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China versus India – where should investors place their bets? Andy Thomson explores the key characteristics of two markets demanding everyone's attention.

Waking giants

Given their billion-plus populations, emerging middle classes and high growth rates, it is inevitable that comparisons have been made – and will continue to be made – between China and India. For private equity investors, characteristics such as these are obviously compelling. Which is why many Western GP groups are seeking to establish an on-the-ground presence in at least one if not both territories. And even those with no such intention feel obliged to at least examine the potential impact of developments in Asia's two largest nations on the present and future prosperity of their businesses.

Equally, it would be misleading to assume that the similarities between the two countries outweigh the differences. Indeed, private equity professionals familiar with both China and India are keen to stress that you will underestimate the many and various distinctions at your peril. Asked which of the two countries presents the best private equity opportunity, one emerging markets investment specialist told PEI that attempting an answer would be like choosing between the US and Europe. It's simply not a case of one or the other, he said – both deserve consideration on their own terms.

Below we take a look at various aspects of the private equity markets of China and India in the spirit of both recognising the similarities where they exist, and also identifying the nuances. Already, the two markets are becoming highly influential in the context of Asian private equity – and increasingly that influence will be felt on the global stage as well. Here, we measure the strides – occasionally backwards but mostly forwards - taken so far.

1. INDUSTRY SECTORS: CHINA'S 'QUICK WINS'

Many of the most high-profile success stories in China's burgeoning growth capital market have arisen from what observers describe as "quick wins": media and communications businesses that can be expanded very quickly. Notable examples include Focus Media, a Shanghai-based placer of advertisements in commercial buildings, which raised $171 million (€145 million) from a Nasdaq IPO in July 2005, just eight months after receiving a $30 million investment from a 3i-led consortium; and Shanda Interactive, an online gaming firm that delivered a 14 times cash multiple to Hong Kong's SAIF Partners when it raised $150 million from Nasdaq in May 2004.

However, for US-based venture capitalists, piling into China in the hope of discovering another Silicon Valley is not without danger. The concern has to be that they anyone making the move today will instead be confronted with a venture bubble on the point of bursting as valuations soar in cities such as Beijing and Shanghai, where capital inflows have been concentrated (notwithstanding a regulation-inspired hiatus in new deal activity – see "Regulations" below.)

In traditional Chinese industries such as cement, glass and steel, there are also fears of an excess of capital seeking deals.

Jonathan Bond, managing partner and head of fundraising and IR at emerging markets investor Actis, says fears of overheating in certain sectors in China have resulted in his firm developing a narrow focus on investments of between $10 million and $30 million in medium-sized businesses with strong domestic brands – whilst avoiding export-reliant companies. Bond is also keen on the Indian mid-market at the current time, seeing it as "further advanced" than China's and offering exciting opportunities in sectors such as healthcare, IT and engineering. These 'knowledge-based' sectors also tend to be the focus of venture investors in India, with life science a particularly strong area of investment.

Verdict: more opportunities across the board in both countries, but signs of overheating – particularly in China.

Bond: China overheating

2. BUYOUTS: ON THE RADAR

In both China and India, the respective governments are demonstrating a willingness to offer increasing control to foreign investors in certain sectors where investment has traditionally been restricted – hence the first signs of a buyout market are emerging. For example, Newbridge Capital last year became the first overseas investor to obtain management control of a domestic Chinese bank when it committed funds to Shenzhen Development Bank.

But despite the Newbridge deal and Carlyle Group's recent agreement to take control of Chinese construction group Xuzhou for $375 million, buyouts have been a more regular occurrence in India than China – albeit that buyout activity there is almost solely focused on the mid-market phenomenon. Actis' Bond says buyouts account for a growing proportion of deal flow seen by his firm, which last year led the $14 million MBO of Nitrex Chemicals, the former nitrocellulose manufacturing and trading division of ICI India.

