A New Strategy for M&A, Buyouts & Corporate Acquisitions in China

Sourcing and executing successful corporate acquisitions and buyouts from unexited PE deals in China

CHINA FIRST CAPITAL
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For strategic acquirers and financial investors targeting control deals in China, the large overhang of over 7,500 unexited private equity deals presents an **unprecedented opportunity.** The challenges of executing M&A deals in China remain. But, at no previous time was the environment as favorable to identify and close, at attractive valuations, the acquisition of a profitable, high growth, well-run, larger (+USD$50mn revenues) private business in China.

The reason for the positive change in the environment for control deals in China is the serious degradation in the environment for minority ones. Specifically, China's private equity industry is in a state of deepening crisis. Having financed the growth of many of China's best private companies, the PE firms are now finding it **increasingly difficult to engineer a liquidity event** before the expiry of their fixed fund life. They are emerging as distress sellers of desirable assets.

This M&A strategy memo is directed towards all **three classes of potential acquirers** -- 1) global businesses seeking China market entry; 2) corporate acquirers seeking market or margin expansion in China through strategic or tuck-in acquisitions; 3) China domestic or global buyout firms seeking quality operating assets that can be built up and sold. Their methods, timetable, metrics and deal targets will often differ. But, all three will find the current situation in China **more suitable** than at any previous time for executing M&A **transactions of USD$100mn and above**.

IPO valuations for Chinese companies reached their apex in 2009-2010. Since that time, IPO multiples began to come down sharply, then activity fell off before all IPO activity stopped entirely, first in New York, then Hong Kong and finally in China itself. Regardless of when IPOs resume and at what p/e multiple, the current situation in China is one of **large systemic uncertainties and limited exit options.** For investors, owners and acquirers, the result is the beginnings of a **genuine market for corporate control for private sector businesses in China.**

The industrial logic of doing acquisitions in China has never been in doubt. The scale, high annual growth rate and fragmented nature of China's domestic economy all create a powerful attraction for control investors. The challenge has traditionally been a negative selection bias on the sell-side, that the Chinese companies available for purchase are often troubled, state-owned, inefficient or poorly-managed. **China's best corporate assets**, its larger private companies, were not previously available to control investors.

The exit crisis in China PE creates an **opportunity for acquirers to realign China M&A strategies.** The target set will become both larger and higher in quality. Deals should be easier to execute, and then easier to integrate and manage after acquisition.

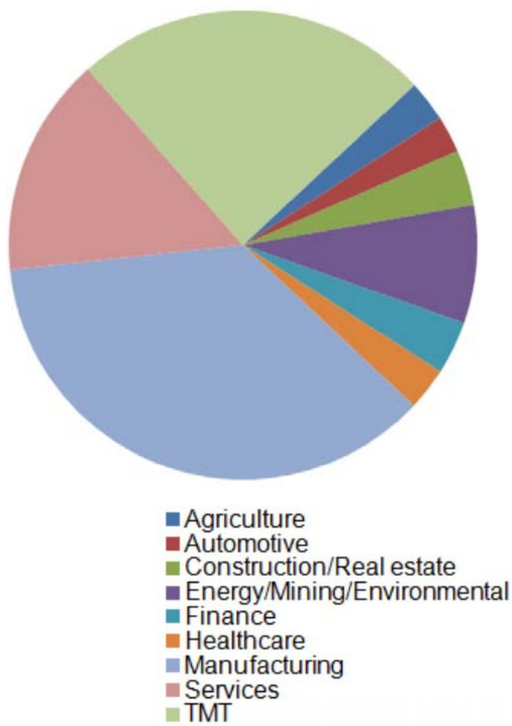
Looking ahead, we expect to see a significant increase in M&A deals targeting PE-invested companies in China. Trade sale has long been the most common exit route for institutional investors, including VC and PE, in the US and Europe. China's PE industry was always an anomaly, with its reliance on IPOs as a single unhedged exit strategy. **M&A is a necessary and attractive option** for a China PE industry urgently in need of exits.

For acquirers, the primary M&A strategy now in China should be to **"capture created value"** . That is, to buy control of businesses that since the time of the original PE investment have delivered sustained robust operational improvements through EBITDA margin expansion and revenue growth. These targets optimally are now leaders in their industry sector, with established brands, products and distribution. Such companies have scope to grow strongly in years ahead, particularly if the **acquirer commits new capital** to finance future expansion.

The opportunity to add capital and stimulate growth, though operationally relevant for all potential acquirers, is particularly important for buyout investors. The difficulty of financing control deals in China with bank leverage mean that buyout firms must generate **positive investment returns** by building a larger business, measured by revenues and profits.

