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The Rise of Private Equity in China: A Case Study of Successful and Failed Foreign Private Equity Investments

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THE RISE OF PRIVATE EQUITY IN CHINA: A CASE STUDY OF SUCCESSFUL AND FAILED FOREIGN PRIVATE EQUITY INVESTMENTS

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To my beloved family

for their incredible love and support

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List of Abbreviations

AML	Anti-Monopoly Law
BOC	Bank of China
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission
CCP	Chinese Communist Party
CDB	China Development Bank
CIC	China Investment Company
CIRC	China Insurance Regulatory Commission
CNOOC	China National Offshore Oil Corporation
CSRC	China Securities Regulatory Commission
CTBC	Chinatrust Commercial Bank
FDI	Foreign Direct Investment
GP	General Partner
ICC	International Chamber of Commerce
IPO	Initial Public Offering
KFB	Korea First Bank
LBO	Leveraged Buyout
LP	Limited Partner
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce

NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	Non-Performing Loans
PBOC	People's Bank of China
RMB	Renminbi
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SASAC	State-owned Assets Supervision and Administration Commission
SAT	State Administration of Taxation
SDB	Shenzhen Development Bank
SDB	Shenzhen Development Bank
SEZ	Special Economic Zones
SOE	State-owned Enterprise
TPG	Texas Pacific Group
WTO	World Trade Organization
XCMG	Xugong Construction Machinery Group

Chapter 1: Introduction

China's immense growth over the past three decades presents many paradoxes. China is now considered to be a global superpower, yet it still struggles to provide its citizens with clean water and food. Though the country is on its way to becoming the world's largest producer of renewable energy, Beijing's smoggy gray sky is a testament to China being one of the most polluted countries on the earth.[1] As China's largest city by population, Shanghai has grown into an international business hub boasting a modern skyline glittering with skyscrapers, while two-thirds of the population continue to reside in rural areas making less than $2,000 a year.[2] Perhaps the greatest paradox of all in China is the coexistence of its old Communist state politics and new capitalist economy.

Deng Xiaoping's open-door policy in 1978 marked the beginning of China's economic reform. By opening up to the outside world, the Chinese government intended to actively develop foreign economic cooperation and exchange.[3] Foreign direct investment (FDI), or investment made to acquire lasting interest in enterprises outside of the economy of the investor, slowly started to flow into China starting from the 1980s.[4] In particular, venture capital and private equity, two forms of financial FDI, were introduced to China during this period. Previously, the government was the main source of capital for domestic enterprises, but a large portion of that capital went to China's state-owned enterprises (SOEs), which meant the private sector was experiencing a

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[1] Christina Larson, "The Great Paradox of China: Green Energy and Black Skies," Yale Environment 360, August 17, 2009, accessed April 27, 2014, http://e360.yale.edu/feature/the_great_paradox_of_china_green_energy_and_black_skies/2180/.
[2] Edward Wong, "Survey in China Shows a Wide Gap in Income," *The New York Times*, July 19, 2013.
[3] Ronald Coase and Ning Wang, *How China Became Capitalist* (New York: Palgrave Macmillan, 2012), 110.
[4] Harrison G. Blaine, *Foreign Direct Investment* (New York: Nova Science Publishers, 2008), vii.

shortage of financial capital. Venture capital and private equity filled in this financing gap. Unlike venture capital, which focuses more on companies in an early stage of development, private equity investment is directed at firms that have already matured in its development. Foreign private equity investment has taken longer to evolve in China because it requires a more sophisticated capital market, which took time for the Chinese government to establish. China is now the top destination for private equity investment in Asia as more than two-thirds of total Asian private equity investment currently flood into the country.[5]

Due to its relatively late start, private equity is considered a nascent industry in China with many opportunities and challenges. Large global private equity firms began their China operations beginning in the late 1990s with hopes of making impressively high returns. In the past two decades, there have been many examples of successful as well as failed foreign private equity deals in China. Interestingly, the Chinese government has shown instances of supporting foreign investment in industries deemed sensitive, while blocking investment in less sensitive sectors, which is usually not the case. This thesis aims to illuminate the reasons behind this anomaly. It investigates the considerations of Chinese regulators when reviewing foreign private equity proposals through an analysis of four main case studies in order to reveal a facet of China's evolving market economy. Given the regulatory, political, and cultural challenges in China's current private equity environment, this paper proposes that the future of China's private equity market may not be as promising as anticipated by foreign investors.

[5] "Asia's Favorite Money Pit?" *AVCJ Private Equity and Venture Capital Report CHINA* (Inclusive Media Investments Limited, 2012).

Beginning with an overview of private equity, Chapter 1 builds a fundamental basis for the case studies by laying out the definition, process, and trends along with a literature review of private equity investment pertaining to emerging markets. Chapter 2 illustrates how China's private equity industry has developed since the mid-1980s, dividing it into three phases, especially focusing on the evolution of regulations relevant to private equity. Chapters 4 and 5 present case studies of successful and failed attempts of foreign private equity firms to invest in Chinese companies. The cases will focus on deals made by foreign private equity firms, particularly U.S. private equity firms, because these deals offer a more objective view of the reasoning behind Chinese regulators. The Chinese government generally favors domestic private equity firms because of its desires to expand China's own private equity industry.

The case studies will first offer a brief background of the two companies involved in the deal along with their reasons for wanting a successful transaction, then draw out the whole process of the agreement as well as reasons for success or failure, and conclude with the idiosyncrasies of the deal. Case Study I, the successful deal between Newbridge and Shenzhen Development Bank, was chosen because it was the first time a foreign private equity firm took control of a state-owned bank. Case Study II, Blackstone's acquisition of BlueStar, was selected because it was the largest foreign investment in a Chinese firm in a non-initial public offering (IPO) context and the first time a private equity fund bought into a SOE without a planned exit. Case Study III, Carlyle's failed takeover of Xugong, concerns the biggest planned acquisition by a foreign investor of a controlling stake in a leading SOE that was blocked by the Chinese government. Case Study IV, the collapse of Coke's plan to acquire Huiyuan, was the largest bid to date for foreign control of a Chinese firm and the first time China's 2008 *Anti-Monopoly Law* (*AML*) was put to test. Although M&A transactions are considered to be different from private equity deals, the Coke-Huiyuan case was chosen due to the similar functionalities of the acquisition when compared with a private equity investment. Each case reveals significant aspects about China's evolving private equity industry. Chapter 6 draws out the parallels from the case studies and Chapter 7 concludes this paper with the glimpse into the future of China's private equity market, highlighting some of the remaining challenges.

Chapter 2: Overview of Private Equity in Emerging Markets

A comprehensive analysis of the success and failure cases in China's private equity market requires a basic understanding of the field. In the past, private equity was more centered in developed markets like the U.S. and Europe. However, due to the bright prospects of emerging markets, studies on private equity in developing markets have continued to blossom. An overview of private equity's definition, process, and trends along with a literature review on private equity in emerging markets will build a firm foundation for a better understanding of the private equity industry in China.

1) Private Equity: Definition, Process, and Trends

Definition of Private Equity

Private equity, in the simplest terms, can be defined as a type of asset owned by a private company that is not publicly listed on the stock exchange.[6] There are typically three main elements of private equity: financing by an external investor, high risk with high return potential, and private negotiations between the parties.[7] An external investor like a private equity firm would raise funds through pension funds, endowments, and high net worth individuals and use this to privately invest, or provide medium to long-term finance, in return for an equity stake in an underperforming company that has a high potential for growth.[8] Private equity investments were historically made in non-listed

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[6] Harry Cendrowski, James P. Martin, and Louis W. Petro, *Private Equity: History, Governance, and Operations* (Somerset, NJ: John Wiley & Sons, 2012).
[7] Cyril Demaria, *Introduction to Private Equity* (Chichester, West Sussex, U.K.: Wiley, 2010).
[8] *A Guide to Private Equity*, British Private Equity & Venture Capital Association (BVCA), May 2004, Updated in October 2007, http://www.bvca.co.uk/Portals/0/library/Files/Website%20files/2012_0001_guide_to_private_equity.pdf.

companies, but nowadays private equity funds make investments in publicly held companies as well.[9] The basic idea of private equity is to privately invest in a company and make it more valuable over several years in order to sell it to a buyer who recognizes the lasting value that is added.[10] This long-term value creation is achieved through active management, meaning that the investor becomes a minority or majority shareholder of the company and often sits on the board during the investment period. The investor provides not only financial investment but also human capital investment through managerial, operational, and technical expertise.[11]

Based on the target company's stage in development, private equity can also be divided into two categories: venture capital and buyout. The different stages of a company's development include seed, start-up, expansion, and maturity.[12] Venture capital refers to a subset of private equity that is generally associated with investments made in companies at a seed, start-up, or expansion stage in their development, while buyouts are capital provisions to more mature companies.[13] Unlike the European definition of private equity, which considers venture capital and buyouts as a single asset class, the U.S. definition treats venture capital and buyouts as distinct asset classes.[14] A more precise segmentation divides private equity into four different forms: venture

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[9] Douglas Cumming, *The Oxford Handbook of Private Equity* (New York: Oxford UP, 2012).
[10] Ross Butler, *The Little Book of Private Equity* (Brussels: European Private Equity and Venture Capital Association), http://www.evca.eu/media/19732/Little-book-of-Private-Equity.pdf.
[11] Xieshu Wang, "A Survey Based Institutional Comparative Study of Private Equity in China and in Europe." (PhD diss., University of Paris XIII Nord), 5.
[12] Kwek Ping Yong, *Private Equity in China: Challenges and Opportunities* (Hoboken, NJ: Wiley, 2012).
[13] Claudia Sommer, *Private Equity Investments: Drivers and Performance Implications of Investment Cycles* (Wiesbaden: Springer Gabler, 2013).
[14] Ibid.

capital, growth capital, mezzanine capital, and leveraged buyouts (LBOs).[15] Growth capital is a minority equity investment without control rights in a mature company that needs capital. Having both equity and debt characteristics, mezzanine capital is an investment in preferred stock or subordinated debt of a company.[16] LBOs, typically targeting mature companies with strong operating cash flow, point to the purchase of a company using a large amount of debt along with some equity and involves strong managerial ownership.[17] This paper will follow the U.S. definition of private equity referring to buyout investments and growth capital rather than venture capital because the case studies deal with established companies rather than start-up firms.

Process of Private Equity

The process of private equity can be broken down into selecting, structuring, managing, and exiting.[18] The pre-investment stage of selection involves planning, fundraising, and conducting due diligence.[19] General partners (GPs), or managers of private equity funds, first draw out the strategy, type, and structure of the fund and then approach potential investors, namely limited partners (LPs), to raise the fund.[20] The amount and pace of fundraising depends on factors like macroeconomic conditions and investors' appetite for private equity. Afterwards, the GP narrows down the market and target in which it wishes to invest. This complex process is called due diligence, the investigation of a business's performance identifying the merits, risks, feasibility, and

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[15] Peter Cornelius, *International Investments in Private Equity: Asset Allocation, Markets, and Industry Structure* (Burlington, MA: Academic, 2011).
[16] David Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm* (Burlington, MA: Academic/Elsevier, 2010).
[17] Cumming, *The Oxford Handbook of Private Equity*.
[18] Sommer, *Private Equity Investments*.; Yong, *Private Equity in China.*.
[19] Yong, *Private Equity in China.*
[20] Cendrowski, *Private Equity: History, Governance, and Operations*.

viability of a deal.[21] Investments in emerging markets tend to carry particular risks like currency fluctuations, political uncertainties, volatile capital markets, weak regulatory systems, and unreliable judicial systems.[22] Private equity firms take on a more active role when choosing the desired target in developing countries because they rarely receive offers for potential targets like they do in the U.S.[23]

After the selection process ends and a non-binding offer has been accepted by the target company, the private equity firm enters the structuring phase to determine the capital and legal framework of the deal. It chooses either to buy a pure equity stake, convertible bonds, or LBO and lays out terms for the degree of management control.[24] Once an investment closes, the private equity firm will begin to actively manage the portfolio company to enhance its operational and financial performance. Although holding a majority stake with strong management control may offer the private equity firm more freedom to implement large-scale restructuring and make big corporate decisions, a minority stake can also allow the private equity firm to add value with some degree of management control.[25] Value can be created by improving managerial quality of staff, promoting corporate governance of board members, or maximizing capital efficiency of the firm.[26] There are also intangible values like reputation, credibility and business networks that the private equity firm can offer to the portfolio company.[27]

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[21] Lawrence Zhan Zhang, "The Legal Environment for Foreign Private Equity Firms in China", *Fordham Journal of Corporate and Financial Law* 16, no. 4 (2011): 839-89.; Yong, *Private Equity in China.*
[22] Zhang, "The Legal Environment for Foreign Private Equity Firms in China."
[23] Gonzalo Pacanins, "Private Equity in Developing Countries." (MBA essay, Harvard Business School, 1997), accessed April 26, 2014, http://www.people.hbs.edu/jlerner/develop.html.
[24] Yong, *Private Equity in China*, 18.
[25] Ibid, 22.
[26] Ibid, 23.
[27] Richard Daniel Ewing, "Private Equity in China: Risk for Reward," *The China Business Review* 31, no. 4 (July/August 2004): 48-51.

Finally, the private equity firm realizes its investment returns through a successful exit. After careful consideration of the timing and exit strategy, the portfolio company is harvested. The most common exit strategies are an IPO, private sale, or a trade sale.[28] An IPO on a domestic exchange is regarded to be the most lucrative way of exiting a private equity investment because of the liquidity it generates.[29] Private equity firms can easily sell their shares on the open market or directly distribute them to their LPs. It is also beneficial for the portfolio company because it can quickly raise large volumes of capital at a low cost.[30] The second option is a private sale to a strategic buyer or financial investor, meaning the pre-existing investor commitments will be sold to another private equity fund. This exit strategy tends to have less return on investment than an IPO.[31] The third option of a trade sale, also known as Mergers & Acquisition (M&A), has become an increasingly popular exit vehicle.[32] This entails a sale of the company's stock or assets to another entity for cash, stock, and/or debt. Trade buyers are often willing to a pay a premium to acquire a company with potential synergy effects. The downside to this option is that it may require regulatory approval, especially in countries with anti-monopoly and antitrust laws, so it has the possibility of being rejected if regulators disapprove the buyer.[33] Private equity firms must thoroughly examine this last process prior to its investment because it is arguably the most significant factor that determines a successful private equity investment.

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[28] Cendrowski, *Private Equity: History, Governance, and Operations*, 10.
[29] Andreas Woeller, "Private Equity Investment in the Brics", *Fordham Journal of Corporate and Financial Law* 17, no. 4 (2012): 1307-61.
[30] Cendrowski, *Private Equity: History, Governance, and Operations,* 70.
[31] Woeller, "Private Equity Investment in the BRICS."
[32] Cendrowski, *Private Equity: History, Governance, and Operations*, 111.
[33] Yong, *Private Equity in China*, 27.