In terms of developing a buyout market of heft, the most eagerly awaited development in China is the acceleration of the country's privatisation programme. Some sales of state-owned enterprises have happened – Xuzhou being a notable example – but they have been few and far between and regulatory approvals frustratingly lengthy. Nonetheless, XD Yang, co-head of Asian buyouts at Washington DC-based The Carlyle Group, predicts that "privatisation will be a major source of control deals and driver of private equity activity in the years ahead".

India has not yet embarked on a wide-scale privatisation programme, although it is expected that one will be launched in future. One area of activity that does appear to be flickering into life in India is the distressed debt market, with the government currently drawing up regulations to assist banks in dealing with a mounting bad loan problem. This helps explain the rationale behind the distressed debt joint venture launched in October by US restructuring specialist WL Ross & Co and Indian mortgage group Housing Finance Development Corporation (HDFC).

Verdict: while still nascent in both countries, there is a feeling that large buyouts will become part of the landscape sooner in China than India. India has been a home to small buyouts for some time.

3. EXITS:

India has one very clear advantage over China when it comes to enabling realisations: the Bombay Stock Exchange. Established in 1875, the BSE is the oldest stock market in Asia, one of its best regulated and - with trading in over 6,000 listed stocks - one of its deepest.

What is more, the BSE has been experiencing strong growth for the last two and half years. According to a Reuters report, its capitalisation increased by 32 percent between January and October 2005, making it the second-best performing stock exchange in Asia over that period. It was on the BSE that global private equity firm Warburg Pincus completed its exit from telecom company Bharti Tele-Ventures in October - delivering six times cash invested in the process.

Bond says there is also a strong likelihood of achieving trade sales in India. He says disposals to strategic investors have accounted for the majority of Actis' 18 exits in India over the last seven years at an average cash multiple of 3.1 times.

The picture in China is very different and succinctly summarised by Kelly Deponte, a partner at San Francisco-headquartered placement agent Probitas Partners: "It's easy to get money in, but hard to get it out."

Christoph Rubeli, partner and head of Asia and the Middle East at global fund investor Partners Group, elaborates on the theme: "There are virtually no local exits in China, they're almost always international. Local capital markets are unsophisticated and there are few trade sales because Chinese companies almost invariably buy abroad."

However, signs that China is keen to address the problem are now emerging. In November, the National Development and Reform Commission (NDRC) government ministry drew up plans for changes to legislation in a number of areas, all designed to make China a more attractive environment for entrepreneurs. Although details of the plans are scant at this stage, making domestic exits a more viable proposition is understood to be on the priority list.

One other area to consider is what the reaction will be to huge profits being turned by foreign private equity groups (an issue that has had profound repercussions for the private equity markets of Japan and South Korea for example). Says Mounir Guen, CEO of London-headquartered placement agent MVision: "In China the evolution of the buyout market must be discreetly managed because you can't flaunt your successes. In India, there's not the same type of sensitivity to making profits."

Verdict: exits are much easier to achieve in India. How to get money out of China is a major concern of limited partners.

4. REGULATIONS: CHINA BACKTRACKS

When the Chinese government agency State Administration of Foreign Exchange (SAFE) issued Circulars 11 and 29 earlier this year, it unwittingly pulled the plug on the country's thriving venture capital industry. The main objective of the circulars had been to prevent Chinese residents from moving the ownership and control of Chinese assets to offshore locations (so-called "round-tripping"). However, private equity firms were also using the same method to acquire stakes in Chinese companies – and, having found themselves caught in the crossfire, new deal activity in the first half of the year ground almost to a halt.

In response, SAFE issued Circular 75, which superseded the prior circulars and did much to address investors' concerns (see Asia Monitor, p. 30). Opinions of the Chinese government's actions vary greatly, though. According to some, the swift response of the government via SAFE 75 showed that it

Bhagwat: Indian transport a decade behind

has the private equity industry's best interests at heart.

Others have formed a different conclusion. "At the beginning of 2005, I would have said that China was of a lot more interest to the LP community than India," says Deponte at Probitas. "But when the legal restrictions came in, interest cooled and people became very cautious. In my view, the Chinese government did itself a big disservice in pointing out the differences in the respective legal systems of China and India. People were left very uncomfortable at the thought that the government didn't work out in advance what the impact of its legislation would be – as a result of which, the industry was left high and dry."