Guidance: Premium assets in China will not necessarily be valued at premium prices. We expect M&A valuations in China to remain at moderate levels, meaning 5-11X last year's EBITDA or net income. The large number of unexited China PE deals will act as a ballast preventing M&A valuations from becoming too buoyant.

Unexited China PE Deals By Industry



While the number of attractive targets is increasing, the **complexities of doing M&A in China remain**. The invested PE firms are almost always minority investors. A control transaction will need to be structured and staged to incentivize the majority owner (usually the company's founder and CEO) to sell at least portion of his holding alongside the PE firm, and then likely remain for at least several years at the helm.

In the past, owners have been reluctant to do so. But, the same challenge confronting China PE firms, one of dramatically decreased exit options, in particular the low statistical probability of achieving an IPO, is also having a **material impact on the thinking of company owners**.

Guidance: An M&A transaction in China involving a private sector company needs to begin by an acquirer understanding directly addressing what are often an **owner's two major areas of concern** now: 1) how to finance the future growth of the company; and 2), how to achieve liquidity within some reasonable timeframe. Both issues are now **paramount** in the minds of many owners, due to the collapse in both IPOs and new PE funding in China.

Owners of PE-invested companies are often now experiencing increasingly **severe capital constraints**. The current PE won't finance additional growth. Bank lending remains both difficult to secure and costly. The owners are acutely aware that access to capital is often the decisive competitive advantage in China. A company short of capital is a company short of a secure future. An M&A transaction, where the acquirer intends to invest into the business to raise its growth rate and market share, is one more and more Chinese owners will view positively.

This is especially true where the acquisition is sequenced so that the owner not only stays on after an initial close but remains a significant minority shareholder. The owner would have the right to exit fully in two to four years, at an agreed step-up valuation from the initial close, assuming agreed profit and revenue milestones are met. For an owner, this type of transaction can deliver a final **"blended valuation" higher, and more certain, than all other liquidity options currently available**. It's this fact, perhaps more than the others, that is changing the calculus of some of China's better domestic entrepreneurs. M&A currently offers the best risk-adjusted value for an owner's personal shares.

This **change in mindset**, and willingness to consider seriously a sale to a strategic or financial buyer, is confirmed by frequent discussions we have with the owners of larger private companies in China. Past assumptions about the likelihood and attraction of an IPO exit are now undergoing continual reassessment.

A new realism is tangible. Owners contemplating an IPO now face a likely wait of at least seven to eight years to list and achieve liquidity for their personal shares. That is well beyond the planning horizon of most owners. Trade sale not only offers a more **certain and speedy path to liquidity**. It also gives business owners two crucial things the IPO process in China deprives them of: control over exit timing and a degree of accurate preditability about the price personal shares can be sold for.

Accretion takes on a different meaning in this context. A deal should be executed and managed also to improve the likelihood that the current owner's residual shares will increase in value after the transaction. In a market now severely lacking in growth capital, Chinese entrepreneurs should come to see a strategic or financial acquirer as a smart and reliable source. Owners, in our view, will most readily sell to someone who credibly proves they will build the acquired company into one that is much bigger and much more valuable.

From PE to M&A

PE investment in China has altered permanently the business landscape in China. It has also prepared the ground for a surge now in M&A activity.

Over $150 billion in PE capital was invested to propel the growth of over 10,000 private businesses. PE finance helped create a more **dyanmic and powerful private sector** in China. In quite a number of cases, the PE-invested businesses have emerged as industry leaders in their sectors in China, highly profitable, innovative, fast-growing, with revenues of $100mn and above.

These companies have the scale and established market presence to permit a strategic acquirer to substantially increase its activity in China, extending product range, customer relationships, distribution channels. For buyout firms, acquiring a PE-invested company should offer satisfactory financial returns. Buyout ROE can be significantly enhanced in certain cases by using leverage to finance the acquisition. This will depend on target company's structure and legal domicile.

Possible Deal Terms & Timing

1. Tranche One is purchase of entire PE interest + a minority of owner's shares, to bring acquirer's ownership to +51%

2. Tranche Two is purchase of owner's remaining shares (structured as a call) on successful achievement of earn-out and performance milestones, generally 2-4 years after Tranche One

3. Valuation multiple is same for both tranches, using previous year's net or EBITDA as the basis. (In most cases, Tranche Two enterprise value will be at least double Tranche One, based on doubling of profits over the period). This "blended multiple" compares very favorably with other liquidity options for owners

4. Acquirer to have downside protections, including ratchets to adjust ownership level upward depending on new capital commitments and underperformance against any milestone

PE portfolios now hold a **key to sustained** success in M&A in China. PE firms invested on the expectation of exiting through an IPO, not M&A. But, the IPO markets are closed. They are likely to remain closed, or highly challenging, with only a small fraction of unexited PE deals able to IPO before the fund life of the invested PE firm expires.