Trends of Private Equity

With origins as early as the post-World War II period, private equity has seen tremendous growth throughout the years evolving into an institutionalized area for investment. Although the U.S. private equity industry has been in the lead for quite some time with Europe following right behind, emerging regions like the Asia-Pacific and Latin America have become a more attractive destination for private equity investments since the mid 1990s due to the saturation of the U.S. and European private equity markets.[34]

An emerging, or developing, market economy is defined as an economy with low-to-middle per capita income and usually refers to a country that works to catch up with developed economies.[35] The rapid economic growth of these emerging markets seemed to promise more superior investment returns. Between 1992 and 1999, the emerging markets of Asia saw $50 billion of new capital flow in through 500 different private equity funds.[36] In Latin America, the value of private equity capital grew 114% annually from $100 million to over $5 billion between 1992 and 1997.[37] The high expectations of investors were unmet in the late 1990s with many severely underperforming funds. This was largely due to the shortcomings of emerging markets like low standards of corporate governance, weak legal systems, and dysfunctional capital markets.[38] Exits took longer and returns on investment were lower than expected. However, once foreign investors

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[34] Usmon Kuchimov, *Asian Emerging Markets Private Equity – Challenging Multifold Risks* (Rochester: Social Science Research Network, 2011).; Guy Fraser-Sampson, *Private Equity as an Asset Class* (Chichester, England: Wiley, 2007).
[35] Arindam Banerjee, “Private Equity in Developing Nations,” *Journal of Asset Management* 9, no. 2 (2008): 158-70.
[36] Roger Leeds and Julie Sunderland, "Private Equity Investing in Emerging Markets," *Journal of Applied Corporate Finance* 15, no. 4 (Fall 2003): 111-9.
[37] Ibid.
[38] Ibid.

learned how to develop a more tailored approach aligned with emerging market realities, they were able to see impressive gains. In the last decade, the average return on private equity in emerging markets surpassed that of the U.S.[39] More than $36.5 billion worth of private equity investment went into emerging markets over the past ten years with China, India, and Brazil accounting for two-thirds of market activity.[40] Even after the global downturn in 2008, many institutional investors believed that emerging markets will continue to present attractive investment opportunities.[41] A 2012 survey conducted by the Emerging Market Private Equity Association (EMPEA) showed that more than two-thirds of the 106 institutional investors who were surveyed expected their private equity funds in emerging markets to increase in the following years.[42] This suggests a continuous upward trend for the private equity industry in emerging market economies.

2) Literature on Private Equity in Emerging Markets

The academic study of private equity began in the late 1980s, gaining attention from researchers in fields like corporate finance, institutional economics, and managerial behavior.[43] However, since private equity investments reached emerging markets only since the mid-1990s, the academic literature on private equity in emerging markets is relatively sparse. The World Bank produced some of the earliest literature. Lieberman et al. (1998) examined the links between privatization as a development policy and the fast

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[39] Darek Klonowski, *Private Equity in Emerging Markets : The New Frontiers of International Finance*. (New York: Palgrave Macmillan, 2012) 56.

[40] CFO Innovation Asia Staff, "China, India and Brazil Account for Two Thirds of Private Equity Emerging Market Activity," *Questex Media*, September 18, 2003, accessed April 26, 2014, http://www.cfoinnovation.com/content/china-india-and-brazil-account-two-thirds-private-equity-emerging-market-activity.

[41] "New Survey Shows IIs Still Favor Emerging Markets Private Equity," *Private Equity Asia* 5, no. 5 (May 2009): 29.

[42] Prabha Natarajan, "Private Equity to Hike Emerging-Market Allocations," *LBO Wire*, April 13, 2012.

[43] Wang, "Comparative Study of Private Equity in China and Europe," 7.

growth of equity markets in emerging markets.[44] Although the book focused on the broader equity market, a section about the evolution of emerging market equity funds explains the role of venture capital and private equity funds in privatization and emerging equity markets. Private equity rapidly expands its presence in academic literature in the 2000s. Researchers illustrated the potential of private equity in emerging markets like Asia (Cumming, 2010; Robertson, 2010), India (Kulkami and Prusty, 2007; Dossani, 2012; Chakrabarti, 2013), Russia (Musatova, 2009), and Latin America (Rozeira and Roberto, 2005; Charvel, 2009).

Among the emerging markets, China is the most studied country regarding private equity mainly because of the scope of interest among foreign investors towards China.[45] China's institutional environment greatly differs from the West (Peng and Heath, 1996), with beginnings as a planned economy. This brought scholars to explore how private equity, a Western method of financing, fit into China's distinct economic system . Literature on China's private equity has been produced by academics (Feng, 2004; Bethune, 2006; Jingu and Kamiyama, 2008), consulting firms (Ernst & Young, KPMG, Bain & Company), and professional associations (BVCA, EVCA, AVCJ, ChinaVenture, Zero2IPO, China First Capital). Though there has been a considerable increase in the volume of academic literature on China's private equity market, there are still many unexplored areas worth analyzing, which leaves room for more development.

[44] Ira W. Liberman and Christopher D. Kirkness, *Privatization and Emerging Equity Markets* (Washington, D.C.: World Bank Publications, 1998).
[45] Wang, "Comparative Study of Private Equity in China and Europe," 8.

Chapter 3: Development of Private Equity in China

1) Introductory Phase: Mid-1980s to Mid-1990s

Private equity was an unfamiliar concept in the early years of Deng Xiaoping's 1978 economic reform.[46] The introduction of private equity was prompted by the government's desire to boost the development of science and technology, an industry that had lacked operational efficiency and innovation under China's planned economy.[47] The first venture capital fund was established in 1985 by the central government when the State Science and Technology Commission and the Ministry of Finance joined together to create China New Technology Venture Investment Corporation.[48] Local governments followed suit and established their own venture capital funds. They believed successful technology-based ventures would propel the development of the regional and national economy. Therefore, venture capital funds primarily focused on stimulating scientific and technological advancement rather than earning high returns.[49]

Venture capital had not yet established a foothold in the 1980s, but this slowly began to change in the early 1990s. The government's concentration on science and technology shifted to the capital market. In response to an increased demand for corporate financing, the government created the Shanghai Stock Exchange and Shenzhen Stock Exchange in 1990 and 1991, respectively.[50] At the end of 1992, the China Securities Regulatory Commission (CSRC) was established under the State Council as a

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[46] Yong, *Private Equity in China*, 79.
[47] Wang, "Comparative Study of Private Equity in China and Europe," 8.
[48] Steven White, Jian Gao, and Wei Zhang, "Financing New Ventures in China: System Antecedents and Institutionalization,"*Research Policy* 34, no. 6 (August 2005): 894-913.
[49] Ibid.
[50] Martha Avery, Min Zhu, and Jinqing Cai, *China's Emerging Financial Markets: Challenges and Global Impact* (Singapore: John Wily & Sons, 2009).

ministry-level unit in charge of regulating China's securities and futures markets. It promulgated the *Company Law* in 1994 to reorganize SOEs into corporate entities. This not only centralized and consolidated the capital market, but also lured foreign investors into China.[51] Despite the government's effort to lay a rudimentary institutional and supervisory framework for the nation's financial capital market, there was a very small number of foreign private equity and venture capital firms in China during this phase. Foreign investors were still dubious of the investment returns considering the immature legal and regulatory environment in China.[52] As a result, the government boosted efforts to address these issues.

2) Development Phase: Mid-1990s to Early 2000s

The growth of China's private equity market picked up its pace in the late 1990s. Under the approval of the State Council, the People's Bank of China (PBOC) promulgated the *Administrative Measures on the Establishment of Chinese Industrial Investment Funds Abroad* in 1995, the first nationwide regulation on private equity.[53] It allowed domestic non-banking financial and non-financial institutions to co-fund with an overseas investment institution to invest in China's industrial development projects.[54] In 1996, the National People's Congress (NPC) passed the *Law Promoting the Industrialization of China's Technological Achievements*, the first legal statement allowing venture capital as a commercial activity and enterprises to raise funds that

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[51] Michael Tan, *Corporate Governance and Banking in China* (New York: Routledge, 2013), 33.
[52] Yong, *Private Equity in China*, 79.
[53] Wang Bo, "Risk Prevention Measures for Private Equity in China" (paper presented at the International Conference on Management of e-Commerce and e-Government, Jiangxi, October 17-19, 2008).
[54] Wang, "Comparative Study of Private Equity in China and Europe," 9.

support technology ventures.[55] The main statute regulating investment banks, the *Securities Law*, was born in 1998 to separate deposit-taking and investment bank activities.[56] Several figures, including Prime Minister Li Peng and Vice Prime Minister Zhu Rongji, pushed for greater expansion of China's venture capital industry at the Ninth Conference of the NPC.[57] As a result, the number of venture capital firms significantly increased.[58] Government-led funds slowly gave way to private and foreign funds.[59]

In addition to these efforts, the U.S. dot-com boom also accelerated the rise of China's venture capital industry. During the peak of the Internet boom in 1997 and 1998, many new Internet portals in China were in need of funds to expand their businesses. China's Internet industry grew rapidly, mainly due to the younger Chinese generation's high demand, and this attracted many foreign venture capital firms.[60] The stricter criteria for listing on China's domestic exchanges led Chinese IT firms to list on the NASDAQ instead. Institutional investors preferred to accumulate equity holdings in these overseas listed vehicles.[61] Foreign venture capital funds flowed into China's top Internet portals like Alibaba, Sina, and Sohu. Unfortunately, the boom came to an end when the Internet bubble popped in 2000. Many venture capital firms that invested in China suffered from severe losses and consequently, China's private equity sector shrank in 2001 to 2003.[62]

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[55] Anthony Bartzokas and Sunil Mani, *Financial Systems, Corporate Investment in Innovation, and Venture Capital* (Cheltenham, UK: Edward Elgar, 2004), 164-165.
[56] David Stowell, *Investment Banks, Hedge Funds, and Private Equity* (Waltham, MA: Academic Press, 2013), 43.
[57] Bartzokas and Mani, *Financial Systems, Corporate Investment in Innovation, and Venture Capital, 165-166.*
[58] Yong, *Private Equity in China*, 79.
[59] Wang, "Comparative Study of Private Equity in China and Europe," 10.
[60] Yong, *Private Equity in China,* 80.
[61] Duncan Clark, "Private Equity and Pragmatism in China," *Far Eastern Economic Review* 171, no. 9 (November 2008): 39.
[62] Takeshi Jingu and Tetsuya Kamiyama, "China's Private Equity Market", *Nomura Capital Market Review* 3, no. 3 (2008): 26.

3) Accelerated Growth Phase: Mid-2000s to 2010

China's accession to the World Trade Organization (WTO) in 2001 was partly based on the government's pledge to implement significant changes in the nation's financial system.[63] Major U.S. private equity firms like Carlyle, TPG, and Warburg Pincus entered the Chinese market during this time when the regulatory regime was underdeveloped. There were several important regulations relevant to private equity that attempted to address this problem.

In 2006, the *Company Law* and *Securities Law* were revised to match the standards of developed economies. The new *Company Law* strengthened managerial accountability, minority shareholder rights, and corporate governance.[64] It also specified that direct foreign investments in China can be carried out through a wholly foreign owned enterprise, a contractual joint venture, or an equity joint venture.[65] Adopted at the same NPC session as the new *Company Law*, the revised *Securities Law* laid the groundwork for the development of financial derivatives and multi-level securities markets. Investors were given more protection when issuing or trading securities and Chinese regulators were granted more power to fulfill their responsibilities.[66]

As the number of Chinese enterprises acquired by foreign purchasers began to grow substantially, the government saw the need for a stronger regulatory structure focusing on foreign-funded M&A.[67] On August 8, 2006, six government agencies[68]

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[63] Charles W. Calomiris, *China's Financial Transition at a Crossroads* (New York: Columbia UP, 2007), 63.
[64] Baoshu Wang and Hui Huang, "China's New Company Law and Securities Law: An Overview and Assessment," *Australian Journal of Corporate Law* 19, no. 2 (2006): 235-237.
[65] Zhang, "The Legal Environment for Foreign Private Equity Firms in China," 867.
[66] Ibid, 868.
[67] From June 2005 to June 2006, over 250 Chinese enterprises worth more than $14 billion were acquired by foreign companies. Peter A. Neumann and Tony Zhang, "China's New Foreign-Funded M&A

jointly issued the 2006 *M&A Rules*[69] that replaced the 2003 *Interim Provisions on Mergers and Acquisition of Chinese Domestic Enterprises by Foreign Investors*. The new regulation showed some improvements by allowing Chinese enterprises to be acquired in exchange for equities held by foreign investors when previously, shares could only be bought with cash.[70] It also enhanced corporate transparency and the prevention of illegal practices like "round-tripping."[71] Despite these improvements, many foreign investors worried of increased protectionism because it created an additional screening process for cross-border M&A deals.[72] Foreign investors were now required to notify the Ministry of Commerce (MOFCOM) of a proposed M&A that results in gaining control of a Chinese firm involved in a "key domestic industry, national economic security, or famous national."[73] These broad and vague terms implied great uncertainty. Moreover, MOFCOM's power was reinforced as it was given ultimate approval authority over M&A transactions, which meant that foreign investments would be subject to more stringent government review.[74] Each of the six government agencies that joined to issue the *M&A Rules* was given specific roles and responsibilities related to the whole review process.

Provisions: Greater Legal Protection Or Legalized Protectionism?" *China Law & Practice* (October 2006): 1.

[68] This was a joint effort of MOFCOM, SASAC, SAT, SAIC, CSRC, and SAFE.

[69] The 2006 M&A Rules refer to three rules: Administrative Measures on Strategic Investments in Listed Companies by Foreign Investors, Administrative Measures on the Takeover of Listed Companies, and Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

[70] John H. Farrar and David G. Mayes, *Globalisation, the Global Financial Crisis and the State* (Cheltenham, UK: Edward Elgar, 2013).

[71] "Round-tripping" is the practice of using entities set up outside the country as vehicles that qualify for tax breaks and other benefits available to foreign investors. Kenneth Davies, "China's Investment Watch," *Organization for Economic Cooperation and Development The OECD Observer*, no. 260 (March 2007): 19-20

[72] Kenneth, "China's Investment Watch," 19.

[73] Tai Hsia, Chuan Li, and David Patrick Eich, "Chinese M&A: Moving Target," *International Financial Law Review* 10 (October 2006): 1.

[74] Ge Xiangyang and Lui Chun Fai, "Yet More Uncertainty," International Financial Law Review (October 2000), 1.

Coordination among these entities would become crucial for efficient regulatory practices.

Another significant regulation was the *Anti-Monopoly Law* that took effect in August 2008. After nearly 14 years of debate, the *AML* was adopted by the NPC as the first comprehensive antitrust legislation in China.[75] It prohibited monopoly agreements, the abuse of a dominant position, and M&A that restricts market competition.[76] Although this signified China's march toward a market economy, the failure to effectively enforce the law in several instances revealed the weaknesses of the regulation.[77] Overseas investors also raised the question of the law being used as a pretense for trade protectionism as we will see in the case study of Coca Cola and Huiyuan. Other laws like the *Partnership Enterprise Law*, *Enterprise Bankruptcy Law, Foreign Exchange Regulation, and Foreign Investment Industrial Guidance Catalogue* also contributed to the development of China's regulatory framework for its private equity market.