In India, the use of common law is a source of comfort to Anglo-Saxon investors – as is the thrust of government policy, which seems in a general sense to be pro-business. However, there is occasional frustration at the levels of bureaucracy encountered. "The problem in India is getting things done," opines Partners' Rubeli. "The approval process for deals can be very slow."

Verdict: both China and India have regulatory issues to address, but China is most out of favour at present.

5. INFRASTRUCTURE: A TALE OF TWO CITIES

All private equity professionals canvassed by *PEI* for this article agreed that there is a vast gulf separating China and India when it comes to physical infrastructure. "India is probably a decade behind in terms of the state of its transport networks", is the view of Shantanu Bhagwat, business development partner at Amadeus Capital Partners, a London-based venture firm where he focuses on opportunities for the firm's portfolio companies in Asia.

It's a view supported by a placement agent familiar with the region, who says: "Shanghai is just like any major Western city. The funny thing is, the image a lot of people still have of Chinese cities is roads full of cyclists. But few people use bikes in city centres any more because they'd be in mortal danger from all the speeding cars. In India, the horrors of getting across town in a place like Mumbai are renowned: and if you're trying to travel cross-country, it can be even worse."

The practical implications of a poor physical infrastructure are significant for private equity investors, both in terms of their ability to interact effectively with portfolio companies in different locations around the country, and also the ability of those portfolio companies to source and distribute

A SELECTION OF PRIVATE EQUITY FUNDS INVESTING IN INDIA

FUND/PARENT	FUND SIZE ($M)	STRATEGY	OFFICES
3i	No dedicated fund	Sector and stage agnostic	Mumbai, multiple global offices
Actis India Fund II / Actis	325	Expansion capital, buyouts	Bangalore, New Delhi, Karachi, Mumbai, London
Artiman Venture II / Artiman Ventures	200	Technology	Bangalore, Palo Alto
Barings Private Equity Partners Asia II / Barings Private Equity Partners	300	Late-stage growth, buyouts	New Delhi, Hong Kong, Shanghai, Singapore
Blackstone Group	No dedicated fund	Growth capital, buyouts	Mumbai, multiple global offices
Blue River Capital I / Blue River Capital	150	Quoted, unquoted	Mumbai
CapVent India Private Equity / CapVent India Advisors	150	Co-investments in venture, expansion, buyouts	Mumbai, Zurich
Carlyle Asia Buyout / The Carlyle Group	750	Growth capital, buyouts	Mumbai, multiple Asian offices
Carlyle Asia Venture Partners II / The Carlyle Group	170	Expansion-stage technology	Bangalore, Hong Kong, Seoul
Charter Ventures Asia / Charter Ventures	250	Early-stage venture capital	Bangalore, Hong Kong, Palo Alto
ChrysCapital III / ChrysCapital	350	Growth capital	New Delhi, Palo Alto
East West Life Sciences Fund I / East West Capital Partners	200	Life science, all stages	Bangalore, Shanghai
Everest India Life Sciences Fund / Everest Strategic Partners	100	Mid-sized public and private life sciences	Mumbai
General Atlantic Partners Everest Strategic Partners	No dedicated fund	Stage and sector agnostic	Mumbai, multiple global offices
Henderson Asia Pacific Equity Partners / Henderson Capital	210	Growth capital, buyouts	New Delhi, Hong Kong, Singapore
India Value Fund II / GW Capital Partners	150	Growth capital	Bangalore, Mumbai
India Advantage Fund / ICICI Ventures	240	Late-stage growth capital, buyouts	Bangalore, Mumbai
India Growth Fund / Kotak Mahindra	100	Growth capital, buyouts	Mumbai
India Turnaround Fund / WL Ross & Co and Housing Development Finance Corp	200	Corporate restructurings and turnarounds	Mumbai
India Private Equity Growth Fund / IL&FS Investment Managers and SCP Private Equity Partners	250	Mid-to-late stage investments	Bangalore, Mumbai
JumpStartUp Venture Fund / JumpStartUp	75	Early and growth-stage	Bangalore, Silicon Valley
Merlion India Fund / Merlion (Temasek)	100	Opportunistic	Mumbai
Newbridge Asia IV / Newbridge Capital	1,000	Growth capital, buyouts, restructurings	Mumbai, Hong Kong, San Francisco, Seoul, Shanghai, Tokyo
Oak Investment Partners	No dedicated fund	Stage and sector agnostic	Minneapolis, Palo Alto, Westport
Softbank Asia Infrastructure Fund II / Softbank Asia	500	IT, media, telecom	Bangalore, Beijing, Hong Kong, Seoul
Symphony Capital Partners I / Symphony Capital Partners	425	Growth capital, buyouts	Mumbai, Hong Kong, Singapore
Thomas Lee Putnam Ventures	No dedicated fund	Late-stage venture, public, mid-market buyout, recaps, spinouts	Boston, London, New York
Warburg Pincus	No dedicated fund	Early-stage, growth, late-stage	Mumbai, multiple global offices
WestBridge Ventures II / WestBridge Capital Partners	250	Growth capital	Bangalore, Silicon Valley

