EUROPEAN CHAMBER

中国欧盟商会

European Union Chamber of Commerce in China

Private Equity and Strategic M&A Working Group

The Social and Economic Impact of Private Equity in China

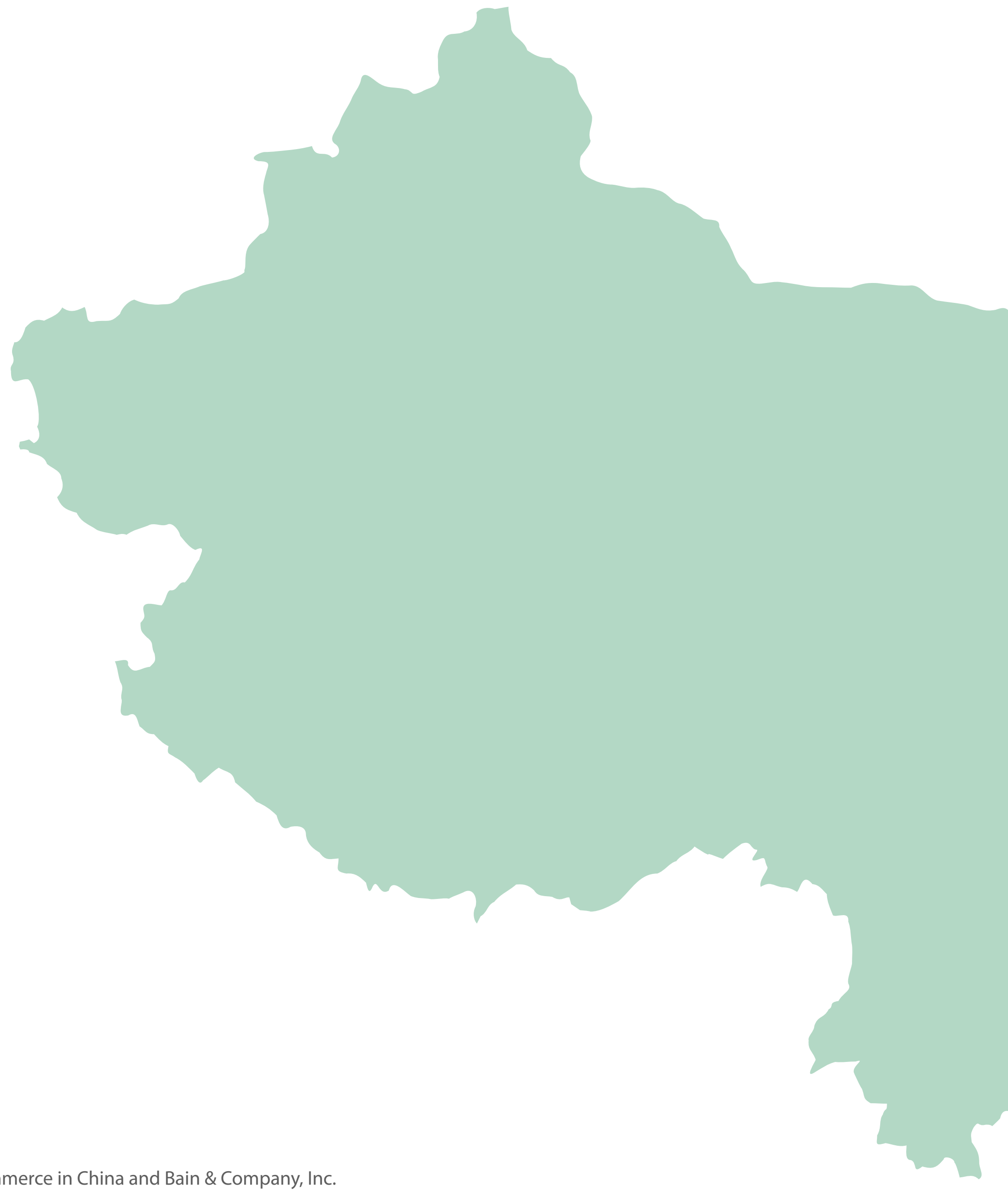
2009 Survey

In partnership with

BAIN & COMPANY

EUROPEAN CHAMBER
中国欧盟商会

The Social and Economic Impact of Private Equity in China – 2009 Survey



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FOREWORD

PRIVATE EQUITY: WHAT'S IN IT FOR CHINA ?

In just 10 years, the venture capital and private equity (PE) industry in China has become a driving force for economic growth, job creation, innovation and entrepreneurial success. China has emerged as one of the leading destination for PE capital, and though slowed by the business-cycle downturn, this trend is continuing through the current turbulence.

This spectacular growth, the entrepreneurial achievements it created and the stellar initial public offerings (IPOs) it generated on both Foreign and Chinese stock markets have been well received. Private equity enjoys a positive image in China with stakeholders: government officials, financial institutions, the general public and, particularly, with entrepreneurs and management teams.

But private equity's favorable image in China might in some cases be challenged, as the ongoing financial turmoil could trigger poor investment returns, questionable management behavior and failed deals.

This survey is the contribution of the European Union Chamber of Commerce in China, in partnership with Bain & Company, to evaluate private equity's role in China at this important juncture in its development. It applies a unique social and economic perspective to an industry often regarded as pure financial engineering. In short, it mobilizes rigorous data to answer the question: "Private equity: What's in it for China?"

Transparency creates trust. It is our goal to strengthen that trust by explaining how this important industry works and describing its contributions to China and its people.

This survey, the first of its kind to be conducted in China, shows that PE, both foreign structured and domestic, has been a driving force in improving companies' financial performance, social outcomes and company governance.

We hope all industry participants – fund managers, fund of funds sponsors, government bodies, professional associations, advisors – will use the data and findings of this survey extensively. The European Chamber and Bain look forward to participating in future conferences and workshops with industry stakeholders.

I would like to express my thanks to the European Chamber team that contributed to the survey, to its president Joerg Wuttke, for his continuous support; to my vice-chairs, in particular Roslina Chai; and to Bain & Company and its partners, Michael Thorneman and Weiwen Han, for producing the underlying analysis upon which this report is based.