Along with this legal groundwork for foreign private equity investment, there were signs of the burgeoning domestic private equity industry. The first mainland RMB-denominated industry investment fund, Bohai Industrial Investment Fund, was created after gaining approval from the National Development and Reform Commission (NDRC), an agency under the State council focusing on macroeconomic management, in December 2006.[78] Since then, many other domestic private equity funds ranging from RMB6 billion to RMB20 billion have been raised to finance small businesses in the

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75 Xiaoye Wang, "Highlights of China's New Anti-Monopoly Law," *Antitrust Law Journal* 75, no. 1 (2008): 133-50.
76 Ibid.
77 Zhang, "The Legal Environment for Foreign Private Equity Firms in China," 870.
78 Melissa Thomas and Alan Wang, "Fine-Tuning the PE Process," *IFLR* (April 2008): 66.

specific industries like manufacturing, energy, or high-technology.[79] Unlike foreign private equity funds, domestic funds are not subject to regulatory opposition or delays, giving them a significant advantage over foreign investors.[80] The 2008 global financial crisis slowed down fundraising, investment, and exit activities of foreign financial institutions. Nevertheless, Chinese domestic funds steadily grew. In 2008, China's private equity industry had 51 new funds worth $61 billion, 71.9% higher than the previous year, which were constituted of 30 foreign funds and 20 domestic funds.[81] With the growing number of RMB funds, many foreign private equity firms have started to put more emphasis on setting up funds geared toward local investors. Although there are still many insufficiencies and challenges in China's private equity market, numerous private equity investors continue to optimistically believe in the great opportunities that it has to offer.

[79] Wang, "Highlights of China's New Anti-Monopoly Law," 11.
[80] Thomas and Wang, "Fine-Tuning the PE Process," 67.
[81] Wang, "Highlights of China's New Anti-Monopoly Law," 11

Chapter 4: Successful Foreign Private Equity Investments in China

1) Case Study I: Newbridge Capital and Shenzhen Development Bank

Shenzhen Development Bank (SDB) was established in 1987 as a regional state-owned commercial bank based in Guangdong. SDB's transformation from a failing bank drowning in bad loans to a healthy lending institution has made it an icon of China's evolving capital market. It was the first bank to announce its IPO in May 1987 and got listed on the Shenzhen Stock Exchange in April 1991, which meant that it would no longer be a privately held company.[82] Shenzhen, a southern coastal city bordering Hong Kong, proved to be a prime location for SDB because of the city's exceptional growth accomplished through the central government's support for special economic zones (SEZ). After obtaining a nationwide banking license, SDB expanded to 225 branches throughout China by 2002.[83] At the end of 2002, 72.4% of SDB's shares outstanding were held by the public and 27.6% were held by Shenzhen government controlled entities.[84] This meant that local entities owned most of SDB's non-tradable shares, but were also the bank's own borrowers.[85] This can result in biased lending practices, which greatly increases the likelihood of lending to risky borrowers. Moreover, SDB's non-performing loans (NPL), or loans that have a high probability of default, to gross loans ratio was 11.6%, which was 4.3% higher than the average of other joint stock banks at

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[82] "About PAB," Ping An Bank Website, accessed April 26, 2014, http://bank.pingan.com/about/en/index.shtml.
[83] Li Yang and Robert Lawrence Kuhn, *China's Banking & Financial Markets: The Internal Research Report of the Chinese Government* (Singapore: John Wiley, 2007).; Li Jin, Yuhai Xuan, and Xiaobing Bai. "Shenzhen Development Bank." Harvard Business School Case 210-020 (August 2009, revised March 2011).
[84] Ibid.
[85] Henny Sender, "Horseman at the Gates," *Far Eastern Economic Review* 166, no. 23 (2003): 40.

the time.[86] Despite the bank's accumulation of low quality loans along with its shareholders who were reluctant to hand over their lending decisions, SDB's extensive national network in China's prosperous regions caught Newbridge Capital's attention.

Founded by Texas Pacific Group's (TPG) David Bonderman and Blum Capital Partners' Richard Blum in 1994, Newbridge Capital was among the first U.S.-based private equity firms focusing on investment in Asia. It is now a part of TPG Capital, which currently boasts of raising the largest Asia-focused fund since the global economic crisis.[87] Due to the Chinese government's unwillingness to allow standard control-type buyout deals, especially for SOEs, Newbridge slowly penetrated China's market through minority stake investments in more traditional industries like food and beverage in the mid-1990s.[88]

In 1999, Newbridge bought a 51% stake in Korea First Bank for $417 million becoming the first foreign owner of a South Korean bank.[89] By redesigning the bank's branch network, centralizing its credit-approval system, and revamping its operational practices, Newbridge was able to transform Korea First Bank (KFB) from a bankrupt creditor to South Korea's most trusted lender.[90] Six years later, KFB was bought by Standard Chartered for $3.25 billion, a nearly four-fold return. This valuable experience proved to be a harbinger of the success that Newbridge would achieve with SDB.

Behind the KFB success story stood Weijian Shan, an experienced Chinese

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[86] Jin, Xuan, and Bai, "Shenzhen Development Bank."
[87] Anita Davis, "TPG Targets Up to $5b for Asia-Focused Fund," *Asian Venture Capital Journal*, October 14, 2011,. http://www.avcj.com/avcj/news/2117183/tpg-targets-usd5b-asia-focused-fund.
[88] Jin, Xuan, and Bai, "Shenzhen Development Bank."
[89] Stephanie Strom, "U.S. Firm Has Control of Korea First Bank," *The New York Times*, September 17, 1999, http://www.nytimes.com/1999/09/18/business/international-business-us-firm-has-control-of-korea-first-bank.html.
[90] Sunny Yi and Chul-Joon Park, "Turbocharging Asian Turnarounds," *Harvard Business Review*, June 2006, http://hbr.org/2006/06/turbocharging-asian-turnarounds/ar/1.

negotiator who joined Newbridge in 1998 as the managing director for Asian operations.[91] After persevering through China's Cultural Revolution in the Gobi desert as a young man, Shan moved to America, where he studied business and rose to prominence in the private equity industry.[92] Continuing with the success that he saw in South Korea, Shan led the first foreign acquisition of a stake in SDB beginning in 2002 despite his reluctance to work on deals with Chinese firms because of the lack of respect for private property rights that would create formidable obstacles for foreign investors.[93]

Despite such skepticism, Shan began a tumultuous journey that began with optimistic negotiations, stalled with SBD's renouncement and Newbridge's counteractive indictment, but ended with a fruitful acquisition of SDB. Private equity was still an unfamiliar concept in China when preliminary negotiations between SDB and Newbridge took place. The highly regulated banking industry, in particular, was an untapped market for foreign private equity investment. Previously, most of the completed deals had been minority-stake investments, not large scale control-buyouts.[94] Shan saw great potential in this market and used his network of senior officials in mainland China to gain support for this project. The Shenzhen government worried that SDB's declining performance would negatively affect the local economy because many export-oriented manufacturing firms relied on SDB's financing. This made it easier for Shan to persuade the municipal government that Newbridge's notable management and operational expertise would help SDB get out of its period of fragility. Along with Shan's impressive track record in Korea

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[91] Peter Hoflich, *Banks at Risk: Global Best Practices in an Age of Turbulence* (Singapore: J. Wiley & Sons, 2011), 145.
[92] "China's Patient Crusader," *The Economist*, May 14, 2005, http://www.economist.com/node/3960876.
[93] Sender, "Horseman at the Gates," 40.
[94] Jin, Xuan, and Bai, "Shenzhen Development Bank."

and wide connections in China, Newbridge posed no competitive threat to SDB, which greatly appealed to Shenzhen government officials.

Backed by the government, Shan and his team started a due diligence process in May 2002 to determine a comprehensive turnaround strategy for the bank.[95] They sought to do this primarily through tight management control of SDB. Board control rights would be especially important because this would allow the firm to address problems of poor governance, management, and credit control culture.[96] Newbridge was able to reach an agreement with SDB in June 2002 with endorsement from Beijing regulators and the State Council.[97] The binding contract gave Newbridge a 17.89% stake of non-tradable shares in SDB, slightly below the China Banking Regulatory Commission's (CBRC) 20% limit for individual foreign holdings in Chinese banks.[98] With 72.4% of shares in public hands, SDB was relatively dispersed compared to other joint-stock banks, allowing Newbridge to gain sizable control with a small stake by securing the right to appoint 8 out of 15 board members.[99] In order to alleviate the government's worries about the risks of a short-term investment, Newbridge promised to not to sell its stake for at least five years.[100] SDB was bought at roughly 1.6 times the book value when market shares were trading at 4.5 times because the NPL ratio was estimated to be much higher than the reported number.[101] In many aspects, this was a win-win situation. Newbridge would be

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[95] Jin, Xuan, and Bai, "Shenzhen Development Bank."
[96] Ibid.
[97] Sender, "Horseman at the Gates," 40.
[98] "Newbridge Obtains Nod for Shenzhen Bank Deal," *People's Daily Online,* October 25, 2004, http://english.peopledaily.com.cn/200410/25/eng20041025_161473.html.; "Newbridge to the Mainland," *The Economist*, June 5, 2004, http://www.economist.com/node/2737033.
[99] "Newbridge to the Mainland."
[100] "Newbridge Stake in Shenzhen Bank Approved," *China Economic Review*, October 25, 2004, http://www.chinaeconomicreview.com/node/32559.
[101] Jin, Xuan, and Bai, "Shenzhen Development Bank."

able to hold a majority stake in SDB with management control at a profitable price and SDB would be able to use foreign expertise to get back in shape. The deal received wide domestic and foreign media coverage once a public announcement was made in September 2002 about the final stage of consultations. It was seen as a dramatic turning point in China's restrictive banking sector. Fred Hu, a managing director of Goldman Sachs in Hong Kong at the time, described this as a "pioneering deal in which the authorities ceded real control" and a "new commercial model in China."[102]

Despite this positive outlook, SDB reneged on its agreement with Newbridge in May 2003. On May 21, SDB abruptly dissolved the transitional management committee set up by Newbridge earlier in September, which led Newbridge to immediately take legal action. Many speculated about the reasons behind SDB's renouncement. Some proposed that the great discontent of SDB's existing board members, which comprised of Shenzhen government officers and senior executives from local SOEs, played a large role in the public fallout.[103] There was great tension between the transitional management team and the existing board members because the Shenzhen officials on the board were more concerned about their own job security than SDB's possible boost in performance with Newbridge's assistance.[104] The opponents of the deal criticized Newbridge, pointing to the discounted price at which the firm announced would buy SBD. Newbridge was depicted as a "greedy" foreign investor that greatly undervalued the bank.[105] The furtive search for an alternative investor began. While foreign private equity firms like The Carlyle Group and Morgan Stanley were unwilling to take on the challenge, Chinatrust

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[102] Henny Sender, "Pulling the Plug," *Far Eastern Economic Review* 166, no.21 (2003): 45.
[103] Jin, Xuan, and Bai, "Shenzhen Development Bank."
[104] Ibid.
[105] Sender, "Pulling the Plug," 45.

Commercial Bank (CTBC) seemed eager about this rare opportunity and emerged as a potential investor willing to pay more than Newbridge.[106] CTBC, Taiwan's leading privately-owned bank, is controlled by a powerful business clan that has accumulated great wealth for four generations, namely the Koo family.[107] The Koos openly expressed their desire to invest in a mainland bank in the past, but were restrained by financial regulations in Taiwan and China.[108] A deal with SDBD would certainly help them build tight business relations and expand their presence on the mainland.

Another speculation was Newbridge's loss of support due to changes in the State Council, Central Bank, and securities agency. Zhu Rongji, China's premier at the time, was a main supporter of the deal with Newbridge. In March 2003, Zhu retired, the Cabinet was reshuffled, and top officials at China's central bank and securities agency were also replaced.[109] This signified great uncertainty for Newbridge because key backers of the deal were no longer there to solidify the agreement.[110] The tide shifted in the favor of those who had opposed Newbridge's acquisition, eventually leading to the fallout.

The sudden announcement issued by SDB triggered an unpleasant legal dispute. Lacking only an official signature from SDB on the contract, Newbridge urged the Shenzhen government to "honor its obligations under this binding international contract" in an official statement, pointing out that the Bank of China (BOC) and CSRC had

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[106] Sender, "Pulling the Plug," 45.
[107] Kwok B. Chan, Tak-sing Cheung, and Agnes S. M. Ku, *Chinese Capitalisms* (Leiden: Brill, 2007) 153-154.
[108] Mark L. Clifford, "Banking's Great Wall," *Bloomberg Business Week*, June 1, 2003, http://www.businessweek.com/stories/2003-06-01/bankings-great-wall.
[109] Xiaowen Tian, *Managing International Business in China* (Cambridge: Cambridge UP, 2007), 66.
[110] Clifford, "Banking's Great Wall."

already approved this deal.[111] SDB's negotiator refuted this by saying it was a "commercial decision" made by the board, rather than a "political decision."[112] Many foreign investors in China are cautious about going to the courts for fear of endangering future relations in such a *guanxi*-based business environment.[113] Although Newbridge would have preferred to settle this dispute outside the courts due to such concerns, SDB's unwillingness to work things out provoked Newbridge to take legal action.[114] A few days after SDB's announcement to terminate the management agreement, Newbridge filed a suit against Chinatrust Commercial Bank in a Texas court, accusing Chinatrust of "flagrant unjustified interference" with Newbridge's "contractual rights."[115] It also charged Chinatrust of conspiring with SDB's president Zhou Lin, who was later arrested for granting allegedly illegal loans in 2006, to undermine their deal.[116] The battle did not stop there as Newbridge went on and launched arbitration proceedings with the International Chamber of Commerce (ICC) in October, demanding financial compensation from the four major shareholders of SDB for the alleged breach of agreement.

Not until April 2004 did the dispute come to an end. In an announcement issued through the Shenzhen Stock Exchange, SDB declared that it, Newbridge, and the four shareholders had concurred to withdraw all arbitration petitions and cross-petitions

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[111] Christine Chan, "Newbridge Insists on SDB Deal," *South China Morning Post*, May 13, 2003, http://www.scmp.com/article/415335/newbridge-insists-sdb-deal.
[112] Clifford, "Banking's Great Wall."
[113] Ibid.
[114] Andrew K. Collier, "Newbridge Still Has an Eye on China," *South China Morning Post*, October 29, 2003, http://www.scmp.com/article/432731/newbridge-still-has-eye-china.
[115] Henry Sender, "Newbridge Unit Files Suit in U.S. Over China Bank --- Asian Subsidiary Alleges Taiwan Concern Interfered with its Exclusive Deal," *Wall Street Journal*, May 23, 2003.
[116] Tom Mitchell, "Shenzhen Development Bank's Ex-chair Arrested," *Financial Times*, March 30, 2006, http://www.ft.com/intl/cms/s/0/49446304-c00f-11da-939f-0000779e2340.html#axzz2xEohLv3u.

without offering a clear reason.[117] Some contend that the damage on the Chinese side would have been more severe than on Newbridge if this deal had ultimately failed. While Newbridge might only have lost a profitable opportunity, Shenzhen could have lost its reputation as a center for leading financial reform and undermined the central government's effort to revamp China's troubled banking sector.[118] It was even said that the CSRS looked upon the aborted deal with scrutiny and criticized SDB for "insufficient information disclosure" during its negotiations with Newbridge and for failure to obtain the shareholders' approval for the transitional management team.[119] This may imply the political pressure on SDB to "seal the deal." Regardless of SDB's motivations, the termination of arbitration proceedings suggests that both parties preferred to settle the original deal rather than continue with this legal feud.

