Players

The personalities and the power behind the deals

"Demand for Islamic-finance solutions isn't just coming from the Middle East — it's worldwide."
— *"Middle East Meets West," p70*

— "Middle East Meets West," p70

M&A Q&A

China Syndrome

The hottest deal market in the world is also the most complicated. In a freewheeling roundtable, three pioneers decipher the mysteries of Chinese buyouts and investing **BY RANDALL LANE**

There are only two kinds of deal professionals these days: those who have done transactions involving China, and those who are thinking about doing so. We're a long way from the early-'90s foibles detailed in Tim Clissold's roman à clef *Mr. China,** when attempting to manage the "institutionalized confusion" of the country's peculiar blend of Marxist capitalism ended up giving Clissold, a pioneer in this most desirable market, a heart attack.

These days, the People's Republic is hot. Some 110 private-equity firms plowed $1.7 billion into 145 Chinese deals last year, according to Thomson Financial, and that doesn't count hundreds of other venture investments, mergers and partnerships.

Those figures aren't lost on the Association for Corporate Growth, which will host its thirty-sixth annual InterGrowth conference in Phoenix around the time you read this. The big emphasis: China, both its Byzantine processes and its phenomenal opportunities. In advance of the conference, *Dealmaker* pulled aside several big China players for a frank discussion about the opportunities and perils the country presents: Andrew Rice, senior V.P. for international business at the Jordan Company, an $8 billion private-equity fund in Chicago; Anna Cheung, investment director for Hong Kong capital growth at New York–based 3i; and T. Patrick Hurley, founder and managing director of Philadelphia's Midmarket Capital Advisors. With a collective two dozen–plus China deals under their belts (Cheung herself is originally from Hong Kong), they provided a candid look at the state of the deal market in the world's most potent economy.

T. Patrick Hurley (left), Andrew Rice and Anna Cheung all see gold in formerly red China.

EVERYONE READING *DEALMAKER* IS SURELY INTERESTED IN DOING DEALS IN CHINA. WHAT'S THE FIRST STEP?

CHEUNG: You probably need a couple of trips. The first contact may be from here, but

Photographs by MATTHEW FURMAN

until you get there you really won't be able to set up meaningful, helpful meetings or meet the right people.

RICE: The process is going to take two or three times as long in China as in the U.S. There's not a well-established network of brokers and intermediaries. In the U.S. and Europe, you can say, "I'm looking for this kind of deal," and the intermediaries come out. There's not a lot of good primary research available on Chinese industries, though you can find firms — consultants, lawyers and accountants — that can help based on their relationships. But it's a long process and a big commitment. I think it requires a couple of trips to get started, but once you get going, it takes monthly trips for a year just to get the deal done. And then your operations guy is going to be going there two weeks a month for six months.

CHEUNG: Either you do it or you don't; there's no halfway. "Fly in and let me try to do something and see how it works" is really difficult. Even *Fortune* 100 companies who have been there spend 10 years, and they're still learning every day.

RICE: The laws are changing constantly, so even for people based on the ground there, it's something of a moving process.

PHOTOGRAPH BY MATTHEW FURMAN

SCORECARD

Andrew Rice

Age 50

City Chicago

Firm The Jordan Company

Position Senior vice president, international business

Education B.S. in industrial engineering and M.S. in engineering administration from New Mexico State University

Career Arc Held business development, strategy and marketing positions at Ameritech, IC Industries and Pillsbury prior to joining the Jordan Company in 1989.

Really Big Deal TJC's 2006 acquisition of Jixi and Jiamusi, two previously state-owned coal-mining machinery companies. It was the firm's largest Chinese deal to date, making it the first foreign firm to own 100 percent of an SOE in the Northeast region.

> "The laws in China are changing constantly. It's really a moving process."

HOW DO YOU GET COMFORTABLE WITH INFORMATION YOU GET FROM CHINESE COMPANIES? HOW DO YOU ENSURE ACCURACY?

RICE: The initial information you get is often not accurate based on Western standards. When you ask about sales, a lot of private companies will tell you the most optimistic view of what the next year is going to be. With profits, a lot of times Chinese accounting is different from our GAAP accounting, and when you reconcile that, it typically reduces both sales and profits.