Good companies, part-owned by PE investors needing to liquidate, with an owner that now faces an especially long, risky and unpredictable path to achieving an IPO exit in the future. This is the unique "perfect storm" of factors that is enabling acquirers, for the first time, to **execute control transactions** for some of the stronger private sector companies in China. Building on this strong foundation, acquirers will prosper in China.

In China private equity, the exit scenarios for a buyout firm are more numerous and higher probability than those of PE firms pursuing minority growth capital deals. Buyout firms can choose from a menu that includes trade sale, dividend recapitalization or eventual IPO. All are easier to execute from a position of majority ownership.

The current exit crisis in China PE represents a once-in-a-business-lifetime opportunity for buyout firms and strategic acquirers. They will profit from others' actute pain.

Deal Financing: A Positive Environment

Transaction risk, in particular the challenge of putting together successfully the financing necessary to complete a deal in China, is lessening. The once-troublesome process for an offshore acquirer to get approval from China's SAFE to exchange into and out of Renminbi is becoming less of an obstacle.

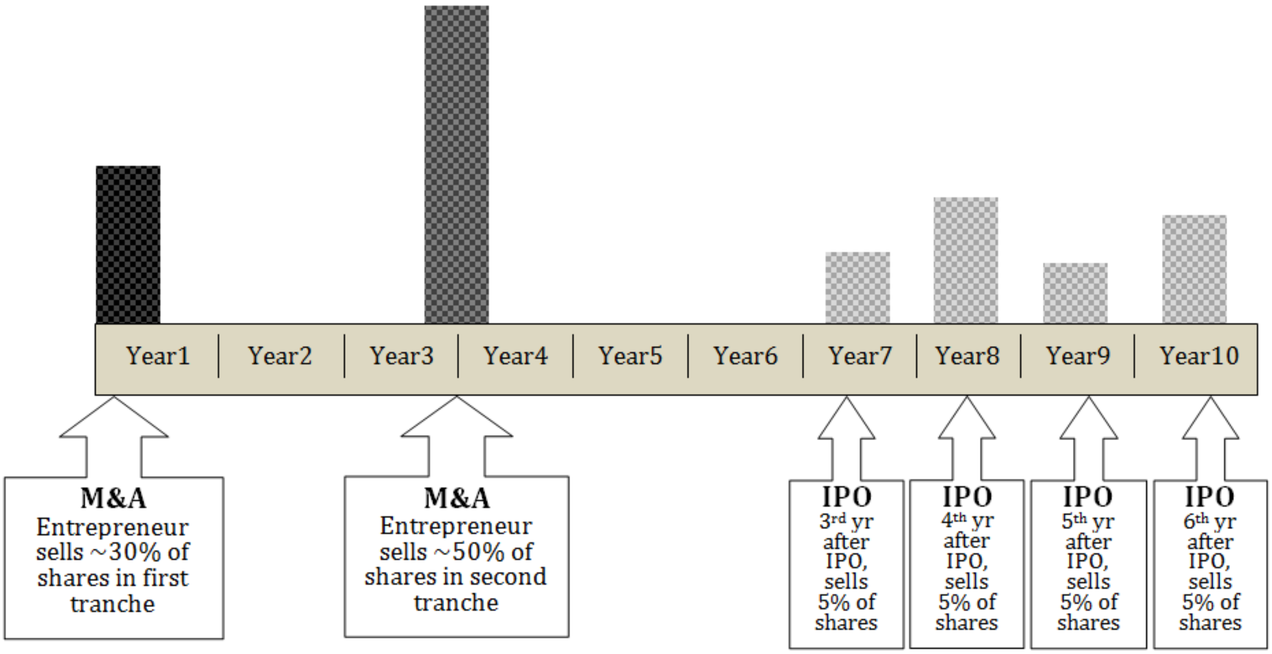
Slowing FDI in China -- caused in large part by big drop in new projects both in real estate and private equity -- is an issue of importance to China's central government economic and financial policy-making bodies. M&A represents a new channel through which "productive" foreign capital can enter China to help sustain high economic growth. **As a result, we would anticipate in many cases a smoother and faster process of gaining SAFE approval.**

A separate, even more attractive, option for some non-Chinese strategic acquirers is to use Renminbi earned from their core business in China to finance an acquisition of a private sector business. More and more foreign companies have this capability. Using your own Renminbi will greatly simplify deal paperwork and approvals, and accelerate time to closing.