Source: Probitas Partners

goods efficiently.

However, private equity investors are finding that India's creaking infrastructure is not all bad news. With the government well aware of the problems and taking steps to address them, the construction sector is enjoying something of a boom: and, as you'd expect, venture capitalists are happily jumping on board. One such example was a recent investment by New Delhi-based ChrysCapital in IVRCL Infrastructure & Projects, a Hyderabad-based construction group.

Verdict: Infrastructure is a major competitive advantage for China, but investors in India are discovering that opportunity can arise out of adversity.

6. MANAGEMENT: INDIA'S TALENT POOL RUNS DEEP

It's rare to find aspersions cast on the ability of Indian management teams. Carlyle's Yang offers a typically flattering portrayal: "Indian managers are normally Western educated and fluent in modern business practices. For example, they tend to keep quality company data which can be rapidly accessed."

Such virtues are not always found in China, continues Yang. "Chinese managers tend to be very smart and are capable of making their companies globally competitive. Nonetheless, you often come across firms with great manufacturing facilities but a poor finance function or sub-standard marketing. It will take a few years before Chinese management are fully educated in modern management techniques." Until then, he opines, it is frequently a case of plugging the gaps in management structures by recruiting top managers from multinationals.

"China and India both need significant improvements in such areas as capital markets, taxation, regulations, banking and bankruptcy policies. There's a wide range of dynamics that need to be lined up."

Some observers associate the strength of Indian management with an influx of talent from the US – from where Indian nationals who established successful businesses are now returning home. However, Kelly Deponte points out that the ability to transfer skills from one market to another (particularly when that transfer is from a mature to a developing market) is far from straightforward. He says the "jury is out" on whether such moves will prove to be a success.

Of more significance, says Shantanu Bhagwat, is the fact that private enterprise has always thrived in India and been actively encouraged in spite of the tight regulatory environment throughout the 1960s and 70s. This, he reasons, has produced a domestic entrepreneurial class that has had to be innovative and creative in order to prosper.

Verdict: Western-style management predominates in India - making it a more comfortable environment for foreign investors than China, where some weaknesses are evident.

CONCLUSION: THE FUTURE IS A CLOSE-RUN RACE

In sum, both China and India are fledgling private equity markets, and both have a long way to go before they can draw meaningful comparisons with the most developed markets of the West. Says Guen: "China and India both need significant improvements in such areas as capital markets, taxation, regulations, banking and bankruptcy policies. There's a wide range of dynamics that need to be lined up."

On the other hand, it is important to re-emphasise the point made at the outset: neither market can be ignored. Says Doug Miller, founder of UK-based placement agent International Private Equity Limited (IPEL): "I think GPs in both the US and Europe need to have a good understanding of what is happening in those markets as they assess domestic investments in their home markets. What is happening in China and India will definitely affect their portfolio companies and can be viewed as both opportunities and threats."

