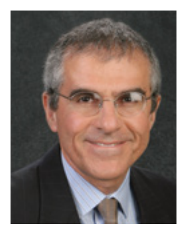
BDO KNOWS INTERNATIONAL PRIVATE EQUITY:

SPOTLIGHT ON GREATER CHINA

The private investment environment in Greater China – the Chinese mainland, Taiwan and Hong Kong – has seen a great deal of change in recent years as the Chinese government has sought to combat economic stagnation and instability in the stock markets. Our own **Lee Duran** sat down with **Kenneth Yeo**, director and head of Specialist Advisory Services with BDO in Hong Kong, to discuss his firsthand observations and predictions for private equity investment in the region. Here are some insights from their conversation.



Lee Duran

Kenneth Yeo

Duran: ***Can you tell me a little more about what the investment environment is like for private equity funds in Hong Kong and Greater China? Are certain regions within Greater China attracting more investment than others?***

Yeo: Hong Kong is the second largest private equity center in Asia after mainland China, with 19 percent of the total capital pool. According to the latest available figures, there were close to 400 Hong Kong-based PE funds with capital under management totaling around $100 billion in U.S. dollars. The majority of PE funds in Hong Kong come from overseas to invest in companies throughout Asia-Pacific, including Japan, Vietnam, Australia, India, Korea and the Chinese mainland.

Hong Kong's profits tax exemption for offshore funds has been extended to private equity funds this year, making Hong Kong a particularly attractive location for investors and strengthening its profile as a venture capital and private equity hub in Asia.

Within the Greater China region, the Chinese mainland is currently host to about 2,400 PE funds, and we're seeing positive trends in the investment environment. Consolidation in China and ongoing reforms in State Owned Enterprises (SOEs) – as a result of China's slowing economy – continue to drive domestic M&A. The Chinese government also proposed a new law this year which, if implemented, will remove many of the current pre-approval requirements foreign investors must meet in order to invest in permitted sectors. Free-trade agreements with Australia and South Korea are also expected to support further deal flow.

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What major investment trends are you currently seeing in Hong Kong and China for both inbound and outbound investments?

The first half of 2015 has been a record six months for M&A in Hong Kong, with $179.6 billion in transactions completed. Transaction levels remain high as we enter the second half of the year, as Chinese companies continue to seek back-door listings by acquiring Hong Kong-listed entities. These deals are creating very high premiums for listed shells in the Hong Kong market.

In the Greater China region, we did see a few mega-deals larger than $1 billion close in 2014, which mainly involved the reemergence of sovereign wealth funds as buyers. Looking at the figures for Q1 2015, though, we saw deal pace slow slightly. Only 281 middle-market deals closed that quarter, in contrast to the 400 that closed in Q4 2014. However, the first quarter is traditionally a quieter period, given the Chinese New Year, and the Q1 2015 numbers actually exceeded Q1 2014 levels by about 3 percent.

With outbound investments, China's SOEs are still involved in some of the mega-deals we've observed, particularly in the agricultural, resources, utilities and energy sectors. But many non-SOE investors, such as PE funds, have also been very active as the Chinese government has encouraged increased private investment. Private Chinese companies are expected to be the main drivers of outbound M&A as Chinese businesses continue to look abroad to acquire experience, brands, technology, human capital and new markets.

A clear trend over the past few years in China is the emergence of local or "onshore funds" that are typically founded by experienced, well-connected individuals that had previously worked in the more established or bulge-bracket investment banks. China has historically made it difficult for offshore vehicles to trade in Chinese business, so these new funds are offering new points of entry into the market. Moreover, because global forces must fight the twin forces of economic stagnation and increasing regulatory and compliance burdens in order to invest in China, local funds have had an easier time stepping in. We expect these local funds to continue to grow as regulators increase their scrutiny of offshore jurisdictions.

In terms of valuations, the average multiple of enterprise value to EBITDA for PE-backed transactions in Greater China last year was around 15. Valuations in the China mainland are, however, still generally higher than those in Hong Kong due to the more expensive investment environment on the mainland.

Which industries do you see being most attractive to foreign investors looking into opportunities in Greater China? Are certain industries booming in specific countries?

Consistent with the current drivers of the broader economy, technology, consumer business and financial services have been among the most popular industries in Hong Kong. Real estate continues to attract individual and institutional investors looking for stable and attractive returns amid low interest rates.

Over the past year or so, we've also seen larger Chinese investment groups express increasing interest in acquiring smaller securities brokerage firms and boutique corporate finance advisory practices. These acquisitions have been driven by the link-up of the Shanghai and Hong Kong stock exchanges, such as the Shanghai Hong Kong Stock Connect and a pending link-up of the Shenzhen and Hong Kong exchanges. These arrangements allow investors in Hong Kong and the mainland to trade a specified range of listed stocks in each other's markets through their respective local securities companies.

What type of capital flow are you seeing coming into Greater China?

According to the UN Conference on Trade and Development, China attracted the most foreign direct investment in the world in 2014, while Hong Kong came in second, despite a difficult global economic environment. Hong Kong received about $103 billion in cross-border investment – 40 percent more than the previous year – while China registered inflows of $129 billion, an increase of about 4 percent from 2013. As a result, there is still a lot of cheap funding and liquidity chasing deals in the market. In terms of outflows in 2014, Hong Kong again ranked second, with $143 billion exiting (the United States was ranked first with outflows of $337 billion). The mainland's outflows were lower, totaling $116 billion.

Hong Kong is currently preparing for a potential 600 billion yuan (about $97 billion) asset management bonanza as a result of the July 1 commencement of a mutual recognition scheme to allow funds to be sold between the

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city and the Chinese mainland on equal terms. The arrangement will help boost Hong Kong's role as an Asian fund management hub. About 100 Hong Kong funds and 850 counterparts in China qualify for the program, together managing around 2.3 trillion yuan in assets.

Hong Kong equity capital raisings broke records in the first half of 2015, reaching about $52 billion. It is also the current global leader for IPOs, with $16.5 billion raised from listings so far this year. Secondary raisings or follow-on stock offers raised another $35.6 billion 1H 2015, as well.

What trends are you observing in exits? Who is exiting and how? Are holding periods getting longer, or are they shrinking?

Hong Kong continues to be an ideal platform for private equity exits, with its IPO fundraising ranking among the top three countries since 2009. Both pre-IPO deals and exits benefited from the strong equity markets in the first half of 2015 and received a major boost from the reopening of China's IPO markets in mid-2014. Trade sales account for about 40 percent of all exits for the past few years in terms of value, and 50 percent in terms of volume. Secondary sales have been on the decline but remain a popular exit option given the higher completion probability as compared to trade sales.

However, the recent decline of stock market indices across Greater China – particularly the mainland exchanges – is likely to have an impact on IPO plans in the second half of 2015. The jury is out as to the extent of this impact and how it might reverberate in M&A activity overall.

In terms of holding periods, we've seen an average of three to five years in recent years, though we've trended closer to five years as of late. As a result, there is still significant unrealized value in PE-backed investments.

What do you think will be the next hot opportunity for PE investment in Greater China?

Internet deals have risen significantly following the 2015 Alibaba IPO. The technology sector is red hot at the moment, as well, followed by financial services and healthcare. Healthcare in particular is expected to grow as the overall population ages and there is a greater demand for senior living and long-term care facilities. We've also seen overall improvement in people's access to healthcare services, such as dentistry, which is further driving consumer demand and investor interest.

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