Newbridge finally succeeded in officially buying a controlling stake in SDB becoming the first foreign investor to gain control of a Chinese bank at the end of May 2004. SDB publicly announced that the board of directors had sold a 17.89% stake to Newbridge for $150 million.[120] The board also approved the appointment of several executives from Newbridge, making non-Chinese nationals compose half of the 15-member board. John Langlois, a Morgan Stanley executive in China, and Jeffrey Williams, the former CEO of Standard Chartered Bank in Taiwan, replaced SDB's chairman Zhou Lin and president He Ru, respectively.[121] Frank Newman, a former U.S. deputy treasury secretary, became SDB's chairman and CEO after Langlois resigned a

[117] Bei Hu, "Newbridge Exits Mainland Row," *South China Morning Post*, April 12, 2004.
[118] Richard McGregor and Jane C., "Jilted Newbridge Lashes Out at Shenzhen Bank," *National Post*, May 13, 2003.
[119] Hu, "Newbridge Exits Mainland Row."
[120] "Newbridge to Buy Shenzhen Development Stake," *Financial Times*, May 31, 2004.
[121] "Shenzhen Development Bank Nominates Directors to Board," *Wall Street Journal Asia*, November 16, 2004.

year later. This was the first time non-Chinese businessmen were given such senior positions at a Chinese bank, which reflects SDB's serious commitment to reforms.[122] Although the new management faced formidable challenges including a high NPL ratio and low capital adequacy ratio (CAR), they were able to overcome this through an effective, centralized, and accountable leadership structure.[123] TPG, which subsumed Newbridge in 2006, was able to strengthen the bank's branch network, cultivate a credit culture, and improve its balance sheet overall.[124] Over the five years under TPG's control, SDB's net profit grew from $25.8 million in 2004 to $736.9 million in 2009, its NPL ratio dropped down from 11.41% to 0.68%, and its CAR went up from 2.3% to 8.88%.[125]

TPG's success in enhancing SDB's financial performance enabled the firm to exit its investment with a highly lucrative stake sale. In June 2009, China's leading insurer Ping An Insurance Group announced its plans to buy a 16.7% stake from TPG along with new shares issued by SDB, which would give Ping An a 30% stake in the bank.[126] It gained the approval from the CSRC, CBRC, CIRC, and MOFCOM despite opposition from the nationalist camp, which does not want any foreigner to profit TPG had the choice of either accepting a cash amount of $1.68 billion, five times the initial investment of $150 million, or a 4% stake of 299 million shares in Ping An. TPG chose the latter most likely because a share-swap option would be more favorable in the eyes of Chinese

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[122] Alexandra Harney, "SDB Appoints Foreign Executives," *Financial Times*, December 16, 2004.
[123] Allen T. Cheng, "Trouble in China?" *Institutional Investor*, February 2009.; Henry Sender, "Newbridge Tries Golden Touch at Chinese Bank," *Wall Street Journal Asia*, May 16, 2005.
[124] Sender, "Newbridge Tries Golden Touch at Chinese Bank."
[125] "Shenzhen Bank's Profit Soars," *Wall Street Journal Asia*, March 12, 2010.; Daniel Inman, "Ping An to Invest in Shenzhen Development Bank," *Bloomberg Business Week*, June 14, 2009, http://www.businessweek.com/globalbiz/content/jun2009/gb20090614_511195.htm.
[126] Inman,"Ping An to Invest in Shenzhen Development Bank."

officials since TPG would continue to retain a large stake in the financial sector.[127] This turned out to be a wise decision because TPG was able to sell all of its stake in Ping An for a total of $2.41 billion in 2010, which was 16 times its original investment.[128]

TPG is one of the few U.S. private equity firms to have made such a lucrative exit such as this. The major obstacle that TPG faced was resistance from the current board of local government officials who did not want to relinquish their control over the firm, rather than disapproval from Chinese regulators. Surprisingly, regulating agencies were actually supportive of the deal. This may have been due to the government's bigger agenda of the banking system reform. After the CCP Central Committee and the State Council held the First National Work Conference in November 1997, there were a series of policy reforms for state-owned commercial banks like SDB, which had been accumulating large volumes of NPLs due to biased lending practices, as mentioned above. The abolishment of the credit plan system, which forced state-owned commercial banks to lend according to government policies, in 1998 was the first step toward voluntary management of the bank's fund allocation.[129] There were also capital injections by the government in an effort to salvage the balance sheet of failing banks. TPG came into the scene under these circumstances. With the help of a strong foreign private equity firm with a previous track record of salvaging a failing Korean bank, the government could remove some of its burdens. Furthermore, the alternative of allowing SDB to partner with a Taiwanese bank was not a politically plausible option. With this case study, we see that

[127] Jamil Anderlini, "Opposition Grows to Ping An's TPG Deal," *Financial Times*, June 14, 2009.
[128] Yvonne Lee and Nisha Gopalan, "TPG Sells Stake in Ping An," *Wall Street Journal*, September 4, 2010.
[129] Kumiko Okazaki, *Banking System Reform in China: The Challenges of Moving Toward a Market-Oriented Economy* (Santa Monica, CA: The RAND Corporation, 2007), accessed April 27, 2014,http://www.rand.org/content/dam/rand/pubs/occasional_papers/2007/RAND_OP194.pdf.

Chinese regulators may allow foreign firms into sensitive industries like the banking sector if there is a bigger agenda at hand. TPG's success in turning SDB into a healthy bank could encourage the government to continue opening up its overly protected business areas in the future.

2) Case Study II: The Blackstone Group and China National BlueStar Corporation

China National BlueStar Co., Ltd., China's major manufacturer of new chemical products and specialty chemicals, was founded by Ren Jianxin in 1984. The Beijing-based firm was brought under the control of the central government in April 2000. The next month, China's State Council authorized the creation of China National Chemical Corp. (ChemChina), a large-scale enterprise administrated by SASAC, to restructure the country's fragmented chemical industry.[130] BlueStar became a special subsidiary of ChemChina, which is currently China's largest chemical company and 19th largest in the world. With 24 state-level research institutes, two national laboratories, and over 40 technical research centers, ChemChina spends tremendous resources on its R&D and even completed 95 key construction projects between 2006 and 2010.[131] Chairman Ren Jianxin strongly believed that innovation, an essential factor for the firm's future success, could be achieved through internationalization.[132] Therefore, BlueStar has continued to put an emphasis on overseas development. In 2006, the company completed the purchase

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[130] Robert Westervelt, "Private Equity Firm Takes Stake in ChemChina's Bluestar," *Chemical Week* 169, no. 30 (September 19, 2007): 8.

[131] *China's Chemical Industry: The New Forces Driving Change* (KPMG Report, September 2011), accessed April 26, 2014, https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Chemical-Industry-201109.pdf.

[132] "Company News: Leadership Amidst Crisis," ChemChina Website, May 8, 2009, accessed April 26, 2014, http://www.lxbjhj.com/en/xwymt/qyxw/webinfo/2009/05/1339396725538220.htm.; Robert Lawrence Kuhn, *How China's Leaders Think: The Inside Story of China's Reform and What This Means for the Future* (Singapore: John Wiley & Sons, 2010), 245.

of Adisseo Group, a leading French animal nutrition feed firm, by acquiring its parent company Drakkar Holdings S.A.[133] Realizing the challenges of cross-cultural M&A, Ren welcomed the prospect of private equity when Blackstone extended the offer in 2007.[134]

A leading global alternative investment manager, the Blackstone Group L.P. began its Asian operations in 2005, focusing on private equity and real estate. After two years, the firm opened a private equity office in Hong Kong, marking its operational expansion to Greater China. Although this was a relatively late start compared to those of other U.S. private equity firms like Carlyle and TPG, Blackstone still managed to quickly magnify its presence in the mainland. Its IPO in June 2007 drew in a $3 billion investment from China Investment Company (CIC), a large sovereign wealth fund.[135] The following month, it played a key advisory role in government-owned China Development Bank's (CDB) $13.5 billion investment in U.K. bank Barclays PLC, the largest foreign investment made by a Chinese company at that time.[136] The company became a "rising star" in China, especially after developing links with the Chinese government, according to an analyst at China International Capital.[137] After reviewing potential investment projects, Blackstone began discussing a possible investment in BlueStar. Preliminary negotiations between Blackstone and BlueStar began in mid-2007, a time when foreign private equity firms faced difficulty in buying stakes of state-backed

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[133] "Overseas Development Page," ChemChina Website, accessed April 26, 2014, http://www.chemchina.com.cn/en/gjyw/whfz/A601701web_1.htm.
[134] Kuhn, *How China's Leaders Think*, 245.
[135] "History Page," Blackstone Website, accessed April 26, 2014, http://www.blackstone.com/the-firm/overview/history.
[136] Graeme Wearden, "China Takes £1.5bn stake in Barclays," *The Guardian*, July 23, 2007, http://www.theguardian.com/business/2007/jul/23/china.internationalnews.
[137] Cathy Chan and Michele Batchelor, "Blackstone to Sign Deal for BlueStar Buyout Firm's Deal is its First in China," *International Herald Tribune*, September 10, 2007.

assets.[138] Despite concerns of government opposition, Blackstone managed to sign a strategic alliance with ChemChina in September 2007 for a 20% stake in BlueStar, marking Blackstone's first private equity investment in the mainland. It promised a considerable sum of $600 million during a time when most foreign private equity deals ranged from $50 million to $100 million in China.[139] BlueStar completed its group restructuring and registered as a Sino-foreign joint stock limited company the following month.[140]

Blackstone's expertise in the chemical industry was a major element to its success. Past private equity investments in chemical companies made Blackstone a credible and appropriate investor for BlueStar. In 2003, Blackstone had acquired the German chemical company Celanese AG and the U.S. chemical and water treatment firm Nalco.[141] Ren trusted that this past experience with globally integrated producers of chemicals would help BlueStar advance its global strategy. Blackstone would not only provide an extra capital boost, enhance corporate governance, and improve management systems, but also accelerate international expansion through its global network.[142] In an interview with McKinsey & Company, Ren noted that "if BlueStar tried to make overseas acquisitions in some parts of the world, it might cause unnecessary misunderstandings

[138] Tim LeeMaster and Nevin Nie, "Blackstone Targets BlueStar Stake," *South China Morning Post*, June 20, 2007.
[139] Rick Carew, "Blackstone Expands Equity Push in China," *Wall Street Journal Asia*, November 2, 2009.
[140] "Press Release: ChemChina and Blackstone Announce Bluestar Closing," Blackstone Website, October 6, 2008, http://web3.blackstone.com/news-views/press-releases/details/chemchina-and-blackstone-announce-bluestar-closing.
[141] " Press Release: Celanese Acquired by Blackstone," Blackstone Website, April 1, 2004, http://www.blackstone.com/news-views/press-releases/celanese-acquired-by-blackstone.; "Press Release: Blackstone, Apollo and Goldman Sachs to Acquire Ondeo Nalco from Suez for $4.2 Billion," Blackstone Website, September 4, 2003, http://www.blackstone.com/news-views/press-releases/blackstone-apollo-and-goldman-sachs-to-acquire-ondeo-nalco-from-suez-for-$4-2-billion.
[142] Tomas Koch and Oliver Ramsbottom, *Growth Strategy for a Chinese State-Owned Enterprise: An Interview with Chemchina's President* (The McKinsey Quarterly, July 2008), 7-8, accessed April 26, 2014, http://www.mckinsey.it/storage/first/uploadfile/attach/140408/file/grst08.pdf.

and adversely affect the transaction, but with Blackstone's participation, the path could be smoother," implying that Blackstone would add to the credibility of BlueStar in future international transactions.[143]

Timing was another factor that worked to Blackstone's advantage. During this period, SASAC was strongly pushing for the strengthening and expansion of mid-level SOEs because it ultimately desired domestic companies to become global players in their respective fields.[144] Many small or mid-sized SOEs in various provinces were facing financial difficulty.[145] Private equity funds could function as a way to carry out the government's strategic reforms in these circumstances. However, the U.S. credit crunch of 2007 made it more difficult for private equity dealmakers to finance leveraged transactions.[146] Therefore, Blackstone may have faced less competition, making it easier for the Chinese government to take notice of Blackstone.

The strongest driving force for Blackstone's success could arguably be the extensive political connections of the deal's orchestrator. Antony Leung joined Blackstone in 2007 to co-head the Hong Kong office with senior managing director Ben Jenkins. Born in Hong Kong, Leung received education from the University of Hong Kong and went on to work for Citigroup for 23 years. When Leung, known for being articulate and market-savvy, was Citi's country corporate officer for China and Hong Kong, he was a compelling advocate for giving loans to political entities in Shanghai

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[143] Ibid.
[144] Yong, *Private Equity in China*, 134.
[145] Koch and Ramsbottom, "A Growth Strategy for a Chinese State-Owned Enterprise," 2.
[146] Sundeep Tucker, "Chemical Deal in China is a First for Blackstone," *Financial Times*, September 11, 2007.

when other Western banks were reluctant to do so.[147] He climbed up the corporate ladder and eventually became the first locally born corporate head of Citi in Hong Kong around 1992. He later joined Chase Manhattan Corporation, which eventually merged with J.P. Morgan, where he rose to the rank of Asia-Pacific chairman.[148] In 1997, Hong Kong's sovereignty was transferred from the U.K. to China. Leung took this opportunity to change the course of his career to politics and became a senior policy adviser under Hong Kong's first postcolonial government.[149] His service as the Financial Secretary of Hong Kong, beginning in 2001, came to an end after two years because his political career was harmed by a scandal when he bought a new luxury car just weeks before announcing an increase in vehicle registration fee.[150]

However, it did not take long for Leung to make a comeback. After four years of keeping a low profile, he was offered a position as Blackstone's first chairman for Greater China, which turned out to be a remarkably clever move for Blackstone. As a result of his experience in business as well as the government, Leung had developed longstanding relationships in China's financial and political community. A Chinese official who had previously dealt with Leung notably said, "I respect [Leung] a lot. On one hand, he was a banker for many years — very experienced. On the other hand, he was an official in the Hong Kong government. I think he has business sense, broad

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[147] Jason Dean, Henny Sender, and Jonathan Cheng, "China Deals Mark Rebound for Leung with Blackstone," *Wall Street Journal*, July 25, 2007.; Jesse Wong, "Antony Leung's New Agenda," *Institutional Investor*, May 2002.
[148] "Our People: Antony Leung," Blackstone Website, accessed April 26, 2014, http://www.blackstone.com/the-firm/overview/our-people/antony-leung.
[149] Dean, Sender, and Cheng, "China Deals Mark Rebound for Leung with Blackstone."
[150] Vivian Wai-yin Kwok, "Leung Goes Back to Work," *Forbes*, January 16, 2007, http://www.forbes.com/2007/01/16/china-leung-finance-face-lead-cx_vk_0112autofacescan03.html.

connections, and also he works very hard."[151] This sense of trust that Leung had built with Chinese politicians and bankers proved to be instrumental in opening the door to big deals. Using his connections, Leung scheduled a meeting with Lou Jiwei, the chief executive officer of CIC and the current Minister of Finance, in late April to pitch for a few of Blackstone's shares. Much to Leung's surprise, Lou and the managers of CIC expressed great interest in buying a major stake.[152] There was little delay in the process because CIC signed the deal barely three weeks after Leung's meeting with Lou. Leung also played a pivotal role in advising CDB's investment in Barclays.[153] Both instances greatly boosted Blackstone's reputation and profile in China. There were conjectures that these established ties helped the subsequent BlueStar deal consummate.[154] Leung's wide network gave Blackstone a head start by skipping the auction process. A person familiar with the deal said in an interview with South China Morning Post, "The fact that Blackstone got to negotiate with a major player like BlueStar without having to go through an auction process that would have brought in a dozen funds and pushed up the price was impressive. That shows the depth of their political connections."[155] Leung was the main engineer behind these connections. Essentially, Blackstone was able to overcome the disadvantages as a latecomer in China's private equity market by hiring the

[151] Jason Dean and Jonathan Cheng,"News in Depth: Blackstone's Leung Emerges as Big Player in China Push," *Wall Street Journal Asia*, July 25, 2007, 15.
[152] David Carey and John E. Morris, *King of Capital: The Remarkable Rise, Fall, and Rise Again of Steve Schwarzman and Blackstone* (New York: Crown Business, 2010), 268.
[153] Martin Arnold, "Blackstone Hails Chinese Success," *Financial Times*, July 23, 2007.
[154] Rick Carew and Denis McMahon, "Blackstone's China Ties Begin to Pay Off," *Wall Street Journal*, September 11, 2007, C3.
[155] Tim LeeMaster, "Buyout Giants show Distinct Tacks in Greater China Push," *South China Morning Post*, August 20, 2007, http://www.scmp.com/article/604813/buyout-giants-show-distinct-tacks-greater-china-push.

right person.[156] This is evidenced by the fact that *guanxi* is a significant component of a successful private equity investment in China.

