

# China Law Update

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## Let's Face It - Business Is Not As Usual

The Wall Street Journal reports that "Leveraged finance is down 82% this year, while announced M&A is down 64% and fee income from private-equity firms is down 74%, according to data from Dealogic and Banc of America Securities analyst Michael Hecht."

Private equity and venture capital deals have screeched to a halt, with no clear signs of improvement.

Not only are deals not getting done, but the market is so barren that some firms have actually had to return to investors funds that were previously raised! Candover, one of the UK's largest private equity firms, just announced that it will give back a large portion of the €3 billion that was raised for its latest fund. Candover is not alone--Permira in the UK and TPG in the US have also returned money to investors.

Private equity and venture capital in the US and Europe has conceded that nothing is working. So rather than play in a broken field, it seems like many firms have quit, been forced to quit or are waiting for someone else to clean up the mess.

What does this mean for private equity and venture capital in China?

Opportunity.

Few buyers, lots of sellers, depressed prices and suffering competition. The first three ingredients provide an opportunity for Chinese private equity and venture capital firms to scoop up the most promising companies at prices that have not been possible in recent memory. Further, troubles of PE and VC firms abroad have led to layoffs, hiring freezes and discontent, creating the opportunity for Chinese firms to poach the best talent from foreign firms, as well as giving Chinese firms access to deals that may have gone to other firms.

Few Buyers.

Candover will certainly not be the last firm that will have to hand back some of the money that it has raised previously. With huge writedowns in portfolio values coming, few exits available and nervous investors seeking to preserve cash, PE and VC groups will be unable to raise capital at the pace that they have become accustomed to in past years. This means that there will be fewer

funds and the size of funds will be smaller. Fewer funds means fewer buyers of business. Smaller funds means smaller deals, so larger deals will be harder to do, and larger companies will have less viable buyers. Even for the PE and VC firms that have dry powder, the recent economic collapse has made investors cautious, particularly in light of struggling portfolio companies, the uncertainty of raising new funds and the turbulent economic landscape. Foreign firms that wanted to break into China are hesitating to make significant outlays to set up new offices in China, pull the trigger on new deals in foreign markets, and even in their own markets, foreign firms have all but stopped making deals.

Strategic buyers that have cash may be in a great position to do deals, but as the global economy has suffered, there are fewer and fewer companies with cash. The earnings reports have been horrible, worse than most analysts' estimates. The blended earnings growth rate for the S&P 500 for Q4 2008, combining actual numbers for companies that have reported, and estimates for companies yet to report, was over negative 40% according to Thomson Reuters. Business in China is also suffering. Factories continue to close throughout the country. Larger Chinese companies are reporting profit falls of over 50% in 2008, and forecasting even worse results this year. As a result of the earnings shortfalls and dire projections, even well known companies that have had long histories of dividend increases—such as Bank of America, Pfizer, Carnival, Dow Chemical, Citigroup and Motorola—have recently reduced or eliminated their dividends. The companies that still do have cash to use have been cautious because they have seen their peers suffer unexpected declines in earnings and sudden cash flow problems. So the universe of strategic buyers has also shrunk.

#### Many Sellers.

During the Chinese stock market's bull run in 2006 and 2007, many companies obtained astronomical valuations from buyers. If private equity balked, then a company could always seek the public markets instead. China's stock market plunge has been well documented. There are virtually no IPO's occurring, and little liquidity. Thus, Chinese companies are increasingly looking toward private equity as a financing source or exit source.

PE is also benefiting from changes in China's banking laws. The government has increased bank reserve ratios to 17.5%, meaning that the banks have less money to lend. The money that is available generally goes to state owned enterprises first, or large corporations, leaving many smaller companies fighting each other for limited funds. Private equity can fill the need created by the lack of access to traditional financing.

Finally, much of a Chinese company's growth has been self-financed through earnings. As earnings have declined dramatically, more Chinese companies have had to seek external funding, particularly VC and PE.

#### Depressed Prices.

With equity markets sinking and the credit markets closed to companies hungry for capital, PE and VC firms in China can make investments at attractive valuations and more stringent terms, which has not been possible in recent memory. With earnings down, company values have come

way down, and PE and VC firms can take advantage of temporary slowdowns or blips in a company's otherwise healthy growth. The lack of buyers and abundance of sellers also drives prices lower.

#### Suffering Competition.

With foreign rivals reeling from failed or in trouble investments, relatively young and healthy PE and VC funds in China can assert market leadership and step in to do the deals that their foreign counterparts cannot do. This includes the higher profile deals abroad that may go to China firms as foreign deal makers stay sidelined. Further, with troubles at home, foreign PE and VC are shying away from doing deals abroad that they are less familiar with, so the China market is left wide open to domestic PE and VC.

Additionally, the layoffs in PE and VC have created an opportunity for Chinese PE and VC to attract talent from big name firms. With carried interest underwater, many more talented people will be looking for a fresh start and PE and VC in China is well positioned to offer the best deal prospects.

#### Opportunities.

PE and VC firms have a lot of choices ahead. They have the China market and the foreign market that is brimming with potential projects. Even though the IPO market dropped dead in 2008, M&A in China posted a record high in 2008, with almost USD\$160 billion in deals completed, according to Thomson Reuters.

So prospects look promising, but, the landscape is much more treacherous. The capital markets cannot be relied on, and exits are much less certain. Earnings have fallen off a cliff, so an investor must assess whether the downturn is temporary or permanent. Investors will not be able to flip their investments easily—there is little arbitrage, for example, if investing in pre-IPO companies because the IPO market is dead.

PE and VC firms will have to earn their money the old fashioned way—through building a business. That means improving the top line, cutting costs, improving management, innovating with products and services, and expanding market share.

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