Also casting a closer eye on China and India is the limited partner community. To date, most of the interest has come from endowments and family offices: in time, pension fund money will follow. The big question confronting all investors is how best to gain access – which in turn spawns a series of further questions: should we invest on a country-specific or pan-Asian basis? Should we seek to identify the best local groups ourselves or invest through funds of funds? Which segments of the market do we want exposure to, and which should we avoid?

Whatever the answers to those questions and others, the fact is that the emphasis is increasingly on *how* to gain exposure rather than *whether*. "There's a lot of research being conducted," says Bond. "People used to be sceptical about the case for committing to China and India – but are increasingly less so."

Most practitioners ultimately perceive China as a private equity destination to be better than India in some respects and worse in others. This equilibrium may be sustained for some time. "If it can overcome the regulatory issues, China may well have more private equity successes sooner than India," says Deponte. "But one will never go shooting past the other: it will always be a close race." ■

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3i	No dedicated fund	Sector and stage agnostic	Hong Kong, multiple global offices
IDG-Accel China Growth Fund / IDG, Accel Partners	250	Venture capital	Beijing, Guangzhou, Shanghai, Shenzhen, Boston, Palo Alto, Santa Clara, London
Actis China Fund II / Actis	166	Expansion, buyouts, pre-IPO placements, PIPES	Beijing, multiple global offices
Baring Private Equity Partners Asia II / Baring Private Equity Partners	300	Late-stage growth, buyouts	Hong Kong, Shanghai, Singapore, New Delhi
Battery Ventures VII / Battery Ventures	450	Venture capital	Wellesley, San Mateo
CDH China Growth Capital Fund II / CDH China	310	Growth capital	Beijing
General Atlantic Partners	No dedicated fund	Stage and sector agnostic	Multiple global offices
Granite Global Ventures	450	Expansion-stage venture capital	Shanghai, Singapore, Menlo Park
Henderson Asia Pacific Equity Partners / Henderson Capital	210	Growth capital, buyouts	Hong Kong, Singapore, New Delhi
Intel Capital	No dedicated fund	Technology	Hong Kong, multiple global offices
Investor Capital Partners Asia Fund / Investor Asia	322	Buyouts	Hong Kong
JAFCO Asia Technology Fund II / JAFCO Asia	100	Technology	Beijing, Hong Kong, Singapore, Taiwan, Seoul
Jerusalem Venture Partners	No dedicated fund	Technology	Shanghai, Jerusalem, London, New York, Tokyo
LC Fund II / Legend Capital	100	Venture capital	Beijing, Shanghai
Newbridge Asia IV / Newbridge Capital	1,000	Growth capital, buyouts, restructurings	Hong Kong, Shanghai, Mumbai, San Francisco, Seoul, Tokyo
SB Asia Investment Fund II / SAIF Partners	643	IT, media, telecom	Beijing, Hong Kong, Bangalore, Seoul
Shenzhen Capital Group	361	Small cap technology	Shenzhen
Siemens Mobile Acceleration	No dedicated fund	Communications	Beijing, Oberhaching, Paris, San Jose
Standard Chartered Private Equity	No dedicated fund	Expansion capital, acquisition finance, buyouts	Hong Kong, Singapore
The Carlyle Asia Buyout / The Carlyle Group	750	Growth capital, buyouts	Multiple Asian offices
Asean China Investment Fund & others / UOB Venture Investments	N/a	Venture capital	Beijing, Shanghai, Shenzhen, Singapore, Sunnyvale (California)
Walden International	No dedicated fund	Communications, electronics, software, IT	Beijing, Hong Kong, Shanghai, Bangalore, Kuala Lumpur, Singapore, Palo Alto, San Francisco
Warburg Pincus	No dedicated fund	Early stage, growth, late stage	Multiple global offices
WI Harper Group Fund 5 / WI Harper Group	225	IT, life sciences	Beijing, Singapore, Taiwan, San Francisco

Source: China Venture Capital Association