A combination of these three factors: field expertise, timing, and *guanxi*, generated the synergy needed to gain regulatory approval. Blackstone's investment plan was officially given the green light on January 10, 2008 when the NDRC announced the government's approval on its website.[157] As a minority stake, Blackstone was limited to appointing two seats on BlueStar's board of directors, which were taken by Leung and Jenkins. Even though it had minority control, Blackstone did not assume a passive role. It used its corporate partnership with ChemChina to bid for Nufarm, an Australian agricultural chemicals maker, in November 2007.[158] This joint overseas acquisition was in alignment with BlueStar's goals to expand internationally and Blackstone's objective to boost returns.[159] Despite the deal's eventual failure, it demonstrated that there are still opportunities for minority investments in SOEs.

Blackstone continued to evolve and gain competitiveness in China after the BlueStar deal. In August 2009, the firm announced its plans to establish an RMB fund, money raised by local investors. In an effort to develop the domestic private equity industry, the Chinese government had been discussing the regulatory framework for setting up local-currency funds since 2007.[160] The ongoing debate among regulators over the rules did not deter Blackstone's initiative. An RMB-denominated private equity fund

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[156] Dean, Sender, and Cheng, "China Deals Mark Rebound for Leung with Blackstone."

[157] Jason Subler, "China Approves Blackstone Investment in BlueStar," *Reuters*, January 10, 2008, http://www.reuters.com/article/2008/01/10/us-blackstone-bluestar-idUSPEK28690120080110.

[158] Peter Smith and Sundeep Tucker, "Blackstone Links with BlueStar on Nufarm bid," *Financial Times*, November 2, 2007, 13.

[159] Cathy Chan and Ambereen Choudhury, "ChemChina Said to Seek Buyout of Nufarm with Blackstone," *International Herald Tribune*, November 3, 2007, 16.

[160] Rick Carew and Peter Lattman, "China Nears New Rules Governing Deal Firms," *Wall Street Journal*, August 17, 2009, C3.

would allow Blackstone to make investments with more ease because it is characterized by faster regulatory approval, simpler registration processes, and more access to local deals.[161] With hopes of raising Shanghai into an international financial center, the government of Pudong signed an agreement with Blackstone to form an RMB fund under the name of Blackstone Zhonghua Development Investment Fund with a target of 5 billion yuan ($732 million).[162] Some market watchers said that Blackstone's relationship with the government had helped the firm four years down the line to obtain this approval.[163] Blackstone set a precedent and paved the way for non-Chinese private equity investment based on local currency.[164]

Blackstone has yet to make an exit from its stake in BlueStar. It has failed twice in a Hong Kong IPO of BlueStar Adisseo Nutrition Group, a unit of BlueStar, due to excessive market volatility.[165] Nevertheless, Blackstone will continue its wide-ranging expansion in China. "China is a required course, not an elective, for any sensible global financial institution," said Blackstone Chief Executive Stephen Schwarzman in an interview with the Wall Street Journal.[166] In other words, China's importance in the foreign private equity industry will continue to grow and Blackstone plans to take the lead in this movement.

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[161] "New Opportunities: RMB Funds in China," *Interfax: China Investment Weekly*, March 26, 2010.
[162] David Barboza, "For U.S. Private Equity, Yuan is Ticket into China: Firms Hope that Funds in Local Currency Will Draw Newly Rich Clients," *International Herald Tribune*, November 20, 2009.; "Blackstone Slates Final Close for RMB Fund Debut." *The Asian Venture Capital Journal* 23, no. 29 (August 3, 2010): 5.
[163] Sonja Cheung, "Future is Cloudy for Investors in China's State-Owned Sector," *LBO Wire*, March 10, 2014.
[164] Maya Ando, "Blackstone RMB Vehicle Signals New PRC Fund Wave," *The Asian Venture Capital Journal* 22, no. 23 (June 23, 2009): 1.
[165] Deng Chao, "Finding an Exit from China Gets Harder," *Wall Street Journal*, July 23, 2012, http://blogs.wsj.com/deals/2012/07/23/finding-an-exit-from-china-gets-harder/.
[166] Rick Carew, "Blackstone Hones China View," *Wall Street Journal*, Nov 2, 2009, 23.

Chapter 5: Failed Foreign Private Equity Investments in China

1) Case Study III: The Carlyle Group and Xugong Group Construction Machinery

Xuzhou Construction Machinery Group (XCMG) is one of China's largest manufacturers of construction machinery and is based in the Jiangsu province. After its foundation in 1989, XCMG has grown to become China's second biggest construction equipment maker and has gradually expanded its business worldwide by selling machines at a lower price than its foreign competitors.[167] It is wholly owned by the government of Xuzhou, a critical part of the HuaiHai Economic zone, which boasts of vibrant machinery and mining industries. With advanced technology patents and technical innovation, XCMG aspires to become an internationally competitive firm ranking among the world's top three in the industry.[168] Xugong Group Construction Machinery Co., Ltd., which supplies more than half of the domestic market for hydraulic cranes and road-paving equipment, is one of XCMG's subsidiary companies.[169] Due to growing competition in the construction machinery sector, the Xuzhou city government concluded that Xugong needed capital injections and restructuring in order to globally expand its national brand.[170] Xugong began a rigorous auction process in 2004 that consisted of two rounds and six international bidders among which Carlyle Group surfaced as the front-runner for the control of Xugong.

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[167] "Chinese Companies: Over the Great Wall," *The Economist,* November 5, 2005.
[168] "About XCMG: Company Profile," XCMG Website, accessed April 26, 2014, http://en.xcmg.com/about/companyprofile.htm.
[169] Ivan Tselichtchev and Philippe Debroux, *Asia's Turning Point: An Introduction to Asia's Dynamic Economies at the Dawn of the New Century* (Singapore: John Wiley & Sons (Asia), 2009.
[170] Yong, *Private Equity in China*.

The Carlyle Group, a Washington, D.C.-based global asset management company specializing in private equity, has dominated foreign private equity investments in China since the early 2000s. It began as a boutique investment bank in 1987 founded by five partners with backgrounds in finance and politics. Some of its past directors include former U.S. President George H. W. Bush, former U.S. Secretary of Defence Frank Carlucci, and former U.K. Prime Minister John Major, which explains its reputation for having deep political connections in Washington.[171] The 1998 establishment of Carlyle Asia Partners LP, an Asia-focused buyout fund amounting to $750 million, signaled its full-fledged effort to invest vigorously in Asian firms, particularly in the financial, consumer, and manufacturing services.[172] It purchased a stake in a medium-sized Korean bank called KorAm Bank with JP Morgan in 2000 and in Pacific China Holdings, a Chinese department store chain, the following year.[173] In 2004, Carlyle revealed its ambitious plans to invest as much as $1 billion in a wide variety of industries in China.[174]

One of its aspired investment projects was the purchase of an 80% stake in Xugong Group for $300 to $400 million. This would have not only represented the first LBO in mainland China by a foreign private equity firm, but also an unprecedented concession of a state-owned firm's majority stake to a foreign company.[175] External and internal obstacles laid ahead of Carlyle. Externally, there was fierce competition against large firms like Caterpillar, AIG Global Investment Group, J.P. Morgan Partners LLC,

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[171] Peter Smith, "A Probe into Carlyle's 'Access Capitalism," *Financial Times*, May 8 2003.
[172] Angela MacKay, "Carlyle Succumbs to the Lure of Mainland China," *Financial Times*, November 10, 2003.
[173] Ibid.
[174] Peter Wonacott, "Carlyle Group Plans Investment of as Much as $1 Billion in China," *Wall Street Journal*, April 21, 2004.
[175] Laura Santini,"Carlyle is Front-Runner for Control of Xugong," *Wall Street Journal Asia.* November 25, 2004.

Warburg Pincus LLC, and Citigroup also wanting to strike a deal with Xugong. Internally, Carlyle faced a turnover among senior-level staff with Michael Kim, co-head of buyouts in Asia, leaving to start his own fund and taking several executives with him.[176]

Despite such obstructions, Carlyle rose as the highest bidder after a long auction process and declared in October 2005 that it had signed a definitive agreement with Xugong Group to buy a 85% stake for $375 million, leaving 15% in the hands of XCMG. This price was roughly 1.7 times Xugong's net asset value and roughly seven times its earnings.[177] Unlike all the previous private equity investments by foreign firms in China, this deal would give a majority stake in the company. Both the Xuzhou government and Carlyle Group viewed this as a beneficial transaction. Xugong Group Chairman Wang Min said in a statement, "This is the right choice for a win-win outcome. It will unload our heavy historical burdens as an SOE, build an energetic and competitive system in the company, and help us build an international brand."[178] Through Carlyle's injection of fresh new capital, Xugong planned to undergo a structural reform and widely expand its business. Xiang Dong Yang, the managing director and co-head of Carlyle Asia Partners, also expressed optimism saying, "We are excited about this important investment in Xugong, one of our largest in China. We look forward to working with the Xugong

[176] Laura Santini, "Carlyle Agrees to Revised Deal; U.S. Private-Equity Firm is on Track to Buy Stake in China Pacific Life," *Wall Street Journal Asia,* September 8, 2005.
[177] Francesco Guerrera, "Carlyle Seals 'Landmark' Xugong Deal Construction," *Financial Times*, October 26, 2005.
[178] "News Release: The Carlyle Group Agrees to Acquire an 85% Stake in Xugong Group Construction Machinery Co., Ltd.," The Carlyle Group, October 24, 2005, accessed April 26, 2014, http://www.carlyle.com/news-room/news-release-archive/carlyle-group-agrees-acquire-85-stake-xugong-group-construction-machinery-.

management team to create a leading international construction equipment company."[179] Gaining a majority stake in a large SOE like Xugong would assist Carlyle in obtaining future deals through more experience and name recognition with Chinese government officials.[180]

Contrary to this bright outlook, Carlyle was unable to overcome the last hurdle of obtaining approval from the central government's regulatory authorities. In particular, MOFCOM stood in the way of Carlyle's acquisition. There were several supposed reasons for MOFCOM's opposition to the buyout. Some thought of it as a retaliatory response to the U.S. government's protectionist behavior.[181] In 2005, there was a competition between Chevron Corporation and China National Offshore Oil Corporation (CNOOC) to acquire U.S. oil producer Unocal Corporation. Although CNOOC's opening bid was higher than Chevron's initial bid, strong congressional opposition based on claims that CNOOC's takeover could threaten national security and economic interests forced CNOOC to back down.[182] MOFCOM used a similar argument to justify its disapproval of Carlyle's buyout plans. Allowing foreign control over an important state asset like Xugong could endanger the country's economic security, according to the ministry.[183] Chinese government and industry officials also asserted that the possible exposure of Xugong's advanced technology to foreign competitors could ultimately

[179] "News Release: The Carlyle Group Agrees to Acquire an 85% Stake in Xugong Group Construction Machinery Co., Ltd.," The Carlyle Group.
[180] Santini, "Carlyle is Front-Runner for Control of Xugong."
[181] Jonathan Braude, "Acts of Vengeance are a Poor Basis for Forming Policy," *South China Morning Post*, March 27, 2006.
[182] Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth, "Chapter 5: The CNOOC Case," *US-China Trade Disputes: Rising Tide, Rising Stakes* (Washington, DC: Institute for International Economics, 2006) 47-54.
[183] "Carlyle to Pay Xugong US $145," *China Daily*, October 25, 2006, http://english.people.com.cn/200610/25/eng20061025_314945.html.

threaten national security.[184] However, construction machinery is generally not regarded as a sensitive sector.[185] On the contrary, infrastructure, defense, banking, energy, and steel are several sensitive areas that have been traditionally linked to national interests meriting regulation.[186] Xugong's technology to make construction equipment may be linked to economic competitiveness and efficiency, but it is an overstatement to say that it is vital to China's national security.[187] Therefore, this can be seen as the government's way of retribution rather than a genuine concern for security issues.

Others suspected that the political hostility toward the deal was connected to nationalist sentiment spurred by Xugong's rivals. After the deal was announced, the Chinese government was confronted with great pressure from competitors in the construction equipment manufacturing industry that feared Xugong would become too strong and competitive with Carlyle's extensive network and capital injection.[188] They worried that the acquisition could substantially hurt their interests. In order to assuage these concerns, MOFCOM declared that it would investigate assertions of Xugong creating a monopoly and hurting other construction machinery manufacturers. Carlyle was requested to submit an antitrust report along with a pledge not to create a monopoly, but this turned out to be insufficient for Xugong's competitors.[189]

One of Xugong's industry rivals, heavy machinery manufacturer Sany Corporation aggressively voiced its discontent in June 2006. Sany chief executive Xiang

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[184] Wang Hu, "Xugong Struggle May Yield Foreign Investment Rules," *Caijing*, March 7, 2007, http://english.caijing.com.cn/2007-03-07/100043165.html.
[185] "Chinese Companies: Over the Great Wall," *The Economist*.
[186] Joongi Kim, "Fears of Foreign Ownership: The Old Face of Economic Nationalism,"*SAIS Review* 27, no.2 (2007): 167-77.
[187] Geoff. Dyer, Tom Mitchell, and Sundeep Tucker, "Forbidden Country? How Foreign Deals in China are Hitting Renewed Resistance," *Financial Times*, August 8, 2006.
[188] Yong, *Private Equity in China.*
[189] Stuart Anderson, "The Biggest in the World," *Cranes Today,* 384 (2006): 24-6.