Andre Loesekrug-Pietri
Chair, Private Equity and Strategic M&A Working Group
European Union Chamber of Commerce in China
December 2009

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EXECUTIVE SUMMARY

This first survey on the social and economic impact of private equity in China demonstrates that PE firms provide a strong source of support in helping Chinese companies to grow and contribute to China's macroeconomic and development goals. PE firms transfer management know-how to businesses in their portfolios, build globally competitive companies, improve corporate governance, develop an innovative private sector, support inland development and foster domestic consumption. The purpose of the survey was to document the above mentioned effects based on facts and figures.

Although private equity is a relatively new phenomenon in China, it is developing rapidly, as China has become one of the top destinations for PE investment. As with many fast-growing new industries, the societal changes set in motion by these capital flows raise questions about whether PE enriches Chinese social and economic development as a whole.

It is in this context that the Private Equity and Strategic M&A Working Group of the European Union Chamber of Commerce in China and its survey partner, Bain & Company, set out to examine PE's social and economic impact in China. This report presents data on key social indicators, including job creation, spending on research and development and the distribution of investment to inland provinces. It evaluates key measures of economic performance, including revenue and profit growth, the stimulation of greater domestic consumption and tax contributions. The study also aims to be a major source of quantitative information about private equity in China and to contribute to a constructive debate about its current role and future development.

Covering the period from 2002 to 2008, the survey included a highly representative panel of companies, representing more than 50 percent of all private equity investments through 2006. We excluded deals completed after 2006 in order to be able to track post-investment performance for a period of at least two years. Supplemented by 17 in-depth interviews with PE-backed company executives, this report reveals private equity's social and economic contribution through their portfolio companies.

- Private equity's SOCIAL impact on China is notable in three principal areas:

First, PE-backed companies created more jobs and paid higher wages and salaries.

Total employment at private equity-financed companies **increased by 16 percent** over the survey period compared with just 8 percent at publicly listed companies. PE-backed companies also pay significantly higher wages. The gross salary growth rates at PE-backed companies outperformed those of the listed companies by **seven percentage points**.With a **50 percent higher growth rate** of employment than their peers for graduates with associate degree or higher, PE-backed companies are also raising job quality. Private equity's qualitative impact on hiring and compensation is helping to move China's economy toward greater domestic consumption and more social stability.

Second, innovation and efficient spending on research and development are important goals for PE-backed firms.

Measured as a percentage of revenue, R&D spending at PE-backed companies was more than **two-and-a-half times** that of their publicly listed counterparts. Not only do PE investors raise awareness of innovation's importance at the companies in which they invest, they also frequently disseminate best practices and increase the productivity of R&D spending. By helping Chinese companies to climb the value chain, PE firms further the public policy goal of establishing China as an innovative society.

Finally, PE is a strong contributor to the government's "Go West" policies.

Not confined to the coastal regions that have attracted disproportionate investment capital, private equity is flowing across all provinces. The survey found that **42 percent** was directed to companies headquartered in inland provinces.

- Private equity's ECONOMIC impact on China stands out in three categories:

First, PE-backed companies in China booked higher revenues and profits than their publicly listed counterparts.

PE-backed companies achieved a 3 percent higher revenue growth. They also posted a noteworthy **39 percent average increase in profits** compounded annually, **14 percentage points higher** compared with a 25 percent average increase reported by their publicly listed competitors. These results underscore the efficiency gains achieved within those companies thanks to the involvement of the private equity fund managers. Indeed, beyond the capital they invest, PE fund managers often engage actively with the managers of their portfolio companies, introducing them to new management practices, better financial controls, improved brand development and enhanced corporate governance, among other disciplines, to improve performance.

Second, PE-backed companies generate higher tax payments than their publicly listed peers.

Reflecting their stronger financial performance since 2002, PE-backed companies yielded tax payments that **grew at a 28 percent rate compounded annually, 10 percentage points higher** than their benchmark peers. Due to their status as technology companies or as businesses with foreign investors, many PE-backed companies enjoy more favorable tax rates than their publicly listed counterparts. Thus, their higher tax payments suggest that PE shareholders bring improved corporate governance with respect to the disclosure of taxable income.

Finally, PE-financed firms support the expansion of China's domestic consumer goods and retail industry.

Since 2002, PE investments in consumer goods and retail companies have grown at a **77 percent annual rate compounded**, making this sector one of the largest magnets for PE funds in China. Retailers backed by PE investors booked **sales growth of 47 percent** compared with just 16 percent for publicly listed retail companies.

We hope that the findings in this survey will be helpful to all stakeholders of the private equity community as well as to a wider audience. The European Chamber plans to update the findings on an annual basis to foster a constructive dialogue among industry players, invested companies and regulatory authorities, and to spread awareness of how private equity is helping to sustain China's development objectives.

REPRESENTATIVE PANEL

To build a representative view, the survey tracked companies accounting for more than 50 percent of total private equity investment over the period under investigation.

The survey examined mainland Chinese companies that received at least US$20 million in financing from foreign or Chinese private equity funds between 2002 and 2006, and tracked their performance during the period from 2002 to 2008. It excluded deals completed after 2006 to permit tracking of post-investment performance for a period of at least two years.

The analysis is based on data obtained on 100 PE-backed companies, accounting for more than 50 percent of the total value of private equity deals completed during the five-year period (see chart 1). These companies represent a broad range of industries, company sizes and geographies (see chart 2). PE investments in real estate companies and in China's biggest financial institutions were not included in the sample: a small number of very large deals in those two sectors completed during the survey period risked biasing the results.

