fund to fund: Brand names like KKR or The Carlyle Group might be almost as liquid as a block of a listed equity, but a lesser known Asian manager may

arouse little or no buyer interest.

The liquidity ranking classifies funds as excellent, very good, and good, based on Setter's in-house data on the number of buyers a fund family has. Fund families are further ranked by the number of followers they have on the platform and by the number of buyers who have registered their interest.

The platform acts as a closed social network for secondary market participants, similar to professional network LinkedIn where users are able to join and connect with each other and as well as follow the funds there interested in.

Despite the platform drawing around 700 registered users since its launch, not all are convinced of its practical applications. For example, larger transactions – involving multiple LP interests – are unlikely to be brokered through

sized LP interests. Jason Sambanju, managing director at Paul Capital, makes the point that liquidity is harder to come by where smaller interests are concerned as it is not a space where many professional secondary investors – such as Paul Capital – operate.

"I can see how investors with small stakes and very few options may use these kinds of platforms," he says. "If they provide some sort of liquidity solution for these small LP interests I can see how it is adding to the industry to have such platforms come in."

Misperceptions

The flipside of this is that the platform might add to the impression that private equity is more liquid than it actually is. As one industry participant points out, buyers who are interested

in buying small interests may not be attuned to the fact that once you buy into a private equity fund you are committed.

Despite these misgivings, the platform is still being put to use. According to Setter, Secondary Link members have collectively more than 3,000 funds on their shortlists. They have also expressed a willingness to collaborate on due diligence on 1,135 funds with fellow members while listing themselves a potential buyers for 1,350 funds.

How much impact Secondary Link will have in long run, however, is entirely dependent on it gaining traction. After all, platforms such as these are only as good as the number of people that use them.

"I can see these platforms becoming more significant contributors to the liquidity in the market but I couldn't say by how much," says Sambanju. "Sizing the secondary private equity market is always more of an art than a science because there are no public disclosure requirements when you transfer LP interests, so there is no real depository of information." ▀

Asia's 10 most sought after private equity fund families

Fund family	Setter liquidity rating	Potential buyers
Pacific Equity Partners	Excellent	40+
CDH China Fund	Excellent	40+
CVC Asia	Excellent	40+
KKR Asia	Very Good	30+
TPG Asia	Very Good	30+
Hony capital	Very Good	30+
Carlyle Asia Partners	Very Good	30+
Baring Asia	Very Good	30+
Carlyle Asia Growth Partners	Very Good	20+
Affinity Equity Partners	Very Good	20+

Source: Setter Capital

an online platform due to their sheer complexity. Meanwhile, the platform may not be of interest to those investors, such as a fund-of-funds, who rely on asymmetry of information for an advantage in market.

"The LPs give them money so they can go out and source interests on a proprietary basis," says one secondaries investor. "Once LPs can go direct and source a piece of a fund they will no longer want the middle man, the fund-of-funds will become disintermediated."

On the other hand, there is the view that online platforms may be more useful for smaller-

Home from home

In 2010 Japan Home Centre was already a successful domestic brand but to realize its IPO ambitions it needed the right partner to guide it through a period of rapid expansion – EQT Partners

DESPITE ITS NAME, JAPAN HOME CENTRE has little connection to the country. It is actually the flagship brand of a home-grown Hong Kong enterprise – International Housewares Retail Company (IHR) – founded by Peter Lau and Lisa Ngai in 1991.

However, the name goes some way to explain its roots. The company was first established as a one-price store, modeling after Japan's popular 100-yen shop concept – or dollar store in the US – with most of its products sourced from Japan. However, by 2010 the business had long since abandoned this model, broadened its range of products and evolved into Hong Kong's leading discount houseware chain.

By the end of fiscal year 2011, IHR had grown to more than 213 directly-owned stores in Hong Kong – including its up market City Life and EPO Gift and Stationary store brands. In addition, it had several overseas licensed stores in East Malaysia, UAE, New Zealand and Saudi Arabia, with group sales of around HK\$1 billion (\$128 million).

For Lau and Ngai the next step was to go public, but the business was in need of a suitable pre-IPO investor to provide capital and guide the firm through further expansion and the eventual listing. The founders hired PricewaterhouseCoopers to run a limited auction and a handful of investors registered their interest, among them EQT Partners.

"At that point the company had 19 years of history, it was a major housewares retails chain in Hong Kong and it had strong cash flow," explains Tak Wai Chung, a partner with EQT. "It had also remained a very stable business throughout several different economic crises. We thought we could really add value to its overseas expansion strategy."

After around four months of negotiations, EQT emerged as the preferred candidate. The deal closed in early 2010, with the private equity firm paying HK\$224 million for a 40% stake, investing through EQT Greater China II.