But once you do due diligence, there are a lot of very good law firms and accounting firms that can go in and do a proper, full-blown due diligence and get accurate information that you can use.

CHEUNG: It's more art than science. You can spend as much money as you'd like hiring the best to do due diligence, but if the company doesn't provide the right information, you're not analyzing the right information. So a lot of times, it's experience. There might be touch points. You ask certain questions, and you can tell if you trust someone. You have to be on your toes.

RICE: In a lot of state-owned enterprises, the mentality is production-oriented. So it's common that if you ask a plant manager what his sales are, his view is "We can make a million units and we'd like to price them at $100 each, so our sales are $100 million." But ask more questions: How many units did you ship last year? "Well, we made 600,000 units, not a million." How many of those did you *ship?* And the answer is 400,000. So they made 600, shipped 400 and the rest are in inventory. You start to get a picture.

CHEUNG: A couple of years ago there was a darling IPO called EuroAsia. It was the tulip king; he owned tulip farms. A couple of years later, the company went bankrupt in part because the numbers were wrong. So a listed company can have that happen, and it's all audited. I've personally walked away from deals where the numbers are great but I had a gut feeling that something wasn't right. I might be wrong, but I'd rather walk away than be sorry later.

HURLEY: It's important to have a resident Chinese who has either represented or worked for a Western company; he can help you know how to think about what you're approaching. I've been out on some primary research visits. Chinese companies are always happy to have Western visitors. And if there are two or three Chinese-speaking people who talk with the general manager, who might not even know who his owners are, you'll get different stories that will eventually be able to be woven together.

CAN YOU PLAY IN CHINA EFFECTIVELY WITHOUT SPEAKING MANDARIN OR HAVING LIVED THERE?

CHEUNG: My view is no.

RICE: I've been there 18 times in the last two years, and I don't speak the language — but we have a whole team on the ground that does. I've been doing business in China for over 10 years, so I've read a lot about the culture, the way businesspeople think and their negotiating mentality. So when I'm talking, even though I have translators, I understand how it works. But the serious negotiations are done by our Chinese colleagues on the ground. It would be very hard to consummate the deal and manage the investments afterward without those folks.

HURLEY: But if you're going over there, you can't just have a translator. You have to have a translator who knows how you think and process information, and who can convey subtleties that you can't.

RICE: I visited a company with one of our operation guys. We had our own person translating. I visited the factory and didn't like it. I was just trying to be nice, so I said, "This is a great operation. You must be

* FOOTNOTE

Jack Perkowski, the real-life Mr. China richly chronicled in Tim Clissold's book of that name, raised $420 million in the early 1990s. Although the thinly veiled story of his venture-capital firm reads mostly like a cautionary tale of what not to do in China, the company yielded vehicle-parts maker Asimco Technologies.

proud of the wonderful company you have." His translator said something, and my guy said, "No, that's not what he said." His translator had told him I said, "He loves the factory and wants to buy your company."

GIVEN THAT CHINESE PUBLIC MARKETS ARE ESPECIALLY LIQUID, WHAT'S THE SPREAD BETWEEN PUBLIC AND PRIVATE VALUATIONS?

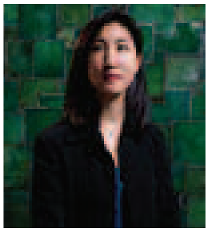
RICE: This could be fun. Right now the public markets for larger companies are way out of whack — prices are 40 or 50 times earnings. The Jordan Company plays mainly in the private-market space. We're in Heilongjiang province, out of the main cities. There's still a mentality with most private business people and government officials in those areas that the business is worth net-net asset value, which is book value. If you pay a 20 to 40 percent premium, you might have a business doing $50 million in sales, making $10 million pre-tax, that has a book value of $20 million.

There are all sorts of deals where they'll say, "Great company. We'll pay you a 50 percent premium over book value, and you get it for three times EBITDA. There are many of those — smaller deals, typically. And they're not in the Shanghai/Beijing area.