Chart 1 – Value of private equity deals completed during 2002-2006

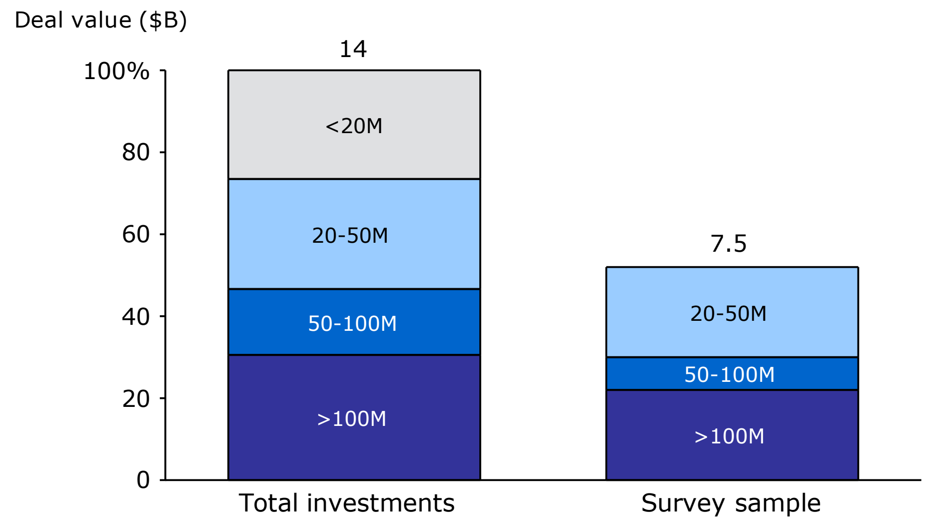
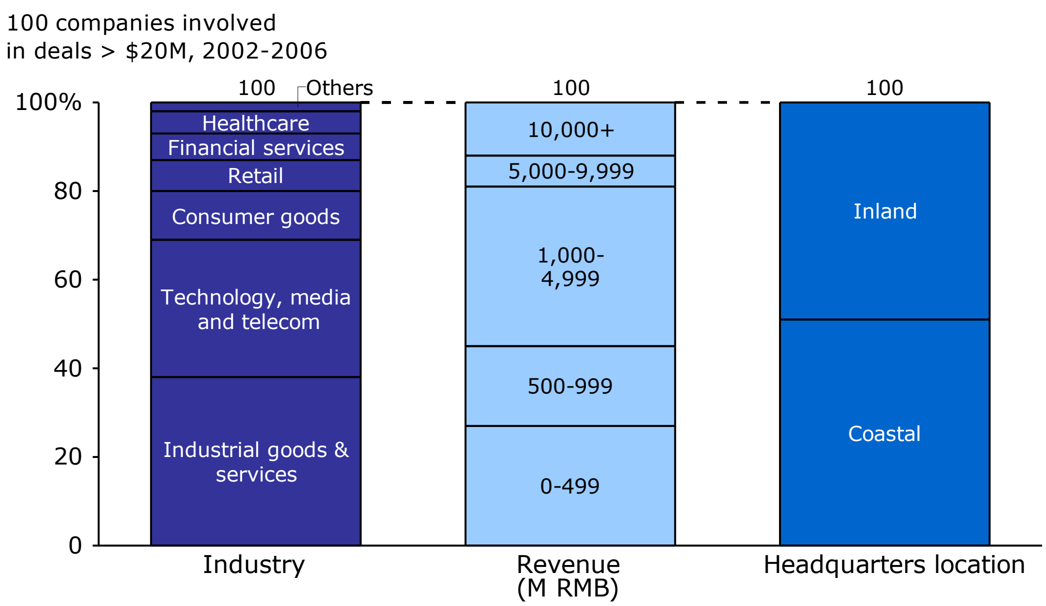


Chart 2 – Survey participant profile



Comparisons with publicly listed companies

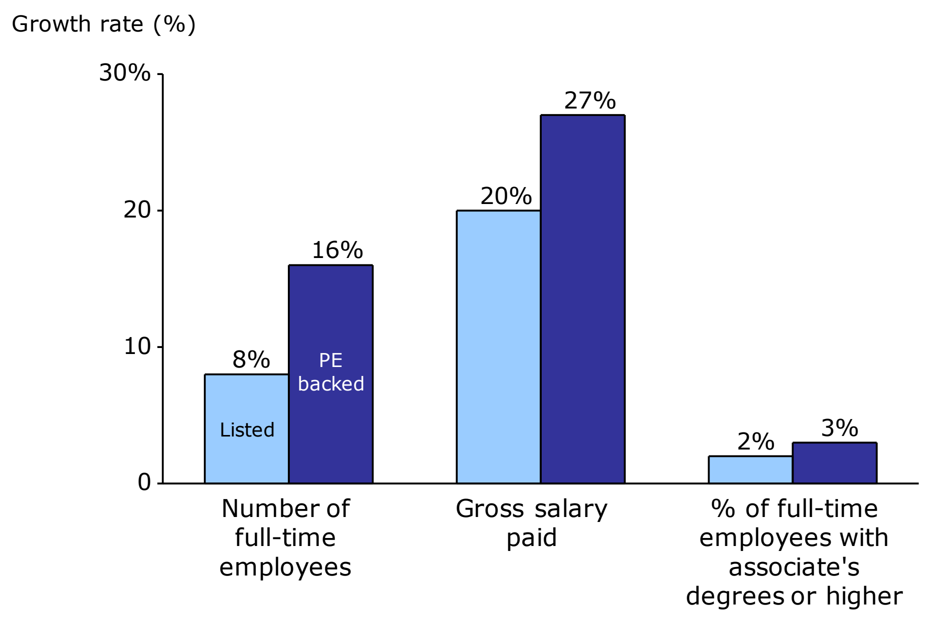
The survey compares the performance of the private equity-backed companies to that of 2,424 public Chinese companies listed on domestic and foreign exchanges such as Shanghai, Shenzhen, Hong Kong, European and American stock exchanges. The analysis covers a range of social and economic indicators, including job creation, wages and salaries, tax payments, employees' educational attainment, revenue, profits and other metrics.

SOCIAL IMPACT 1

Developing people: More jobs, better pay and higher educational attainment

PE-backed companies have a disproportionately large impact by creating more full-time jobs, increasing gross compensation and hiring better-educated workforces (see chart 3). Superior performance in these three areas is one characteristic of a high-performing company on a fast growth track. Based on in-depth interviews, we observed that this focus on quality is especially prevalent at the executive level.