The aim was to take IHR public within four years of the investment. In the interim EQT would help drive organic and inorganic expansion overseas while simultaneously consolidating the company's market position at home.

"We liked the technical experience that came with EQT," says Lau. "My partner and I built the

business from a single shop so we didn't have experience of bringing a company to IPO. We also believed that if we were going to expand overseas with reasonable speed we would need help in making acquisitions."

EQT's started by bringing in some key people. Ina Cheng, former head of retail and marketing at Marks & Spencer in Hong Kong, was hired as COO, with Yiu Keung Yeung – an EQT advisor ex-CEO of KFC Hong Kong and Macau and former COO of hotpot chain Little Sheep – joined the board and provided operational consultancy.

Acquisition trail

One of the first tasks was a strategic review of the overseas business. Until then all of IHR's overseas stores had been licensed stores. It was decided to accelerate expansion in new markets but to concentrate on direct ownership of stores rather than licensed stores, thereby enabling the company to control both the pace at which new stores were set up and how they were run. This was done through acquisition and by establishing of a number of local joint ventures.

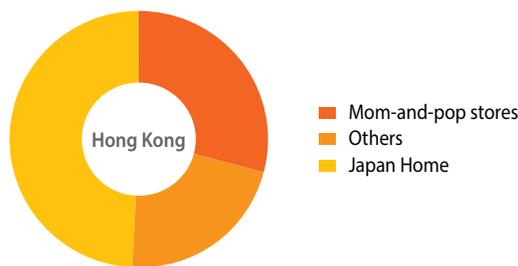
The entrepreneur, Chin Chain Yong, contributed S\$2.3 million to the venture and stayed on to oversee daily operations.

It had taken Japan Home 12 years to set up 17 stores, but under new ownership the Singapore network quickly grew to 38 outlets..

"The pace of expansion is so much faster when you are in control and you can drive the expansion strategy," says EQT's Chung. IHR was able to make some key changes to the merchandising, using its own sourcing capabilities and replacing many of the lower quality China-sourced items to upgrade the chain's entire product portfolio.

IHR then turned its sights to Malaysia, forming a 58.25% joint venture with a local partner already well-known to the business – a previous franchisee from about 10 years ago, Lim Shek Han. He had to be persuaded to put his money into the new venture and this was achieved by explaining the upside of the business and offering an equity incentive on IHR going public. Han made capital investment of MYR60,000 (\$18656). Chin, the Singapore joint venture

Market share of houseware specialist stores



Source: Frost & Sullivan

Singapore was the initial target, given its similarity to Hong Kong in terms of size, demographics and culture. There was a separate chain of 17 stores operating in the territory as Japan Home – as the name was similar to IHR's own flagship brand, the firm decided to keep it.

The deal was finalized in November 2011 after a year-and-a-half of negotiations with IHR buying 60% of Japan Home for S\$4.3 million (\$3.4 million) in cash and shares in a new joint venture.

partner, also took a stake in the Malaysian venture earlier this year, contributing a further MYR1.8 million

Lau stresses the importance of leveraging the knowledge of a local partner in a region where cultural differences are more pronounced. The strategy was to introduce the same range of core products sold in Hong Kong and then adjust the range to suit local needs and tastes. As such the rate of expansion has not been as rapid as in

Singapore. IHR now has nine directly own stores in Malaysia.

“There are different shopping malls and culture centers and they all have different needs, so we are constantly adjusting,” says Lau. “But basically we believe value for money is what the customer wants regardless of culture, so our approach is to adjust the smaller items gradually to fit the Malaysian market.”

IHR then looked to expand into China, first by acquiring six outlets from Nanjing Yuguang Trading Company, Suzhou Shuohui Trading Company and other individuals for a RMB366,658 (USD60,000) before setting up 85.6%-owned joint venture with local partners. The company trades under the Living Plus brand – so named because in China it is illegal to register businesses with a country name in the title.

This was followed by the outright acquisition of five stores in Macau for HK\$8 million.

Store strategy

In terms of rejuvenating the company’s core domestic market, the focus was not only on the number of new stores but also same store sales (SSS) growth. While official numbers are not published, EQT’s Chung explains that at the time of investment SSS growth was only 4.9% in fiscal year 2011, but that has since grown to 12.1%.

This has come through a combination of driving more traffic through the store and encouraging the purchase of more items per transaction. Marketing spend was only part of this effort. IHR has also gone through an extensive store re-profiling program. The aim was to improve the classification process and look at income levels in different regions to ensure the right customer were being targeted with the right merchandise in the right stores.

Prior to EQT’s involvement, IHR only had three categories of store, classified by size. Now there are nine.

“The exercise was essentially to enhance and optimize the merchandise portfolio based on purchasing power and preferences,” says Chung. “For example, the aromatic fragrance product category had previously not existed, but we realized that by targeting customers with higher spending power it could sell very well in certain stores.”

