
Event Report

2009 China Business Conference: “The Private Equity and Venture Capital Outlook”

APRIL 10, 2009

On April 10, 2009, Columbia Business School held its second annual China Business Conference. The Private Equity/Venture Capital panel presented a near-term industry outlook from the perspective of both general and limited partners. Industry insiders included: moderator Daniel R. Mintz, founding managing director of Olympus Capital Holdings Asia; Feng Deng, founding managing director, Northern Light Venture Capital; Rodney J. Dillman, president of MassMutual International; Gregory Mark Hill, managing director of Trenwith Securities; Ling Liu, managing director of The Cathay Capital Group; and Mike Strauss, vice president of Institutional Sales at Westminster Securities.

China has been the fastest-growing major nation for the past quarter of a century with an average annual GDP growth rate above 10%. However, the global financial crisis and the concomitant fall in global export demand have slowed China's growth to its lowest level in nearly a decade. China's economy, the third largest in the world, grew 6.1% in the first quarter of 2009, down from 6.8% last quarter and from 13% for all of 2007. Despite such recent headwinds, experts featured in the Private Equity/Venture Capital Panel at the 2009 China Business Conference are confident of a pending recovery and share an optimistic outlook of private equity in the region.

Private equity in China is still very much in its early stages in comparison to the U.S. As a result, there are still investor concerns ranging from regulatory hurdles and financial transparency to capital market liquidity. But according to Daniel Mintz of Olympus Capital Holdings Asia, private equity in China has recently transformed from an exotic asset class to a

mainstream one in a relatively short time. Private equity deals in China cut across industry segments, with approximately \$10 billion in deals executed last year even in the face of market adversity. China is now one of the largest destinations of private equity in Asia, second only to Japan. Rodney Dillman of MassMutual International commented that China is poised to satisfy the broader industry’s investment preferences: a three to seven year holding period, a 25% to 30% internal rate of return, investing partners with similar expectations, and aligned strategic needs with management.

Feng Deng of Northern Light Venture Capital focused on the similarities between venture capital in the U.S. and China. In fact, China’s venture capital industry resembles that of the U.S. 20 years ago, as early Chinese venture capital investors learned the dynamics of the trade from their U.S. counterparts. From term sheets to investment structures, the Chinese took their cue from the Americans, and did so at a much faster pace. Indeed, private equity funds more closely resemble venture capital funds, as they prefer to inject growth capital in local businesses.

As such, the blockbuster takeovers characteristic of American private equity are seldom seen in China. In a country where the largest companies are still controlled by the state, owners are particularly hesitant to relinquish majority control to foreign investors. Yet another deterrent to leveraged buyouts in China is the difficulty in replacing top executives. Since the role of business owner and manager is often combined, leadership change can be challenging. Furthermore, finding professionals equipped to navigate tenuous economic conditions can be an arduous task. This is not to say, however, that private equity investors are giving up on control.

Ling Liu of The Cathay Capital Group and Gregory Mark Hill of Trenwith Securities discussed the notion of control in China. In this case, 51% ownership does not necessarily translate into control, and conversely, one can own 80% and control nothing. In such an environment, Ms. Liu attested, negative control in the form of veto power is an attractive tool to wield managerial influence. By contrast, Mr. Hill stated preference for the “carrot and stick” approach. Often times, “carrots,” representing incentives like granting management international market access, are more effective than “sticks,” reflecting punitive threats like the exercising of veto power. By giving management the opportunity to participate meaningfully in the future growth of their company, control investments can indeed represent a lucrative investment opportunity going forward.

The panelists also noted that appreciating cultural norms is absolutely pivotal. In Chinese culture, trust built over time transcends contractual obligations. The depth of relationships is

more important than the breadth. Thus, a successful investor must not merely solidify his relationship with a chairman but also the chairman’s close friends, family, and advisors. As Feng Deng attested, “localization is very, very important,” thereby underscoring the need for a comprehensive understanding of the local cultural norms.

Despite the aforementioned challenges associated with investing in China, the panelists shared an optimistic outlook for the future of private equity in the world’s most populous nation. Mike Strauss of Westminster Securities claimed that China is better positioned than the U.S. to emerge from the economic and financial crisis. The reason is that while many consider the American financial system to be broken, the Chinese financial system remains relatively healthy as banks continue to lend. Moreover, as the U.S. funds its stimulus package through deficit spending, China relies on a fiscal surplus to fund stimulus initiatives poised to spur domestic demand. Private equity investment will undoubtedly be a key component of China’s future growth, but investor success relies on a keen understanding of control investing and the broader cultural implications.

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