Chart 3 – Human capital metrics comparison



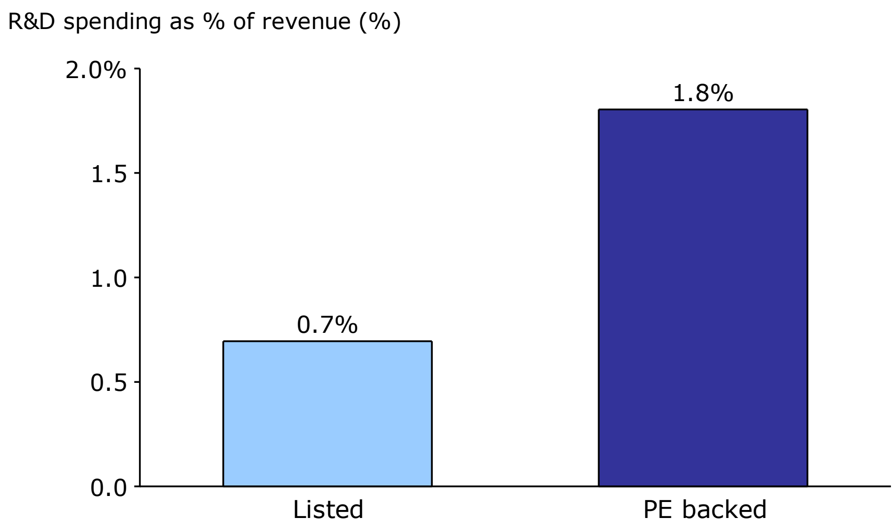
SOCIAL IMPACT 2

Increasing innovation: More R&D spending

Private equity funds provided more resources for research and development and helped to ensure their portfolio companies directed the R&D spending to clearly identified goals. The survey analysis revealed that PE-backed companies spend 1.8 percent of revenues on R&D, more than two-and-a-half times the R&D investments made by publicly listed companies in the survey (see chart 4). PE investors strengthen innovation in two ways: first, by setting clear innovation priorities for their portfolio companies; second, by introducing best practices to increase the productivity of their R&D investments.

> *"We help create a framework for prioritizing R&D opportunities and put in place criteria for decisions around R&D investment."*
>
> **A private equity fund manager**

Chart 4 – Overall research & development spending as a percentage of revenue

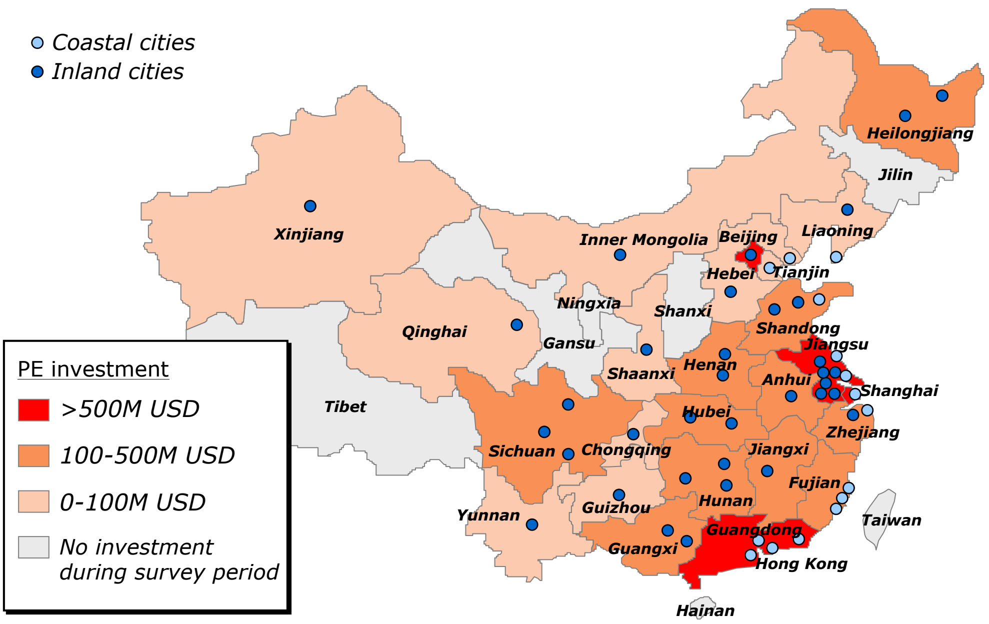


SOCIAL IMPACT 3

Contributing to China's "Go West" policies: Private equity moves inland

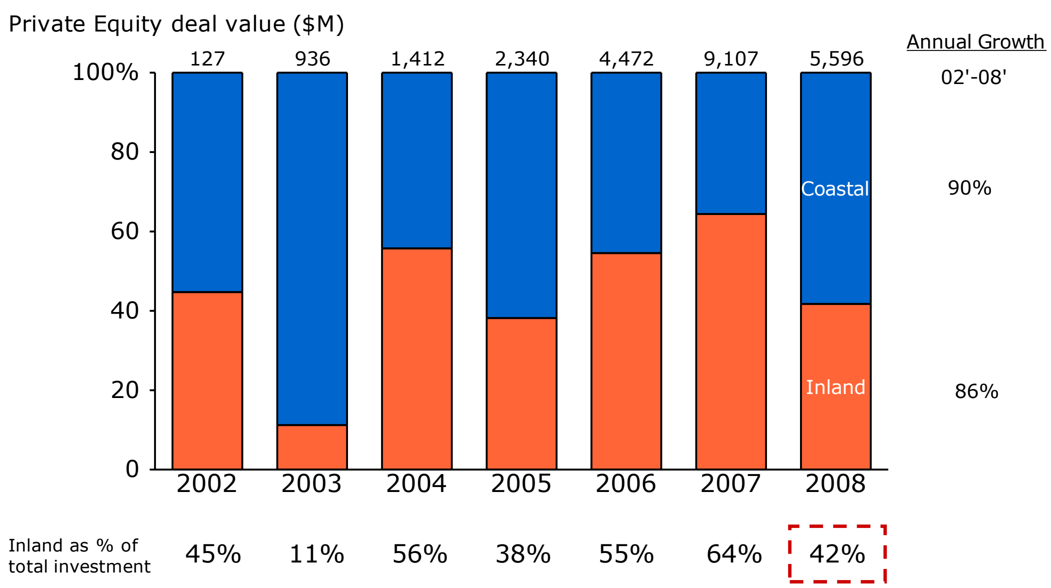
Although they make sizable investments along the coast, private equity funds are also leaving their imprint on China's inland provinces (see chart 5). Since 2002, PE investments have flowed in nearly equal proportion to companies headquartered in inland provinces and those based in more affluent coastal provinces.