Wenbo announced on his personal blog that it wanted to purchase Xugong at a 30% premium over Carlyle's offer; however, he did not offer a detailed plan of how his company wanted to finance the bid. "What Sany is doing is for the country because manufacturing is a national strategic industry. The leading authority in a strategic industry equals national sovereignty. As a member of this industry, we do not wish to see national sovereignty damaged," Xiang wrote in his blog post titled "XCMG Acquisition: A Beautiful Lie! (徐工并购：一个美丽的谎言！).[190] In a provocative and sarcastic tone, Xiang laid out the reasons the deal should not go through. His usage of phrases like "selling anything it fine, but selling out the country is wrong" and *"quxianjiguo* (曲线救国)," meaning saving the nation through twisted means, made it evident that Xiang wanted to stir up nationalist sentiment.[191] There was doubt about Sany's financial capability of actually acquiring Xugong considering its smaller size in terms of net sales and profit.[192] Nevertheless, Xiang continued posting articles denouncing the Carlyle deal and succeeded in gaining widespread attention from the public and press. The domestic media began portraying the deal in a negative light calling the cheap purchase of an SOE by a foreign investor a form of corporate raiding.[193] The government responded to this outcry in late June. In an attempt to assuage the upset public, the State Council issued an

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[190] Geoff Dyer, "Sany Fights to Keep Xugong in China," *Financial Times,* June 12, 2006.; Xiang Wenbo, "徐工□□□□□□□□□□!," *向文波的BLOG*, *Sina*, June 12, 2006, accessed April 26, 2014, http://blog.sina.com.cn/s/blog_487d2dfa010003st.html.

[191] Wenbo Xiang, "徐工并□：一个美□的□言！

[192] Wan Zhihong, "War of Words in Company Takeover Battle," *China Daily*, June 16, 2006.

[193] Yong, *Private Equity in China*.

edict that required key equipment manufacturers selling stakes to foreigners to first consult the central government and relevant departments.[194]

Nevertheless, a growing protectionist wave swept throughout China, which eventually led to a three-day closed-door hearing in July 2006 that involved bureaucrats from MOFCOM and CSRC as well as shareholders, competitors, suppliers, and customers of Xugong to determine the legality of the Carlyle deal.[195] This type of meeting was unprecedented in China. Besides Carlyle, which was excluded from the hearing, all parties with a perspective on the deal were able to have their say.[196] Such an initiative indicates the increasingly cautious attitude of policymakers in Beijing when making decisions such as this because it requires them to address the more important question regarding market reform. Though the government did not publish the content of the hearing, some participants disclosed that there was an effort to set ground rules for the M&A of SOEs and leading Chinese companies.[197] This effort was realized the following month when SASAC and MOF issued a circular about a new regulation stating that the "sale of state-owned assets should not violate the restrictive or prohibitive rules concerning the country's economic safety."[198] Moreover, MOFCOM was given more legislative power with the *Interim Provisions on Mergers and Acquisitions of Domestic*

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[194] "China Moves to Revive Machinery Industry," Chinese Government's Official Web Portal, June 30, 2006, accessed April 26, 2014, http://english.gov.cn/2006-06/30/content_323342.htm.
[195] Geoff Dyer and Sundeep Tucker, "Officials Debate Carlyle-Xugong Takeover," *Financial Times London ed.,* August 3, 2006.
[196] Ibid.
[197] Geoff Dyer, Sundeep Tucker, and Tom Mitchell, "Forbidden Country? How Foreign Deals in China are Hiting New Resistance," *Financial Times,* August 3, 2006, accessed April 26, 2014, http://www.ft.com/intl/cms/s/0/101dc332-267a-11db-afa1-0000779e2340.html#axzz300chdv4O.
[198] "China Tightens Control Over State Asset Sales," Embassy of the People's Republic of China in the U.S.A. Website, January 20, 2007, accessed April 26, 2014, http://www.china-embassy.org/eng/xw/t293053.htm.; Kim, "Fears of Foreign Ownership: The Old Face of Economic Nationalism."

Enterprises by Foreign Investors the same month, as explained in Chapter 3. Specifically, Article 12 of the provisions gave MOFCOM the authority to demand the termination of a transaction that could potentially have an impact on national economic security.[199]

Seeing that there was great political pressure from economic hardliners to restrict foreign control of state assets, Carlyle promptly changed its proposal in September 2006. It reduced the size of its proposed stake from 85% to 50% at a price of $220 million, hoping that this would facilitate regulatory approval.[200] Carlyle gave up its right to appoint the chairman of the board, but would still be able to appoint the vice-chairman and five of the ten board members.[201] The Xuzhou city government, the provincial government of Jiangsu, and SASAC accepted the new joint-venture deal, but MOFCOM did not seem to budge.[202] The central government also did not seem to show signs of support. The NDRC published its "Eleventh 'Five-Year Plan' on Utilizing Foreign Investment" in November 2006. One section emphasized the importance of reinforcing the supervision of M&A by foreign investors and ensured domestic control of key industries and enterprises that involve national security.[203] This was in unison with MOFCOM's provisions of M&A in June, which reveals the political unwillingness to change policy directions.

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[199] "Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors," Ministry of Commerce People's Republic of China Website, August 10, 2006. http://english.mofcom.gov.cn/article/policyrelease/Businessregulations/201303/20130300045825.shtml.

[200] Jamil Anderlini, "Carlyle Changes Tack in Bid for Xugong Stake," *South China Morning Post*, September 28, 2006.; Cathy Chan, "Carlyle Group Reconsiders Proposed Stake in Xugong," *International Herald Tribune*, October 18, 2006.

[201] Jamil Anderlini, "Carlyle Trims Target Stake in Xugong US Firm Seeks to Win Beijing's Nod by Reducing Acquisition in Construction Machinery Maker to 50pc at a Higher Price," *South China Morning Post*, October 25, 2006.

[202] "Chinese Watchdog Approves 50 Per Cent US Stake in Construction Machinery Firm," *BBC Monitoring Asia Pacific*, November 12, 2006.

[203] "New Policy Stresses Quality of Foreign Investment," *Xinhua News Agency*, November 10, 2006,. http://www.china.org.cn/english/BAT/188506.htm.; Nathan Bush, "SinoCFIUS: Same Wall, Same Guards, New Watchtower," *Competition Law International* (January 2012): 43-48.

Seeing the stagnant status of regulatory approval, Carlyle made a final attempt to salvage the deal in March 2007. It decreased the size of its stake down to 45% for $184 million.[204] This did not seem to alleviate the government's fear of selling a strategic company to a foreign investor. The contract between Xugong and Carlyle eventually expired the next year and Carlyle finally admitted its failure. In July 2008, Carlyle and Xugong released a joint statement saying that the agreement had lapsed and they would not longer proceed with the investment.[205] A spokeswoman for Carlyle affirmed that the company was not discouraged by this defeat saying, "While we're not proceeding with the investment, we value the strong partnership we have developed with Xugong. Carlyle has a long-term commitment to China and values the relationships it has developed with the various government agencies it has worked with through the years."[206] Even though the Xugong deal suffered numerous impediments, Carlyle continued to make investments in more than thirty companies deploying more than $1.3 billion between 2006 to 2008.[207] Carlyle's China Pacific Insurance Group deal made $5.2 billion in returns from a $790 million investment in 2012, making it not only Carlyle's most profitable exit on an acquisition, but also the biggest in the industry.[208] This illustrates how private equity firms can still succeed in making handsome profits if they are patient and fully aware of how to work in China's opaque regulatory system.

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[204] Peter Harmsen, "U.S. Official Lashes Out at China's Lack of Progress in Opening Economy," *The Ottawa Citizen*, March 30, 2007.

[205] Tom Miller, "Carlyle, Xugong Ditch Contentious Stake Deal US Group Admits Defeat Amid Hostility to its Bid," *South China Morning Post*, July 24, 2008

[206] Rick Carew and Peter Stein, "Leading the News: Carlyle Fails to Gain Xugong Stake Amid Takeover Wariness in China," *Wall Street Journal,* July 23, 2008.

[207] Sundeep Tucker, "Carlyle Admits Defeat in Xugong Tie-Up," *Financial Times*, July 22, 2008.

[208] Prudence Ho, "Carlye's China Pacific Investment Returns Over $5 Billion," *Wall Street Journal*, January 7, 2013, accessed April 26, 2014, http://blogs.wsj.com/deals/2013/01/07/carlyles-china-pacific-investment-returns-over-5-billion/.

2) Case Study IV: Coca Cola Company and China Huiyuan Juice Group Ltd.

China Huiyuan Juice Group Ltd., founded in 1992, is the country's leading fruit and vegetable juice producer based in Beijing. This privately owned firm went public on the Hong Kong Stock Exchange in 2007 and has increasingly gained popularity in China for its products, including 100% juices, nectars, and juice drinks.[209] Operating more than 30 factories across China and producing over 500 food and drink lines, Huiyuan has managed to expand its presence in the mainland and strengthen its national brand power.[210] The company mission to "promote juice as part of a healthy diet for the good of consumers" implies its strategy of tapping into the growing health-conscious consumer base in China.[211] According to the global marketing research firm AC Nielsen, Huiyuan's market share for pure juices was 43.8% in 2008. It also accounted for 42.4% of China's market for nectars, or juice drinks with lower concentration. Considering that pure juice and nectars made up for 19.3% and 38.2%, respectively, of total revenue, Huiyuan is certainly a prominent leader in the high-end juice market.[212] Although Huiyuan displayed great growth potential with a high market share, a closer look at its 2008 balance sheet showed signs of trouble. Huiyuan's profit attributable to equity holders increased by 7.2% to $53.8 million, but this was mainly derived from a $36.3 million rise in its convertible bonds value.[213] Without this increase, the company would have had a 19%

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[209] David Barboza, "Coca-Cola Makes an Offer for Chinese Juice Maker," *International Herald Tribune*, September 4, 2008.
[210] Tania Bragnigan, "Financial: Takeovers: Coca-Cola Puts Fizz into China with Pounds 1.4bn Bid for Juice Maker," *The Guardian*, September 4, 2008.
[211] *2008 Interim Report* (China Huiyuan Juice Group Limited, 2008), accessed April 26, 2014, http://huiyuan.com.cn/upload/accessory/20131/20131301221172167426.pdf.
[212] Jasmine Wang, "Huiyuan Targets Larger Market Share," *South China Morning Post*, April 2, 2008.
[213] Chi-Chu Tschang, "Behind the Delay on Coke's Juicy China Deal," *Business Week*, December 8, 2008, accessed April 26, 2014, http://www.businessweek.com/stories/2008-12-05/behind-the-delay-on-cokes-juicy-china-dealbusinessweek-business-news-stock-market-and-financial-advice.

decrease in profits. In addition, like many other mainland soft-drink producers, Huiyan struggled with rising costs and falling gross profit margins.[214] Cost of sales went up by 4.8% and gross profit dropped by 22.2%.[215] Huiyuan wanted to grow bigger, but lacked the financial and management resources to do so.[216] These factors explain why Huiyuan welcomed Coca Cola's offer to acquire the firm in September 2008.

The world's largest soft drinks manufacturer, Coca Cola Company was the first U.S. company to enter China after the nation opened up its economy in 1979. Since then, Coke has flourished into one of the biggest foreign drink brands in China's rapidly expanding market. Coke was attracted to Huiyuan for several reasons. First, there has been a growing demand for healthy beverages in China. This can be attributed to the country's rising middle class preferring healthier products due to an increase in health awareness.[217] As more Chinese consumers turned toward Coke's non-carbonated drink products, the company's growth in the carbonated drinks market slowed down.[218] "Sales volume of fruit juices in China surpassed that of carbonated drinks for the first time in 2007," said Euromonitor International analyst Michelle Huang. "Especially in the last two years, Chinese consumers are increasingly choosing healthy drinks such as juice or tea."[219] Soft drinks analyst at Data Monitor, Michael Hughes also noted, "Though China's fruit juice market is relatively small in the beverages space, it is a high-growth market that is expected to grow by more than 10% in the next few years as the middle

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[214] Ibid.
[215] *2008 Interim Report* (China Huiyuan Juice Group Limited, 2008).
[216] Tschang, "Behind the Delay on Coke's Juicy China Deal."
[217] "Coca-Cola Awaits Approval to Buy Chinese Juice Maker," *BBC Monitoring Asia Pacific,* September 4, 2008.
[218] Robin Kwong and Tom Mitchell, "Coke to Squeeze More from China," *Financial Times*, September 4, 2008.
[219] Robin Kwong, "Coke Offers $2.4bn for China Juice Maker," *Financial Times,* September 3, 2008.

class becomes increasingly health-conscious."[220] Seeing this change in Chinese consumer preference, Coke pushed to expand its beverage portfolio beyond carbonated drinks in China. It had already tested this strategy in 2005 when it bought Multon, Russia's second largest juice maker, and in 2007 with the acquisition of Glacau, maker of Vitaminwater, and Jugos del Valle SAB de C.V., a juice producer with a large presence in Mexico and Brazil.[221] The firm sought to continue this global drive in China. "Huiyuan's long-established and successful juice brand would be highly complementary to Coca Cola's China business," said President of Coca Cola Muhtar Kent in an interview."[222]

Second, an acquisition of Huiyuan would help Coke overcome the difficulties of operating in the Chinese market. Although China is the third largest market for Coke in terms of sales volume, margins are considerably thinner than margins in the U.S.[223] Distribution and marketing costs are high due to China's fragmented retail market and state ownership of television advertising.[224] Moreover, domestic competition limits Coke's presence in certain regions in China. Lower-tier cities and rural areas have higher demands for more affordable drink brands and this is largely met by local companies.[225] Their main advantage over Coke is having local insights on tastes and preferences. Brands like Kangshifu, Wahaha, and Wang Lao Ji are popular among locals for their

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[220] "Coca-Cola Awaits Approval to Buy Chinese Juice Maker," *BBC Monitoring Asia Pacific,* September 4, 2008.

[221] Jonathan Birchall and Robin Kwong, "Coke Eyes Record China Takeover," *Financial Times*, September 4, 2008.

[222] Jonathan Marino, "Coca Cola to Buy China Huiyuan Juice," *Mergers & Acquisitions Report* 21, no.34 (September 2008).

[223] Edward Tse, *China Strategy:Harnessing the Power of the World's Fastest-Growing Economy* (New York: Basic Books, 2010), 32.

[224] Ibid.