HURLEY: Most Chinese have no concept of ownership or thinking about value, especially when dealing with the government. You talk about what a company is worth — they refer to these asset exchanges, but they don't think in terms of the earnings multiples or even what liabilities a buyer might be expected to assume. So you're really starting from scratch. It's about how much you're going to invest in the company, because often the seller or owner is more interested in what happens to the company and its ability to grow than what you would pay them. Most of them think in terms of how much money is going to go into the company instead of into the owner's pockets.

"I've walked away from deals where I had a gut feeling it just wasn't right."

RICE: We just acquired the two largest coal-mining equipment companies in China in Heilongjiang, which is the northernmost province. We were the first U.S. company to buy 100 percent of an SOE as part of a restructuring program in the Northeast region, which is former Manchuria.



SCORECARD

Anna Cheung

Age 39

City New York

Firm 3i

Position Investment director, Hong Kong capital growth

Education B.A. in computer science from Berkeley; MBA from the University of Pennsylvania's Wharton School

Career Arc Held positions in corporate finance, capital markets and M&A with Salomon Brothers in New York and Bankers Trust in Hong Kong, followed by three years with Intel Capital and J.H. Whitney, focusing on telecommunications and information-technology investments in North Asia. Joined 3i's Hong Kong office in 2001.

Really Big Deal Was half of the two-person team that completed the 2003 Euro300m refinancing and merger of Fonecta, Telefoongids and Mediatel to create Yellow Brick Road, the most geographically diverse directory group in Europe.

We went in and said, "We'd like you to restructure the company before we buy it." So they took pension obligations — 6,000 of their pensioners were off the books. All these big state-owned enterprises have schools, hospitals, physical plants for steam heating for the communities. We said, "We'd like you to carve that out and work with us on back taxes and bad bank loans." We reached an agreement on all those things before we did the deal. You have to be very patient with a lot of these government officials, because this is totally new to them.

CHEUNG: Valuation has definitely gone up in the last few years. Chinese private equity started in the early 1990s, but it really took off starting around the dot-com days, 1999 and 2000. It started as a venture-type market, turned more into growth and is now developing into buyout opportunities as well.

Historically, most of us have invested through offshore entities. We're not doing direct money into China, because repatriation of funds could be an issue — your exit could be a hurdle. Our exits are usually selling these offshore entities to other foreign investors, or maybe an IPO. That was also because the domestic capital markets were not yet developed. It was a mess. There's a conscious effort on the part of the Chinese government to fix that. They don't want to see all the money going out.

A couple of things are happening: The Shanghai market is coming into play now, so there's another option for people to raise money. Our competition is not just each other — a lot of times these companies just list domestically. Obviously, the choice is listing first, so that's one thing. And the valuation is pushed up by the capital markets.

HOW DO YOU BALANCE THE DISPARITY BETWEEN FROTHY PUBLIC VALUATIONS AND MORE MODEST PRIVATE VALUATIONS?

HURLEY: Most buying out of joint-venture partners has to do with some fair market-value determination separate from where a Chinese company might be trading publicly. So if you're Federal Express or UPS or Aramark, you've had a joint venture and now you're buying out that partner, they've learned to think about value the way Westerners do. Because consolidation is forced by the government, nobody cares about price there. In the joint-venture world, you've got Western managers who have focused on profits for a long time, so the Chinese sellers in those particular cases are getting Western values.

CHEUNG: That's more the case with strategic investors. The kind of deals private-equity investors do are, unfortunately, generally more closely linked with the capital markets.

PHOTOGRAPH BY MATTHEW FURMAN

RICE: *Fortune* 500 companies are not very good at managing entrepreneurs, so private-equity firms in the U.S. and Europe play a valuable role: acquiring companies, consolidating the industry — you buy 10 or 15 companies and put them together — and then over three to five years, you bring in professional management, put in proper systems and the entrepreneurs retire. Then it's easier to sell a good company or do an IPO. The same opportunities will be available in China. There's a huge market for these smaller private companies — $5 million to $30 million — that either aren't big enough or just aren't ready to go public.

CHEUNG: We're slightly different. We're comfortable doing minority investments. We did a dozen deals in five years in China — all minority investment, all about backing management teams to grow the business. The other type of investing works as well.