Chart 5 – PE investment by geography for deals >US$20M in 2002-2006



The trend toward inland investments accelerated sharply in recent years, slowing somewhat in 2008, when inland companies attracted 42 percent of the US$5.6 billion that PE investors deployed in deals over US$20 million (see chart 6).

Chart 6 – PE investment inland vs. costal



ECONOMIC IMPACT 1

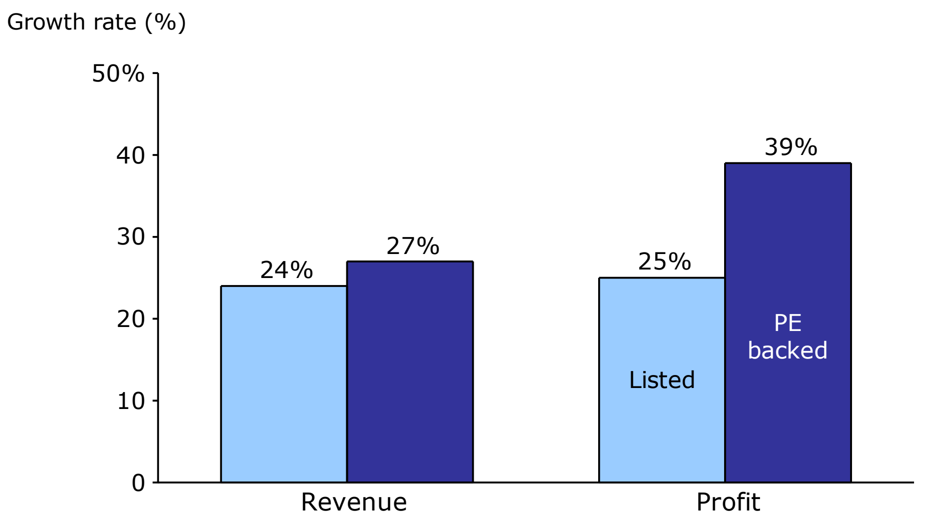
Boosting growth and profitability: PE creates better-run companies

Companies with PE shareholders turned in annual revenue growth that was three percentage points higher than their publicly listed peers. In the year they first received PE investments, the surveyed companies posted total revenue of RMB 535 billion. Two years later, the same group generated RMB 867 billion in revenue.

Despite increasing spending for employee compensation, R&D and taxes, PE-backed firms booked substantially more robust profit growth than the benchmark companies (see chart 7). They posted an average earnings growth rate of 39 percent versus 25 percent for the publicly listed companies in the survey. In the year that funding was received, the surveyed companies had net profits of RMB 36 billion. Two years post-funding, profits of the same group of companies reached RMB 71 billion.

One factor in the steeper rate of profit growth is that PE-backed companies benefit from the transfer of management know-how. This higher profit growth is generally not achieved through reduced employment or lower salaries but through efficient management of costs, information technology and inventories, creating a virtuous circle.

Chart 7 – Revenue and profit growth comparison



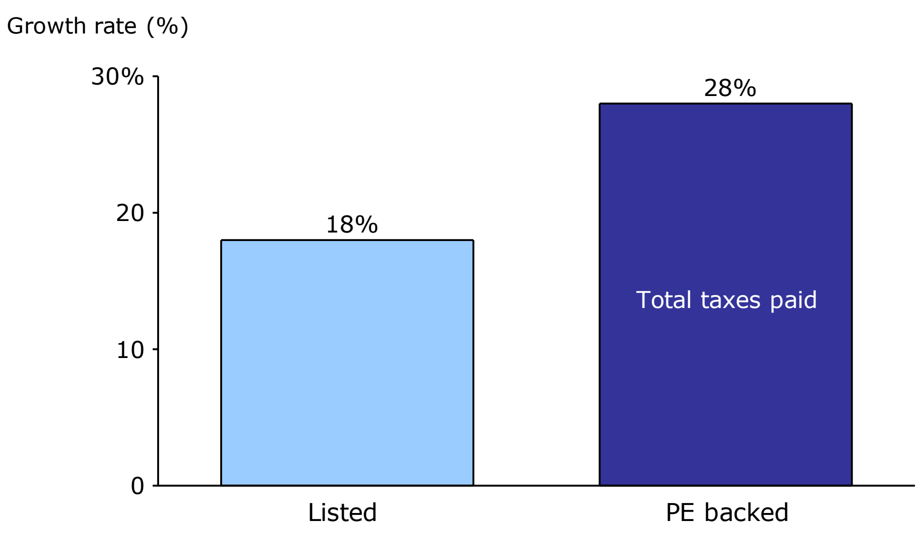
ECONOMIC IMPACT 2

Strengthening corporate governance and increasing tax payments

Interviews with executives at companies that accepted private equity investments revealed that they valued the role their PE partners played in improving corporate governance. Major impacts of corporate governance are improvement of account transparency and tax disclosure. The data show that PE-backed companies yield higher tax payments to the government, and that these have increased at a rate faster than taxes paid of publicly listed businesses since 2002.

During the period covered by the study, total tax payments of PE-backed companies increased at a 28 percent compound annual rate, 10 percentage points higher than those of their publicly listed peers (see chart 8). Due to their status as technology companies or as businesses with foreign investors, many PE-backed companies often enjoy more favorable tax rates than their publicly listed counterparts. Thus, their higher tax payments suggest that PE shareholders bring improved corporate governance with respect to disclosure of taxable income. Finally, it is important to note that the tax payments made by listed companies come under particularly close scrutiny, making the results of this benchmark comparison noteworthy.