There has also been a focus on expanding it the firm’s customer base and looking beyond its core demographic. While the typical customer has always been the middle income housewife, the firm is now actively targeting the younger and male demographics. This is in part reflected by a broadening of the product mix in selected stores. For example, household electronics has grown from being a very small category many years ago to accounting for 20.7% of revenue.

The second part of the domestic rejuvenation process involved a review of product sourcing. Mainland China is the obvious choice and 70% of IHR’s goods come from there, but the appreciation of the renminbi against the Hong Kong dollar has made it more difficult for the company to improve its gross margins.

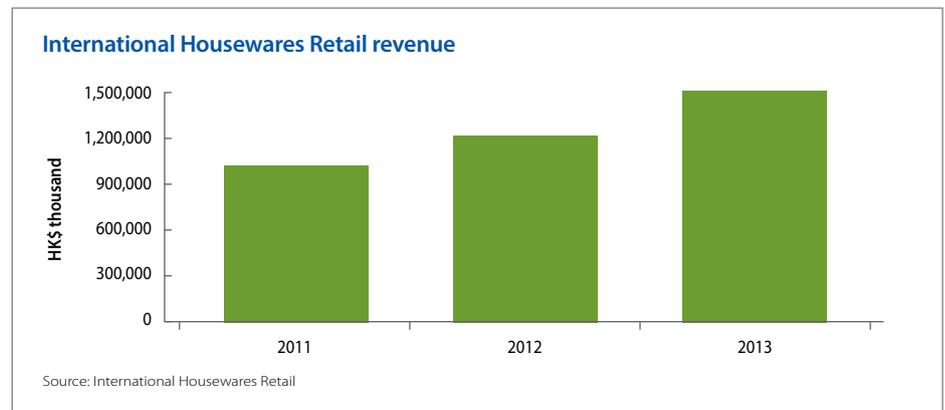
“How we could continue to improve margins was by replacing the middle man,” says Chung. “We leveraged our increasing procurement volume to take out distributors from our supply chain and increase the number of directly-sourced products in the mix.”

Lau adds that the company’s main source of profit over the last 10 years has been this ability cut out the middle man. Today the company

systems and providing working capital.

Singapore and Malaysia are regarded as the most attractive overseas markets. By the 2016 financial year IHR hopes to have 108 stores in the former and 59 in the latter. “We believe in the long run Malaysia should be a good market as they have good buying power, they have a lot of shopping centers and rent and labor is lower than in Singapore,” says Lau.

Progress is expected to be slower in China where regulatory hurdles and immaturity of the market has set a more conservative pace for expansion. Currently the market is divided into two main channels – local mom and pop stores and hyper markets – with an even smaller segment consisting of the up-market houseware



sources products from nearly 650 factories in 13 countries. It is also using more suppliers outside China, with South Korea, Japan, Thailand, Malaysia, and Indonesia featuring prominently. The ambition is that in a few years China will account for just under half of IHR’s products.

Another means of expanding gross margins is IHR’s private label strategy – replacing general consumer brands with a range of IHR exclusive brands sourced directly from manufacturers. Japan Home Centre brands now include: Kagaku stationary, Naxos personal health products, Matsusho electrical appliances and EZ Keep storage items. Around 51% of IHR products are now either sourced directly or unique to the company and 47% is Hong Kong sourced.

Aggressive expansion abroad and a change of strategy at home appear to be paying off. Operating profit reached HK\$129million for the year ended April 2013, up from HK\$76 million two years earlier, demonstrating a compound annual growth rate of 30.1%.

The company will continue its expansion with HK\$242 million earmarked to finance new store roll-outs. A further 20% of proceeds will be put towards improving logistics warehousing, while the remainder will be used to renovate existing stores in Hong Kong and Singapore, improving IT

bought in department store.

EQT’s Chung explains that a dominant player within the specialized houseware chain concept has yet to emerge but IHR will have to adapt its approach.

“What we have chosen to do in China is an upgraded version of what we have in Hong Kong, because it is less economical to compete on price alone in China,” he explains. “So we have taken a bit more effort to refine the merchandising with a combination of imported items and items we can put a theme or a concept around.”

IHR plans to open three more store in China and 20 more in Macau over the next three years.

The company realized its long-held ambition to go public in September, raising around HK\$693 million, including over-allotment, through a Hong Kong IPO. Net proceeds accruing to IHR were approximately HK\$462 million. EQT’s holding fell to 21% due to a combination of the dilution effect and a partial exit amounting to 5% of the company on a fully diluted basis.

The private equity firm has liquidity – IHR’s stock has gained 14% since it started trading compared to a 0.50% increase in the Hang Seng Index – but there are no plans to cash out just yet. ▀

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