[225] Vikram Chakravarty and Chua Soon Ghee. *Asian Mergers and Acquisitions: Riding the Wave*. (Singapore: John Wiley & Sons, 2012), 22.

ready-to-drink tea beverages.[226] Coke's acquisition plan was a response to all these challenges. The purchase of a popular local brand like Huiyuan would enable Coke to expand its distribution network and obtain product development expertise specifically based on Chinese consumer tastes.[227]

Last, Coke also desired to gain competitiveness against its international rival through this acquisition. A decade ago, Coke had made the big mistake of letting PepsiCo Inc. jump ahead and become the domestic leader in non-carbonated beverages like juice, flavored water, bottled water, sports drinks, and tea.[228] Coke's lack of innovation forced it to continue relying on carbonated drinks, which led to stagnant sales and slow growth.[229] With Coke lagging behind, Pepsi's share of the U.S. market for such drinks grew to almost double that of Coke's.[230] Nevertheless, Pepsi was still behind Coke in China's non-carbonated drinks sector. In 2008, the firm announced that it would be boosting investment in new products and marketing in China by spending $1 billion more in the market over the next four years.[231] Coke could not afford to let Pepsi surpass its global operations in China. Through the Huiyuan acquisition, Coke sought to outrun its competitor and ultimately become the China's dominant producer of fruit juices.

The deal began with Coke's offer in September 2008 to pay $2.4 billion for a majority stake in Huiyuan. This relatively high price came as a surprise to many because it was nearly three times Huiyuan's share price on the day prior to Coke's

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[226] Tse, *China Strategy*, 32.
[227] "All the Juice in China," *Financial Times*, September 4, 2008.
[228] Betsy McKay, Sky Canaves, and Geoffrey A. Fowler, "Coke Looks to Avoid Past Misstep with China Bid," *The Globe and Mail*, September 4, 2008.
[229] Conrad de Aenlle, "China Deal Draws Praise for Coke," *The New York Times*, September 13, 2008.
[230]McKay, Canaves, and Fowler, "Coke Looks to Avoid Past Misstep with China Bid."
[231] David Blecken, "PepsiCo to Boost Presence in China," *Media*, Haymarket Business Publications Ltd., November 13, 2008.

announcement.[232] Coke had already secured binding agreements with three shareholders representing 66% of Huiyuan's total shares.[233] Chairman Zhu Xinli, French food giant Groupe Danone, and private equity firm Warburg Pincus held a 36%, 23%, and 7% stake, respectively.[234] Danone mentioned that the high premium was one of the main reasons it agreed to the deal. "The price is good. It's three times the market price and reflects a price to earnings ratio of 50," said Dannon. "We are happy now to concentrate on the Chinese water market."[235] This deal was said to have been the largest bid to date for foreign control of a Chinese firm and the second biggest deal in Coke's own history.[236] The only process left was gaining regulatory approval from the Chinese.

Some expressed optimism, while others had doubts about Coke obtaining consent from Chinese regulators. "If Coke offers a really great amount of money, nationalism will yield to the money," said Conita Hung, director of equity markets for Delta Asia Financial Group in Hong Kong.[237] Huang Dejun, president of Beijing consulting company Orient Agribusiness, predicted that Beijing will allow the deal because Huiyuan's total share of juice sales in China is less than 8%, meaning that the purchase would not likely give Coke a monopoly in the market."[238] Other deal watchers said that Huiyuan's status as a private company and the beverage sector's small role in the

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[232] Sky Canaves and Geoffrey A. Fowler, "Coke Bets $2.4 Billion on Chinese Juice Market; Offer for Huiyuan Marks Effort to Tap Growing Affluence," *The Wall Street Journal Asia*, September 4, 2008.
[233] Craig Simons, "Coke Bids for China Juice Giant: $2.4 Billion Offer to Buy Huiyuan Juice is Largest by World's Biggest Soft Drink Company since it Paid $4.1 Billion for Glaceau in 2007," *The Atlanta Journal - Constitution*, September 4, 2008.
[234] Birchall and Kwong, "Coke Eyes Record China Deal."
[235] Kwong, "Coke Offers $2.4bn."
[236] Andrew Peaple, "Heard on the Street: Financial Analysis and Commentary," *The Wall Street Journal Asia*, September 8, 2008.; McKay, Canaves, and Fowler, "Coke Looks to Avoid Past Misstep with China Bid."
[237] "China Wary of Coke Juice Deal," *Chicago Tribune*, September 29, 2008.
[238] Craig Simons, "Chinese Officials, Coke Start Talks on Juice Company." *The Atlanta Journal - Constitution*, September 19, 2008.

economy are reasons to believe that the agreement could be approved.[239] Unlike the steel or high-technology machinery industry, the beverage industry is not often viewed as a strategically sensitive industry.

Nevertheless, some analysts expressed skepticism citing the *AML* that had taken effect the previous month. "Coke picked a bad time for this deal," said Li Su, president of Beijing consulting firm H&J Vanguard Research, "Government regulators are likely to be concerned because the acquisition would be deadly for mid-range and smaller beverage companies."[240] The vice chairman of Roth Capital Partners, Donald Straszheim also doubted that the deal would be allowed noting the *AML*. "We do not see significant reasons why the authorities would allow a major acquisition by a foreign firm of a highly visible domestic company," he said in a report to clients.[241] A researcher at the Chinese Academy of International Trade and Economic Cooperation, a government think tank under MOFCOM, Mei Xinyu said that the large size of the two companies and Huiyuan's high-profile domestic brand name were two main challenges that would deter government approval.[242]

The skeptics had a more accurate outlook judging from the negative response toward the deal from rival domestic juice makers, local media, and public opinion. After the announcement of the deal, Huiyuan's domestic competitors aggressively complained that the deal would give Coke a dominant share in the juice market. Zhang Qian, manager of China Lingbao Amusi Fruit Juice, asserted that even though the takeover would not

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[239] Betsy Mckay, Sky Canaves, and Geoffrey A. Fowler, "Coke Deal Juices Its China Business," *Wall Street Journal*, September 4, 2008, http://online.wsj.com/news/articles/SB122046514527195959.
[240] Simons, "Chinese Officials, Coke Start Talks on Juice Company."
[241] "Squeeze Fear on Coke China Buy," *Evening Standard*, September 4, 2008.
[242] McKay, Canaves, and Fowler, "Coke Looks to Avoid Past Misstep with China Bid."

have a head-on impact on Lingbao's business, it still posed a monopolistic threat. "We hope the government and the judiciary department can forestall the deal," she said in an interview.[243] Chang Tong, manager at China Haishen Juice Holdings, and Hou Yali from Beijing Shunxin Qianshou Fruit Beverage Co., Ltd. also expressed great concerns about what the deal would do to Chinese home-grown brands.[244]

What is more, many reports covered by Chinese local media negatively depicted the takeover bid. "Coca-Cola drinks Huiyuan Juice," was a common headline in the news.[245] Yellow journalism played a role in stirring up nationalist sentiment as well. For instance, national tabloid Global Times published a commentary saying, "They are following the strategy of 'Don't touch mine, but I will take yours.' If we give up our local brand...we will be manipulated by them."[246] Public opinion on the Internet was also not in favor of the sale. In an unscientific online poll by the major Chinese portal Sina.com, roughly 80% of the 450,000 people who took the poll objected Coke's acquisition of Huiyuan.[247] Clearly, many Chinese netizens were disturbed about the potential loss of a popular domestic brand to a foreign company.

Amidst this resistance, MOFCOM began the antitrust review in mid-November. The spokesman of MOFCOM emphasized that the government would abide by the

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[243] Jasmine Wang and Woods Lee, "Ministry Says Review of Coke Bid Market-Oriented," *South China Morning Post*, September 11, 2008.
[244] "China's Commerce Ministry to Hold Hearing on Coke Offer for Huiyuan," *Xinhua News Agency*, September 15, 2008, http://news.xinhuanet.com/english/2008-09/15/content_10005195.htm.
[245] "China Exclusive: Official: China to Insist on Principle of Market-Oriented Economy on Huiyang-Coca-Cola Union," *Xinhua News Agency*, September 10, 2008.
[246] Geoffrey York, "Coke's China Deal Faces New Headwinds," *The Globe and Mail*, September 12, 2008.
[247] Duncan Mavin, "Juice Deal Puts Chinese Entrepreneur in Hot Water," *CanWest News*, September 12, 2008; Tsang, "Behind the Delay."

principals of a market-oriented economy under the legal process.[248] "[The ministry] is against monopoly while supporting 'normal economic activities,'" Yao Shenhong said in an interview with Xinhua.[249] Coke and Huiyuan issued a joint statement on the Hong Kong Stock exchange stating that MOFCOM's review would continue until March 23, 2009.[250] The review would consider factors like the deal's effect on market share, market concentration, branding power, and consumers.[251] To show its commitment to the mainland, Coke pledged in early March that it would invest $2 billion in China over the next three years.[252]

However, this proved to be insufficient in winning the government's approval of the deal. After six months of review, MOFCOM rejected the deal on March 18, 2009, saying that Coke is "very likely to take a dominating position in the domestic market if the acquisition went into effect."[253] The ministry also argued that consumers may have to accept a high price fixed by Coke and smaller juice businesses may be threatened due to reduced market competition. Despite MOFCOM's denial of protectionism, many analysts, lawyers, and bankers thought otherwise.[254] Steve Harris, coordinator of the Asia antitrust practice for the law firm Jones Day, remarked, "Businesses could interpret the

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[248] Ji Shaoting, Lai Jianqiang, and Li Huiying, "China to Insist On Principle of Market-Oriented Economy On Huiyuan-Coca-Cola Union," *Xinhua News Agency*, September 10, 2008, http://news.xinhuanet.com/english/2008-09/10/content_9904527.htm.
[249] Ibid.
[250] "Coco-Cola Anti-Trust Application Files Not Complete Until Nov. 19," *Xinhua News Agency*, December 5, 2008, http://news.xinhuanet.com/english/2008-12/05/content_10461093.htm.
[251] Jin Sun, "The Implementation of China's Anti-Monopoly Law: A Case on Coca-Cola's Abortive Acquisition of Huiyuan Juice," *Frontiers of Law in China* 6, no. 1 (March 2011): 117-30.
[252] Jasmine Wang, "Coke Uncaps Rare US$2b Plan to Boost Mainland Presence." *South China Morning Post*, March 7, 2009.
[253] Robert Lea, "Coke Blow as Chinese Block Juice Takeover," *Evening Standard (London)*, March 18, 2009.; "Coca-Cola Purchase of China's Huiyuan Fails to Pass Antimonopoly Review," *Xinhua News Agency*, March 18, 2009, http://news.xinhuanet.com/english/2009-03/18/content_11031482.htm.
[254] Gordon Fairclough, Carlos Tejada, and Valerie Bauerlein, "Beijing Rejects Coke's Takeover Attempt - Thwarted Huiyuan Juice Deal could Chill Investment in China, while Hampering Attempts to Expand Abroad," *Wall Street Journal*, March 19, 2009.

decision as a protectionist move, not sound antitrust regulation."[255] Managing partner at Atlanta Capital Management, William Hackney similarly noted, "[It] sends a strong protectionist message to the rest of the world."[256] Many prospective foreign buyers had hoped for a successful deal because it would signify the government's willingness to allow more future foreign acquisitions of domestic companies. However, the ultimate failure of the Coke-Huiyuan case evidenced the formidable hurdles that foreign investors considering M&A deals would have to overcome in the future.

Unlike all the other Chinese firms dealt with in the previous case studies, Huiyuan is not a SOE, a possible factor why the government was forced to be more sensitive of how the M&A transaction could have disrupted fair market competition. The sheer size of the deal may been alarming for regulators. Similar to the Carlyle-Xugong case, it is difficult to believe that the U.S. government's blockage on CNOOC's bid in 2005 did not influence the decision made by MOFCOM. It could possibly have been a classic case of tit-for-tat, indicating the Chinese government's tendency to resort to economic protectionism if the U.S. does so as well. This portrays the political considerations of regulators in their review process. Moreover, the Coke-Huiyuan deal depicts that even sectors that are not strategically sensitive to national or economic security like the retail industry can be a difficult market to penetrate for foreign investors.

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[255] Guy Collier Joe, "Coke Bid Hits Wall in China: Juice Offer Blocked," *The Atlanta Journal - Constitution*, March 19, 2009.
[256] Jasmine Wang, "Huiyuan Juice Shares Extend Decline by 9.79pc," *South China Morning Post*, March 21, 2009.

Chapter 6: Lessons Learned from Case Studies

Each case study offers valuable insight into the intricacies of private equity investments in Chinese firms. As laid out in Chapter 3, the Chinese government has progressively developed the regulatory environment for foreign private equity investment to build a more sophisticated market economy in the face of economic internationalization. However, the state continues to maintain a stronghold on certain industries. Hsueh calls this China's "bifurcated strategy," referring to the duality of the government strictly managing strategic sectors related to national security or the promotion of economic and technological development, while relinquishing control over less strategic sectors.[257] However, the case studies in this thesis prove that there can be exceptions to this approach. As previously mentioned, traditionally, China's strategic industries were in banking, defense, power, resources, telecommunications, and transportation.[258] In the State Council's recently published "12th Five-Year Plan for National Strategic Emerging Industries," the government included industries like biology, environmental protection, new energy, and high-end equipment manufacturing.[259] Neither Xugong nor Huiyuan were in any of these strategic industries, but the government did not allow foreign private equity investments in these firms. In contrast, Newbridge obtained approval even though SDB was in the highly regulated and sensitive

[257] Roselyn Ying-Yueh Hseuh, "China's New Regulatory State: The Government's Bifurcated Strategy Toward Foreign Investment" (PhD diss., University of California, Berkeley, 2008), 15-18.
[258] Charlie Zhu and David Lague, "In China, A Power Struggle of a Different Order," *The New York Times*, October 17, 2012, http://www.nytimes.com/2012/10/18/business/global/in-china-a-power-struggle-of-a-different-order.html.
[259] Yao Lu, "China Releases 12th Five-Year Plan for National Strategic Emerging Industries," *China Briefing*, July 25, 2012, http://www.china-briefing.com/news/2012/07/25/china-releases-12th-five-year-plan-for-national-strategic-emerging-industries.html.

banking sector. This implies that there are underlying factors that may not appear to be obvious on the surface.

There are numerous variables that influence the outcome of private equity deals in China; therefore, it would be inaccurate to make generalizations based on these case studies. Nevertheless, an examination of the parallels drawn from the four case studies can shed light upon why exceptions to the "bifurcated strategy" exist. The two main parallels that will be discussed are *guanxi* and nationalism.

First, the role of *guanxi* cannot be overlooked when doing business transactions in China and the case studies show that foreign private equity investment is not an exception. The literal translation of the *'guanxi'* means connections or social relationships. Not only is *guanxi* embedded in China's group-oriented society, but it also plays a key role for business success in China.[260] The two forms of *guanxi* are often divided into "the web of personal connections, relationships, and obligations that business people can use to obtain resources and advantages" and "the exchange of favors or the purchase of resources."[261] This analysis will pertain to the former type of *guanxi*. Business transactions in Western countries also heavily rely on networks, but the Chinese way of networking is different in the sense that connections especially with government officials are much more crucial to success. This is mainly because all business relationships in China involve some kind of encounter with the government. Foreign investors in China must develop good personal relationships with key government

[260] Fang Yang, "The Importance of Guanxi to Multinational Companies in China," *Asian Social Science* 7.7 (2011), 163-4.
[261] Jonathan Wilson and Ross Brennan, "Doing Business in China: Is the Importance of Guanxi Diminishing?" *European Business Review* 22.6 (2010), 653.

officials because government assumes the roles of legislator, law enforcer, and judge.[262] Some academic studies have contended that the strategic importance of *guanxi* may be diminishing with China's increased outward investment, market liberalization, and legal reforms (Guthrie, 1998; Yang, 2001; Wilson and Brennan, 2009). However, the parallels between the two success stories of foreign private equity investment presented in this thesis seem to suggest otherwise.