Chart 8 – Tax payment comparison

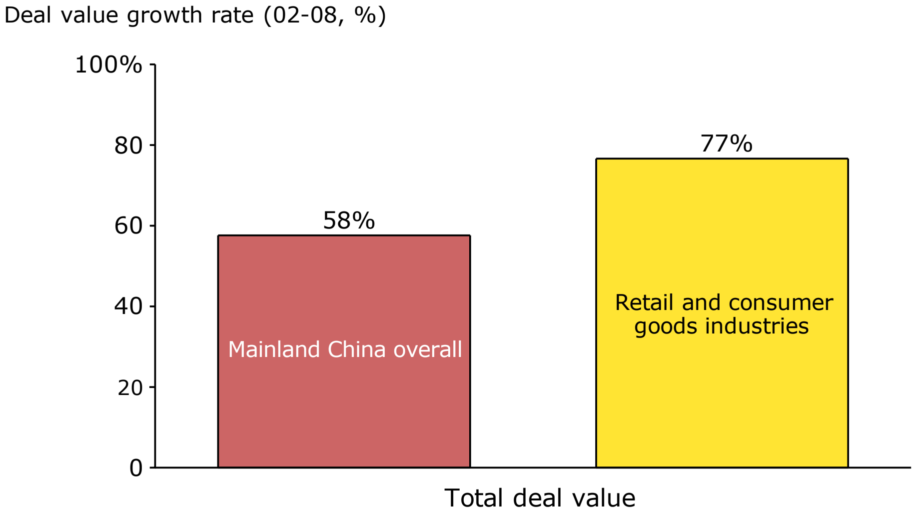


ECONOMIC IMPACT 3

Changing China's business model: PE helps lead the shift toward domestic consumption

Private equity investors are showing strong interest in China's consumer goods and retail industry. While PE investment in China increased by 58 percent since 2002, investment in the consumer goods and retail industries grew by 77 percent (see chart 9).

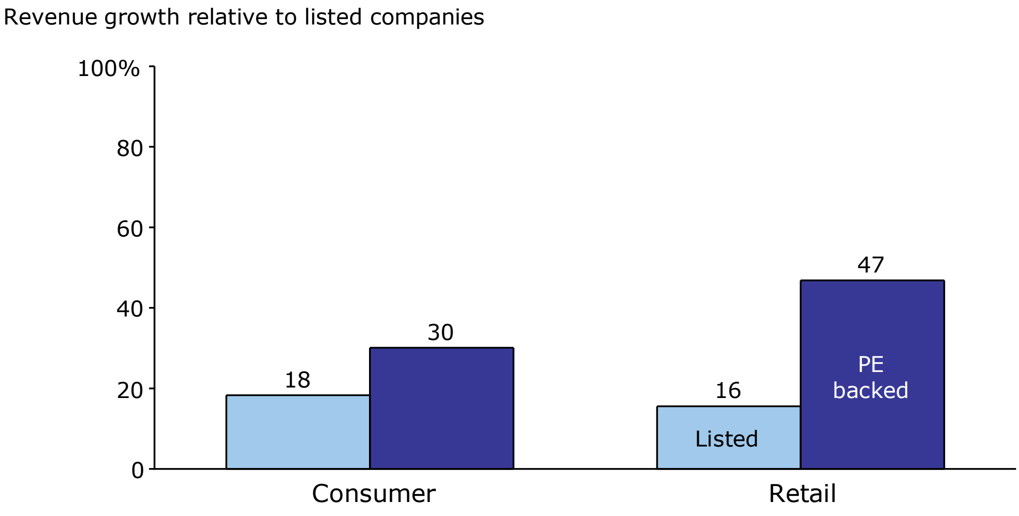
Chart 9 – 2002-2008 total deal value growth rate



PE investments in consumer and retail businesses now rival those made in the traditionally strong IT and media sectors. Accounting for less than one-third of the value of IT and media deals in 2002, consumer and retail investments reached parity with them in 2008.

Private equity's increasing presence in the consumer goods and retail sector is having a positive impact on overall domestic consumption and sales. Retailers backed by PE investors booked sales growth of 47 percent compared with just 16 percent for publicly listed retail companies. While consumer goods companies backed by PE investors booked sales growth of 30 percent compare with 18 percent for publicly listed peers (see chart 10).

Chart 10 – Revenue growth comparison



BACKGROUND INFORMATION

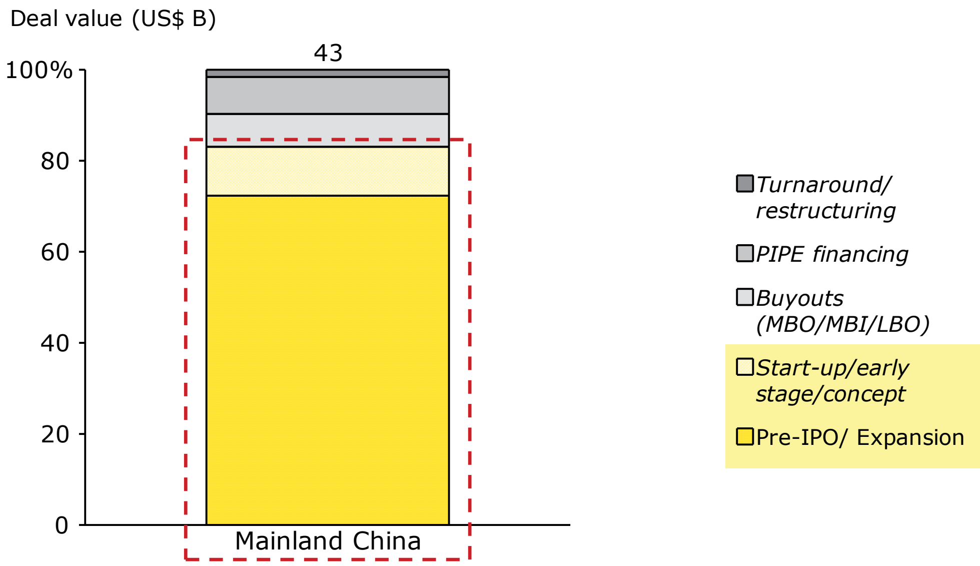
Importance of private equity in China

Investing capital raised primarily from institutional investors, private equity funds typically buy stakes in operating companies. Through boom-and-bust cycles over several decades, PE has developed into a mature asset class. In the global context, and especially in the United States and Europe, PE deals in recent years have been concentrated in buyouts, with private equity investors taking full ownership of the target companies.

