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## How Private Equity Firms Can Play In China

The McKinsey Quarterly,

*The McKinsey Quarterly*

International private equity houses are stepping up their efforts to invest in China in the next few years, reflecting a gold rush mentality that could leave some investors disappointed.

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Private equity funds with good connections and deep insights account for the bulk of recent investments. But some new entrants have relatively untested China investment teams.

The influx of new money reflects the pulling power of the "China story," which suggests that there are opportunities that investors cannot afford to miss. Supporters of this contention point to a handful of pioneers who have made big profits by listing their portfolio companies on overseas stock exchanges such as the Nasdaq.

In practice, however, most investors will continue to struggle to pull off successful deals in China as investment conditions worsen. Many private equity investors might be better served by investing their funds in overseas companies that will benefit from China's economic boom. Those who are willing to make a bet on the growing pool of Chinese companies will face a number of challenges.

First, an oversupply of capital is placing more negotiating power in the hands of the target companies, possibly limiting potential investment returns. It could also be increasingly difficult for investors to conduct due diligence, as companies may feel able to withhold information.

Second, inexperienced investment teams might find it hard to keep tabs on the management of Chinese portfolio companies. For example, we recently saw a fund that has been seriously hit by its "remote-controlled" approach to investing in China. The fund's local representative--a junior staff member--was so intimidated by his U.S.-based partners that he simply told them what he thought they wanted to hear and disregarded the underlying downward spiral. And it did not help that the local representative was seen as a lightweight by the Chinese portfolio company, which chose to ignore his presence.

Third, some private investors may struggle to secure domestic debt financing because many local banks remain wary of what they regard as foreign predators. In general, private equity companies can expect little help from the Chinese operations of international banks, which have limited capacity for lending local currency. Some funds have opted for a partial solution: obtaining specific guarantees of bank financing before the investment.

Given these challenges, we believe a number of private equity funds can find better China-related opportunities closer to home. For example, although Fortune 500 companies have the scale and international scope to move operations and sourcing to China, many midsize U.S. companies have yet to follow suit. Some of these companies are held back by their lack of expertise in the region, while others are reluctant to change their traditional way of working.

There may be an opportunity for private equity groups to invest in these midsize U.S. manufacturing companies because, while they are struggling to keep up with the Chinese competition, they retain substantial brand value, sales channels and intellectual property. Through investment, private equity funds can inject the management talent to help a company shift operations and sourcing to China--which can lead to substantial cost reductions. Our experience suggests that there is tremendous room for such deals because there is little competition to invest in midsize U.S. manufacturing companies.

The key is to develop a management team that can repeat these restructurings. To recoup their investment, private equity firms might want to sell these companies to Chinese rivals looking to expand overseas. Given the relative inexperience of the potential Chinese trade buyers, astute sellers may well be able to strike a very attractive deal.

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