SOME OF OUR READERS SAY THEY AREN'T SURE WHAT TO DO ABOUT BRIBES, ESPECIALLY WHEN ACCEPTING THEM IS A VIOLATION FOR SOME U.S. COMPANIES.

RICE: We have a very strict policy of not paying bribes. With some of the companies we've invested in, we've been suspicious that there might have been some of that activity. In those cases, we set up an asset deal. With some businesses, after we've invested somebody wants a payoff, and we won't do it. We've lost a lot of future business. At the end of the day, the Chinese government knows there's a transition.

CHEUNG: There may be gray areas where by American standards it's bribing, and the Chinese say, "That's how we do things in China." For investing, I think it's easy to steer clear of it. But in doing business, in terms of gift giving, do you call it a bribe or do you call it entertainment? Each company needs to be clear about what it's going into.

RICE: The Foreign Corrupt Practices Act is an American rule, and we have to follow it very strictly. If I know that one of our companies is doing something that violates it, I can go to jail. In our opinion, there really is no gray area. That makes it difficult, because in some industries, the company buying your product expects something in return. We just cannot do that.

HURLEY: In the business community, the Chinese are wary of one another. There's no sense of disclosure unless it's absolutely required, so no one considers it unusual not to tell you that someone they're directing business to is a family member. There's no sense that it might not be appropriate.

RICE: That's an interesting point. For a lot of our deals, we'll do a Kroll Associates–type analysis. We'll perform a complete background check on the company and the owners, and all of this stuff gets disclosed. In these little towns, everybody knows everything.

SCORECARD
T. Patrick Hurley

Age 50

City Philadelphia

Firm Midmarket Capital Advisors

Position Founder and managing director

Education BBA in accounting from Temple; MBA from Drexel

Career Arc In 1979, started at Howard, Lawson & Company, which eventually became the M&A unit of FleetBoston's capital-markets group. Left as head of Fleet M&A Advisors' Philadelphia office to found Midmarket Capital in 2002.

Really Big Deal Advised $50 million dental manufacturer Imaging Sciences International on its January 2007 sale to the Danaher Corporation.

HURLEY: Yet if you ask the question, it's a short response and it's incomplete.

RICE: Right. And once you have the information, it's awkward. What you don't want to do is have an agreement with the government that you can invest in a business and lay off 10 percent of the workers, and then accidentally lay off the nephew of the mayor. They're never going to tell you that by the way, this man is the mayor's nephew. You need to get that information somehow so you don't do something awkward.

THERE'S SO MUCH GROWTH IN PRIVATE INVESTMENT, SO MANY MORE FUNDS FOCUSING ON CHINA. WILL THERE BE A FALLOUT?

RICE: If you analyze most publicly traded companies in China, it's hard to come up with any underlying rationale for the valuations. When I speak with people who play a lot in that, they say it's strategic. China is big. More and more people will move into the middle class over the next 10 or 20 years. You're investing in a franchise, investing strategically so the reality of the investment is going to catch up.

THAT SOUNDS A LITTLE BIT LIKE THE PROMISES OF THE DOT-COM ERA.

RICE: Most of our companies are in the U.S. or Europe, but everybody wants to source in China and sell in China. Sometimes they want to manufacture or do an acquisition to get a foothold, but when you translate that into the public markets for these valuations, that's where there's more of a leap of faith. Having said that, there are pockets where these investments are very real and easily justifiable.

For example, until two years ago it was against the law for foreign companies to market, distribute or sell products that they didn't make themselves in China. Now that the laws have changed, there's a lot of opportunity in retail and a lot of consolidation opportunities.

The other thing is when you have a company, you pay a 17 percent VAT. Most of that tax goes to the city and province where the company is headquartered. So if you had a company in one province and wanted to acquire a company in another, the other province wouldn't want that. Now they're working out ways where you can own a business that has manufacturing and distribution throughout China, and they'll divide up the VAT. A lot of rules of doing business in China are changing in a positive way.

CHEUNG: You have to take a long-term view. Europe is not growing very fast. The U.S. is not growing very fast. The growth is in Asia. I believe 25 percent of the deals we did last year globally had a China element, but it's not just China. You have to look at it as a cross-border thing. It's just going to keep growing. D

PHOTOGRAPH BY MATTHEW FURMAN