Focused on growth capital

By contrast, the private equity industry in China shares characteristics more common to venture capital. The main reason is that, in a sense, much of China's economy has been in high-growth mode. Limited access to expansion capital for smaller and midsize companies and new enterprises have led entrepreneurs to turn to private equity investors for growth capital to fill the breach: More than 80 percent of private equity investments were in the form of capital to finance expansion (see chart 11).

Chart 11 – 2002-2008 total deal value by financing stage in China

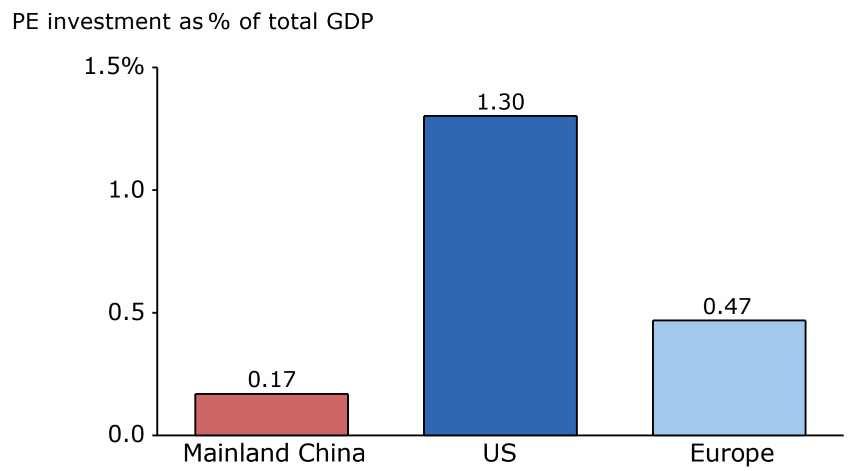


China is Asia's top investment destination for private equity

China has become the top destination for private equity investment in Asia over the past several years. From 2000 through the peak of global economic expansion in 2007, PE deals in China grew at a compound annual rate of 45 percent. Yet, even as new investments slowed in 2008 due to the financial crisis, PE activity in China remained strong relative to other Asian markets. This trend continued through the first half of 2009, as deal volume topped $7.2 billion, nearly matching the total for all of 2008. No other country is recovering as quickly. China is now on par with the region's mature economies such as Japan and Australia/New Zealand as a destination for new investments.

Other indicators point to continued significant growth for PE over the medium term. Today, PE investments in mainland China already represent 0.17 percent of GDP. Significant growth can be anticipated if they were to increase to the European level of 0.47 percent of GDP or the 1.3 percent level in the U.S (see chart 12).

Chart 12 – PE investment as a percentage of total GDP in 2008



	Mainland China	US	Europe
GDP	$4,320B	$14,280B	€11,523B
PE investment	$7.3B	$186B	€54B

Evolving trends that could impact China's private equity industry include, among other things: the introduction of RMB-denominated funds; the closer alignment of domestic regulations with international principles; collaboration with global funds to diversify portfolios; the introduction of industry best practices for limited partners and general partners operating in China; and higher levels of participation by domestic institutional investors and funds of funds investing in private equity.

Private equity glossary

The most common investment strategies in private equity include leveraged buyouts, venture capital, growth capital, distressed investments.

- **Leveraged buyout:** Also called LBO or buyout, this is a strategy financial sponsors employ to acquire a majority stake in a company, business unit or business assets from the current shareholders, typically using a combination of equity and debt. The target companies involved in these transactions are typically mature and generate healthy operating cash flows.

- **Venture capital:** This is an equity investment made to finance the launch, early development or expansion of a business. Venture investing is most often found in the application of new technology, new marketing concepts and new products that have yet to be proven, and it usually involves acquiring a minority stake in the business.

- **Growth capital:** This is an equity investment made most often to acquire a minority position in a relatively mature company that is looking to expand or restructure operations, enter new markets or finance a major acquisition without ceding control of the business.

- **Distressed investments:** Distressed, or special, situations are a broad category referring to investments into financially troubled companies. Investors may acquire debt securities in anticipation of taking control of the company's equity after a corporate restructuring. Investors may also provide "rescue financing" typically a combination of debt and equity to companies undergoing operational or financial challenges.

- **Limited Partner (LP):** A LP is an investor in a fund. It has a share of ownership in a private equity partnership but takes no part in managing it. LPs are liable only up to the amount of their original investment in the partnership.

- **General Partner (GP):** A GP is a fund manager. He takes part in the daily operations of the private equity partnership and is personally responsible for its liabilities.

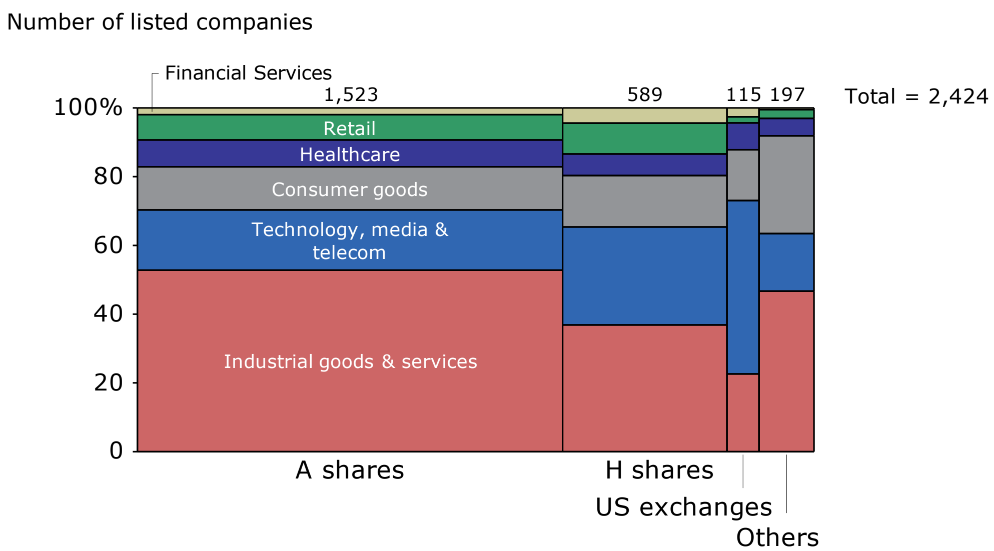
- **Fund of Funds:** It is a pool of capital that invests in several private equity funds. Its own investors are large institutional investors like pension funds or insurance companies. High net worth individuals and relatively small institutional investors participate in a fund of funds to minimize the effort and costs related to managing their portfolio.