For acquirers seeking bank lending to finance a takeover, the conditions have also lately grown more favorable. The offshore arms of China's large domestic banks, as well as banks in Hong Kong and Taiwan, have all shown willingness to lend to finance M&A involving a Chinese company.

This improvement in financing conditions should also benefit sellers and so make deals easier to negotiate and close. M&A valuations in China have generally carried a discount because of the hurdles in getting necessary approvals.

Liquidity Options for Chinese Entrepreneurs



Colors represent the likelihood of entrepreneur achieving liquidity -- darker signifies higher certainty. The probability of achieving IPO is low, and even if successful, there are significant regulatory, timing and market risks for any entrepreneur seeking to sell shares after IPO. Length of bars represents cash received from sale of shares.

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China First Capital

On a retained basis, China First Capital devises and helps execute M&A transactions from among the group of unexited PE deals in China. We are uniquely qualified for this work. China-based and China-focused, we are the only intermediary firm (including law firms, accounting firms, management consultants, research providers, other financial advisors) with the six required tools to help our clients succeed with this strategy of executing control transactions in this arena of PE-invested private companies.

These six are:

1. Proprietary research, advanced analytics and database of over 7,500 unexited PE-invested deals in China

2. Trusted long-term relationships with decision-makers at over 600 PE firms active in China, giving us unmatched sourcing ability and transparency into the portfolios of both dollar and RMB funds

3. Deep experience working successfully as trusted advisor to Chinese SME bosses. This is necessary to gain their active support of a M&A transaction

4. Proprietary deal flow and execution capabilities

5. Over five years on-the-ground work in China doing M&A deals and corporate financings for private SME companies

6. Deep experience working with C-Level and senior management at MNCs, with the sensitivity and dexterity to understand and resolve MNC risk factors in China M&A

CFC's role is to originate, structure and help execute transactions, including acquisitions both by strategic acquirers or buyout firms. We do this while maintaining the highest degrees of both confidentiality and professional integrity.

We are able to identify and "cherry-pick" superior opportunities from inside an existing GP portfolio and make these actionable for acquirers, at market valuations, with support of majority owners. We focus on putting in place effective downside risk protections for our clients.

We begin our engagements by working closely with the client to develop a cohesive strategy. This targets specific areas of opportunity and valuation parameters, across the deal-size and industry spectrum, both dollar and RMB deals. The goal is to enable our clients to execute successful M&A deals that will generate significant returns, while mitigating operational, market, financial, reputational and legal risks.

We work efficiently and quickly to get to close. We are highly active in China's corporate finance industry, especially with PE-invested SMEs, having participated since 2008 in over 50 transactions for companies across China. This gives us the experience, judgment and methods to close bid/ask spreads that often prevent M&A deals from reaching completion.

We have substantial domain knowledge and industry experience working with leading Chinese SME and PE firms in these verticals:

- Financial Institutions
- Energy & Mining
- Agriculture & Food Processing
- Industrials & Manufacturing
- Automotive
- Healthcare, Pharma
- Real Estate
- Retail & Consumer Products
- TMT
- Renewables and cleantech

Our firm upholds the view that investing in China's entrepreneurial companies remains among the world's preeminent long-term risk-adjusted investment opportunities. M&A transactions targeting such companies now offer acquirers especially attractive values.

China First Capital *is a leading China-focused international investment bank and advisory firm for private capital markets and M&A transactions in China. We have a disciplined focus on -- and strive for a leadership position in -- four distinct business areas. These are:*

- *Private placement and equity financing for China's high-growth entrepreneur-led companies;*
- *Strategic M&A transactions, buyouts, domestic and cross-border;*
- *Private Equity Secondaries, buy-side and sell-side representation for acquisitions and early liquidity events;*
- *Restructuring, financings and advisory for China's SOE*

China First Capital's geographical reach and client mandates are across all regions of China, with exceptional proprietary deal flow. We have significant domain expertise in most major industries in China's private and public sector, structuring transactions for a diversified group of companies and financial sponsors to help them grow and globalize. We execute transactions across the capital spectrum to minimize dilution and optimize our clients' capital structure and returns. We are a knowledge-driven company, committed to the long-term economic prosperity of Chinese business and society, backed by proprietary research (in both Chinese and English), that is unmatched by other boutique investment banks or advisory firms active in China.

For more information and to learn more about our strengths and capabilities in direct secondaries, please contact directly our firm's senior management below.

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