The Newbridge-SDB and Blackstone-BlueStar cases show how *guanxi* can lead to a successful private equity deal even in a SOE of which the government is typically protective. Weijian Shan of Newbridge and Antony Leung of Blackstone were both remarkably skilled negotiators who had an extensive *guanxi* network in China. They were able to build such relationships because they had earned the respect of Chinese businessmen and government officials. In particular, their experience in the investment banking sector seems to have helped them build a reputation as a leading expert in the industry. For Shan, his prior success with turning around KFB added to his credibility, gaining the support of China's top policymakers even before making the bid for SDB.[263] Leung was able to skip the bidding process altogether because he directly pitched to high-ranking government officials who ran SOEs. The relationships he had built with the Chinese business and political community in Hong Kong during his time at Citi, Chase, and the government proved to be essential in getting a head start in the search for lucrative private equity deals.

[262] Ying Fan, "'Guanxi,' Government and Corporate Reputation in China: Lessons for International Companies," *Marketing Intelligence and Planning* 25.5 (2007), 499-510.
[263] Jin, Xuan, and Bai, "Shenzhen Development Bank."

Interestingly, Shan and Leung had quite contrasting views of China's market economy and corporate culture. By writing newspaper editorials and serving as an independent board director in a few Chinese firms, Shan has sought out to change China's business culture.[264] His critical perspective on China's growth was evident in his Wall Street Journal article titled "The World Bank's China Delusions."[265] Contending that China's total debt-to-equity swaps and bank recapitalization dealing with NPLs exceeded the total pre-tax profits in China's industrial sector since 1999, Shan attributed the source of China's rapid growth in investment to lax bank lending rather than a surge in profits as the World Bank had reported.[266] His other articles like "The Mystery of China's Sinking Stocks" and "China's Yuan Overvalued" offer similar critiques of China's market deficiencies.[267] He asserted that bank-sponsored investment binges can be detrimental to the banking system in the long-run and proposed that the solution would be to introduce proper incentives for loan officers, implying their tendency to lend based on relationships rather than returns.[268] As an independent board member of Baosteel, a large state-owned iron and steel company, Shan opposed to the firm's plan to convert its state-owned shares into tradable shares in 2005 saying that the scheme is both wrong and illegal because it would lead to an unequal treatment of different shareholders.[269] Similarly, he questioned Beijing's decision to shuffle managers between telecom firms as

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[264] "China's Patient Crusader," *The Economist*.
[265] Weijian Shan, "The World Bank's China Delusions," *Wall Street Journal Asia*, September 10, 2006.
[266] James R. Norman, *The Oil Card: Global Economic Warfare in the 21st Century* (Walterville, OR: Trine Day, 2008), 52.; Stephen S. Roach, *Stephen Roach on the next Asia: Opportunities and Challenges for a New Globalization* (Hoboken, NJ: Wiley, 2009).
[267] Weijian Shan, "The Mystery of China's Sinking Stocks," *Wall Street Journal*, December 19, 2005.; Weijian Shan, "China's Yuan Overvalued," *Wall Street Journal,* June 23, 2005.
[268] "China's Patient Crusader," *The Economist*.
[269] "China Finance: Hangover Cure for the Stockmarket?" *EIU ViewsWire*, *The Economic Intelligence Unit Ltd.*, August 15, 2005.

a board member of China Unicom and led the investigation of a corruption scandal dealing with irregular loans as a board member of BOC's Hong Kong branch.[270]

On the contrary, Leung was involved in a scandal himself in 2003. Briefly mentioned in the case study, Leung's "Lexusgate" scandal drew in sharp criticism from the public. Though Leung denied that he was trying to avoid taxes saying he simply needed a bigger car for his new baby daughter, Hong Kong citizens and lawmakers were not persuaded.[271] He even offered to donate $100,000 to charity, twice the amount that would have been due after higher registration taxes for new vehicles, but many people still questioned his integrity.[272] Some feared that the decision of the Department of Justice not to prosecute Leung would set a precedent making it more difficult to punish public officers for misconduct.[273] His misbehavior was also overlooked by government officials in China because more than a year after disappearing from public view, he was seen in a documentary on China Central Television playing with his wife and daughter.[274] Shortly afterwards, he talked at a financial services forum to which he was invited by the Beijing municipal government.[275] His tight personal relationships with government officials helped him to rise back even after his scandal. Leung's behavior contrasts with Shan, who often denounced unethical conducts in China's business world.

Nevertheless, both figures were able to gain the necessary support from Chinese regulators to complete the private equity deal. This suggests that a dealmaker's expertise

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[270] "China's Patient Crusader," *The Economist*.
[271] Jimmy Cheung and Gary Cheung, "Financial Secretary Avoids Tax on New Car," *South China Morning Post*, March 10, 2003.
[272] Albert Cheng, "Financial Secretary Antony Leung Kam-Chung's 'Lexusgate' Scandal Shows No Sign of Abating," *South China Morning Post*, March 24, 2003.
[273] Klaudia Lee, "The Justice Chief is Challenged About Decision Not to Prosecute Antony Leung," *South China Morning Post*, December 17, 2003.
[274] Carrie Chan, "Antony Leung Back in Spotlight," *South China Morning Post*, September 3, 2004.
[275] Ibid.

in the relevant field may be more significant than his or her views of China's market economy or business ethics. Newbridge had past investment experience in the banking sector and Blackstone had prior involvement in the chemical industry. Shan was able to lead Newbridge to a successful agreement with a state-owned bank through his connections just like Leung used his network to gain regulatory support. Looking at Shan, establishing *guanxi* in China does not necessarily mean condoning to unethical business behavior in China and flattering government officials if one has built a credible reputation with deep industry knowledge.

That is not to say that Carlyle and Coke lacked a wide *guanxi* network unlike Newbridge and Blackstone. Carlyle was one of the pioneers of private equity in China, launching its first Asia buyout in 1999. XD Yang, the dealmaker who led Carlyle's investments in China, was a Chinese-born, Western-educated skilled businessman with previous investment banking experience just like Shan and Leung. His nine years at Goldman Sachs, where he was a managing director and co-head of private equity investment in Asia, would have helped him build an extensive business network in China. Coke also has a long history of doing business in China, re-entering the country in 1979. The company built solid relations with the government especially after sponsoring the 2008 Beijing Olympics. However, both firms still failed to gain regulatory approval of their buyout agreements.

One possible explanation for their failures is the nationalistic opposition toward the deals. The upsurge of Chinese nationalism occurred in the aftermath of the 1989

Tiananmen Square massacre, a dreadful setback to political democratization in China.[276] Nationalism in China is often linked to anti-Western sentiment, which was initially encouraged by government propaganda in the 1990s.[277] Starting from the late 1990s, the U.S. trade deficit with China rose tremendously and there was increasing pressure on China to open its market to Western goods, bringing about economic nationalism, the "ideas and activities aimed at defending and promoting national economic interests to build up strong nation through economic means."[278] During a similar time period, cyber nationalism began to emerge with the rise of the Internet in China. A non-government sponsored ideology and movement that has originated, existed, and developed in China's online sphere over the past two decades, cyber nationalism can play a significant role in China's policy making process.[279] In the past, CCP leaders were forced to change the course of their foreign policy to satisfy heightening public pressure expressed online.[280]

A combination of these two types of nationalism was evident in the Carlyle-Xugong and Coke-Huiyuan case. In both instances, the public voiced great concern online about a Chinese firm being sold at a cheap price to a "greedy" foreign investor. The situation got serious once it started receiving media attention through newspapers and the television. In Xugong's case, the nationalist sentiment was instigated by the CEO of Sany Corporation, Xugong's main competitor. Xiang Wenbo used Internet blogging, a tool that is widely accessible to the public, to stir up hostility against Carlyle. In

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[276] Feng Chongyi, "Nationalism and Democratisation in Contemporary China," *Global Dialogue* 9, no. ½ (Winter 2007), 49.
[277] Guangqiu Xu, "Anti-Western Nationalism in China," *World Affairs* 163, no.4 (Spring 2001), 155.
[278] Ibid.
[279] Xu Wu, "Chinese Cyber Nationalism: How China's Online Public Sphere Affected Its Social and Political Transitions," (Phd diss, University of Florida, 2005), 286-7.
[280] Xu Wu, *Chinese Cyber Nationalism: Evolution, Characteristics, and Implications* (Lanham: Lexington Books, 2007).; C. X. George Wei and Xiaoyuan Liu, *Chinese Nationalism in Perspective: Historical and Recent Cases* (Westport, Conn.: Greenwood Press, 2001).

Huiyuan's case, there was no single figure who sparked the uproar of domestic opposition toward Coke's acquisition, but it rather originated from the people's attachment to the national brand, also known as consumer ethnocentricism, the fear of economically harming his or her beloved country by buying foreign products, the morality of buying imported products, and a personal prejudice against imports.[281] It is more relevant to Huiyuan than Xugong because Huiyuan sells consumer products, which are widely obtainable by the public.

Furthermore, industry competitors seem to have used the nationalist wave and media spotlight to their advantage in both cases, making it even more difficult for the foreign firm to obtain approval from Chinese regulators. The unprecedented meeting among Xugong's shareholders, competitors, suppliers, and customers with MOFCOM and CSRC to discuss the Carlyle deal indicates the Chinese government's sensitivity toward the opinion of domestic players in the market. Although not as large in scale, competitors of Huiyuan also had meetings with MOFCOM to voice their opposition.[282] Once an issue at hand grows out of proportion, the Chinese government is forced to take the domestic opinion into serious consideration in their decision-making process. This is because the government gains legitimacy by serving the people; and in order to serve the people, the government must maintain political and social stability.[283] The vitality of "stability" dates all the way back to the Tiananmen Square incident. After the crackdown,

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[281] George Balabanis et al., "The Impact of Nationalism, Patriotism and Internationalism on Consumer Ethnocentric Tendencies," *Journal of International Business Studies* 32, no. 1 (First, 2001): 157-75.
[282] Rick Carew, James T. Areddy, and Gordon Fairclough, "Deals & Deal Makers: China Dismisses Charges of Protectionism," *Wall Street Journal Asia*, March 20, 2009.
[283] Yong, "Private Equity in China," 34.

Deng famously stated, "Stability above everything else (稳定压倒一切)." Evidently, this crucial principle remains relevant to the Chinese government until this day.[284]

[284] Keping Yu, *Democracy and the Rule of Law in China* (Leiden: Brill, 2010), 8.

Chapter 7: The Future of China's Private Equity Market

There is a plethora of opportunities that China's private equity market has to offer to foreign investors. At the same time, however, the parallels from the case studies illustrate the complexity and unpredictability of the whole private equity investment process in China. In each step of the way, foreign investors are met with formidable challenges, indicating that the future of China's private equity market may not be so bright as it seems.

The selection stage is getting increasingly difficult for foreign private equity investors because good deals are getting scarcer and valuations are becoming exceedingly high.[285] With too many funds chasing after too few deals, target firms are becoming overvalued, which increases the investment risk in Chinese firms. Moreover, the due diligence process, in particular, presents a tough task for investors. In a recent TED Talk, Yong Kwek Ping asserted that the conventional checklist of due diligence is not enough in China. Foreign investors must go beyond and examine things like the family background of the founder or the validity of the firm's business certificates.[286] Investigating whether the founder of a firm has a mistress or suffers from gambling addiction in the due diligence process is unthinkable in the West. This demonstrates the anomalies and challenges that may continue to persist in China's private equity industry.

[285] Yong, *Private Equity in China,* 238.
[286] Yong Kwek Ping, "The Challenge of Due Diligence in China" (Video of TEDTalk, TED@BCG, Singapore, October 2013), accessed April 27, 2014, http://www.ted.com/watch/ted-institute/ted-bcg/yong-kwek-ping-the-challenge-of-due-diligence-in-china.

The structuring phase, as seen in the case studies, can lead to conflicts with the existing board and uncertainties concerning regulatory approval. The Chinese government not only takes political and economic factors into consideration, but is also substantially influenced by cultural factors like *guanxi* and nationalism. In the management stage, foreign private equity investors are frequently confronted with resistance to change and a failure to honor contracts by the target company.[287] Many Chinese companies believe that the terms and conditions of a contract are still negotiable even after its execution, so there are many instances when penalties are ignored.[288] This is strikingly problematic for portfolio management. The lack of sophistication in China's judicial system is another obstacles that foreign investors will have to overcome.

The biggest challenge of all may be the barriers against exit mechanisms for private equity investments in China. There are rising concerns about foreign investment being trapped in China's private equity deals.[289] According to a 2013 research report published by China First Capital, over $100 billion in private equity and venture capital investments is currently locked into deals with no easy exit route.[290] A 2014 Financial Times commentary offered similar research results saying that the number and value of exits have dropped for the third consecutive year. Private equity fundraising in both RMB and foreign currency also saw a sharp plunge in 2013 despite investors saying that China

[287] Yong, *Private Equity in China,* 252..
[288] Ibid.
[289] "Billions of Dollars of U.S. Investment Trapped in China Private Equity Deals," *PR Newswire*, January 9, 2013, accessed April 26, 2014, http://www.reuters.com/article/2013/01/09/china-first-capital-idUSnPnCN37793+160+PRN20130109.
[290] *Private Equity in China 2013: The Opportunity and the Crisis* (China First Capital, 2013), accessed April 27, 2014, http://www.chinafirstcapital.com/en/PEChina2013.pdf.

is the most attractive market in Asia.[291] Based on these trends, foreign private equity firms should be more cautious when investing in Chinese firms in the future.

Nevertheless, many analysts and businessmen have insisted that the opportunities outweigh the risks and ambiguities of China's private equity market. In a Harvard Business Review article, the chairman of Booz & Company, Edward Tse was noted for saying, "Yes, it's a tough market. And yes, your competitors may have gotten there first. But the biggest mistake would be choosing not to invest in China." With a sufficient knowledge and understanding of the context in which China's complicated and competitive market is situated, investors can take full advantage of China's growth potential.[292] Similarly, to reiterate the words of Blackstone's CEO from Chapter 4, "China is a required course, not an elective, for any sensible global financial institution."

There is no set formula for a successful private equity investment in China. The persistence of China's legal, political, and economic risks may exacerbate the volatility of its private equity market. Though the possibility of extraordinary high returns in China paints a rosy picture for foreign private equity investors, they should also keep this Latin phrase in mind: *caveat emptor*. May the buyer beware.

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[291] "How Chinese Private Equity Is Struggling: Charts,"*Financial Times*, April 22, 2014, accessed April 27, 2014,http://news.frrole.com/o/fastft-how-chinese-private-equity-is--financialtimes-london.
[292] Edward Tse, "Is It Too Late to Enter China?", *Harvard Business Review* (April 2010): 96-101.

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