Methodology

Benchmark selection

In the Survey, Bain compared the 100 companies that received private equity investments with 2,424 publicly listed companies having major operations in China. Of these, 1,523 companies listed on the Shanghai and Shenzhen stock exchanges. The study also included 901 Chinese-affiliated enterprises listed on other major exchanges around the world, including exchanges in Hong Kong, Korea, Singapore, Europe and the United States. To qualify for inclusion, a company had to be headquartered in China, have China as its primary geographic location or have the words "China" or "Chinese" as part of its name or in its business description (see chart 13).

Chart 13 – Listed companies included in the analysis as benchmark



To better evaluate the relative performance of companies that had received private equity investments, Bain developed a company databases to create benchmarks. This database included publicly listed companies having major operations in China from six industries—retail; consumer goods; industrial goods & services; healthcare; financial services; and technology, media & telecommunications. In order to perform industry-level analysis, each listed company was assigned to one of the six industries.

Relative performance

To determine the performance of the 100 private equity-backed companies in the survey relative to the benchmark groups, Bain first calculated the growth in the relevant metrics for the private equity-backed company and for both benchmarks for the two-year period beginning from the most recent investment by private equity investors. Thus, the performance of private equity-backed companies that received their initial infusion of PE capital in 2002 was compared against that of the benchmark group for the identical two-year period, 2002 through 2004. Finally, to aggregate the results from different time periods, the weighted average of the relative performance of each company over the relevant period was computed to come up with its overall performance for each metric examined.

Sources & Notes

Chart 1:
Source: AVCJ; Bain analysis

Chart 2:
Source: AVCJ; Bain analysis

Chart 3:
Source: AVCJ; Capital IQ; China statistics yearbooks; company annual reports; Bain analysis
Note: Analysis based on weighted average compound annual growth rate or CAGR (except for percent full-time employees with associate's degree or higher, which used weighted average annual rate) of 100 companies involved in deals above US$20M during 2002–2006; listed companies benchmark use 2002–2008 weighted average

Chart 4:
Source: AVCJ; Capital IQ; China statistics yearbooks; company annual reports; Bain analysis

Chart 5:
Source: AVCJ; literature search; Bain analysis
Note: Analysis based on companies receiving private equity investment above US$20M during 2002–2006; Real estates deals are excluded; financial deals excluded are megadeals of Industrial Bank, Bank of China, China Construction Bank and Bank of Communications

Chart 6:
Source: AVCJ; Bain analysis
Note: Real estates deals are excluded; financial deals excluded are mega-deals of Industrial Bank, Bank of China, China Construction Bank and Bank of Communications; all other deals above US$20M during 2002–2008 included

Chart 7:
Source: AVCJ; Capital IQ; China statistics yearbooks; company annual reports; Bain analysis

Chart 8:
Source: AVCJ; Capital IQ; China statistics yearbooks; company annual reports; Bain analysis

Chart 9:
Source: AVCJ; Bain analysis

Chart 10:
Source: AVCJ; Capital IQ; China statistics yearbooks; annual reports; Bain analysis

Chart 11:
Source: AVCJ; Bain analysis
Note: Data including deals in mainland China from 2002 to 2008, excluding real estate deals

Chart 12:
Source: AVCJ, Euromonitor, Pitchbook, European PE & VC Association, Bain analysis

Chart 13:
Source: Bain analysis

Private Equity Glossary:
Source: http://biztaxlaw.about.com/od/glossaryl/g/limitedpartner.htm
Source: Private Equity Glossary, Foster Center for Private Equity

Acknowledgement to contributors & contact information

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- First and foremost, to private equity fund managers and management teams who answered our questionnaire and in-depth interviews
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About the European Union Chamber of Commerce in China

The European Union Chamber of Commerce in China was originally founded by 51 member companies based in China on October 19, 2000. The rationale for the establishment of the Chamber was based on the need of the European Union and local European businesses to find a common voice for the various business sectors. Nine years after its foundation, the European Chamber now has a total of more than 1400 members in seven chapters: Beijing, Chengdu, Nanjing, Pearl River Delta (Guangzhou and Shenzhen), Shanghai, Shenyang and Tianjin. The Chamber is recognized by the European Commission and the Chinese authorities as the official voice of European business in China.

The European Chamber is an independent member-driven, non-profit, fee-based organization with a core structure of 28 Working groups and 6 Forums representing European business in China. The Chamber is directed by a President and Executive Committee elected each year by and from its members.

About the European Chamber Private Equity and Strategic M&A Working Group

Established in 2008, the working group is established at a national level and is a platform of exchange and expertise on PE and M&A related issues for its members, as well as a communication platform with the Chinese and European governmental authorities on topics of long-term benefit for the European investment community in China. The objective is to achieve a level playing field among all market participants and brings an active contribution to the development of the industry.

Its deliverables include the annual Position Paper on PE and strategic M&A, regular meetings and workshops in several Chinese cities (with professional associations, fund managers, governmental entities), as well as the annual survey on the Social and Economic impact of PE in China.

Members include first and foremost PE and VC fund managers related to Europe or from funds of European origin, as well as heads of M&A for large corporations. The working group also includes all advisers working on PE and M&A matters.

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About Bain & Company

Bain & Company, a leading global business consulting firm, serves clients on issues of strategy, operations, technology, organization and mergers and acquisitions. The firm was founded in 1973 on the principle that Bain consultants must measure their success by their clients' financial results. Bain clients have outperformed the stock market 4 to 1. Bain & Company is the leading management consulting firm advising private equity funds (three times larger than the next largest firm). For more information visit: www.bain.com.

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