Rise of the Rooster

Chinese outbound M&A in 2017 and beyond
Since its inception the private equity industry has successfully capitalised on global changes, and China will undoubtedly be the next big opportunity for General Partners (GPs) over the coming years.

No longer an emerging market, China possesses supreme spending power and investors from the region are becoming increasingly sophisticated in their strategies. This report reveals the prospects that China presents for private equity, not just in terms of increased transaction volumes, but also in terms of funding.

We expect China’s allocation to private equity as an asset class to grow ten-fold over the next decade, and firms that can build bridges into this market will reap the rewards. So, it's time for GPs to decide how global they want to be.

There is no doubt that in recent years the presence of Chinese money and investment has increased and is playing an important role.

This survey illustrates how multi-dimensional the interaction between Private Equity and Chinese outbound investment has become; Private Equity firms raise money from Chinese investors, compete with Chinese General Partners, co-invest with Chinese companies, while also selling to Chinese buyers.

We can clearly see that when investing in a sector, any private equity company will take into account whether it expects Chinese investors to compete with them or whether they may be a welcome source of exit.

This report acts as a unique barometer of industry sentiment and an insight into how these Chinese players are perceived by General Partners globally, and the factors that will affect the dynamics of the private equity industry globally in the coming years.
Unprecedented influx of Chinese capital

Private equity faces an uncertain year ahead, with new political regimes potentially adopting more protectionist outlooks.

Based on how determined Chinese spending power has been to date, the entrance of more buyers to the market presents established private equity in the east and west with opportunities.

This report shines a light on how Chinese buyers are viewed by the private equity community globally.

Amongst the findings we saw some concerns, but also causes for optimism, as these new entrants shift the industry dynamics.

How would you describe the change in the number of Chinese firms making acquisitions outside of China in 2016?

83% of the GPs we spoke with noticed a particular uptick in Chinese acquisitions in 2016.

This perception is underpinned by a record breaking year for outbound Chinese investment, according to data from Mergermarket, with a total of 372 deals worth $206.6bn, a 118.7% increase on the previous year.¹

Several Chinese-financed large-cap deals have piqued the interest of the private equity community globally. Deals such as Hong Kong-based PAG Asia Capital and Apex Technology pairing up in an all-cash deal for US printer manufacturer Lexmark, which saw the company valued at $3.6bn, and the acquisition of Strategic Hotels & Resorts in a $6.5 billion direct investment by China’s Anbang Insurance Group made headlines across the M&A world in 2016.

**CHALLENGES**

**Competition intensifies**

Have you come up against a Chinese buyer outside of China in an auction process more frequently over the last 12 months than the previous?

- **47%** of General Partners (66%) said they came up against a Chinese buyer in an auction process more frequently in 2016.
- **34%** of GPs admitted they had lost out to a Chinese bidder at auction in 2016.

Two thirds of General Partners (66%) said they came up against a Chinese buyer in an auction process more frequently in 2016.

Competition at auctions has already intensified over recent years, with increasing amounts of dry powder chasing fewer true investment opportunities. The addition of more Chinese GPs and strategics can only make the process more pressurized.

Crucially, 47% of those we spoke with noticed that Chinese firms were most active in the mid-market – a space already crowded by a number of medium sized GPs with $1 billion+ funds, and large-cap players reaching down to access high growth opportunities.

More than 1/4 of GPs (29%) admitted they had lost out to a Chinese bidder at auction in 2016.

One could assume that Chinese GPs and corporates are paying over the odds in order to get deals done. Indeed, almost half of the GPs we spoke with (45%) think that the offers submitted by Chinese buyers are overpriced. Whether this is true or not, it is safe to say that while many European and US firms keep their powder dry, looking to land on opportunities at the optimal price, Chinese buyers are seizing the moment and winning processes by putting together financially attractive offers.

As rivalry increases, established GPs will look to play to their strengths. sixty two percent of our GPs believe there is a prevailing skepticism around the origins of Chinese capital, an obstacle many GPs with proven track records do not need to overcome. In a seller’s market every advantage is key, so we can expect to see western firms leverage their heritage and experience to try to get in front of their competition.

Due to either the prices offered or the addition of new players, 76% of GPs believe that increasing numbers of Chinese bidders are having an inflationary impact on valuations.

Be that as it may, the GPs we spoke with have a clear idea of where they think Chinese buyers are most active, and may seek alternative strategies in order to avoid being outbid.
Many of the respondents to our survey cite healthy assets and well-known brands as the asset classes of choice for outbound Chinese investment.

The fact that much of China, particularly its middle classes, still view western, well-known brands as a premium product will reinforce this trend. As new buyers enter the market, the perception is that they are looking to invest in relatively low-risk assets with a long-term future.

If this perception is true, there is still plenty of headroom to invest and operate, particularly in secondaries and distressed markets.
Unlocking exit routes

Do you expect that increasing numbers of Chinese buyers will provide you with more exit opportunities?

86%
of the private equity firms we polled believe that increasing numbers of Chinese buyers will provide them with more exit opportunities.

As GPs look to maintain investment pace heading into a geopolitically uncertain year, it is more important than ever to have a range of exit options to consider. This is particularly the case as appetite for acquisitions diminishes amongst corporates in certain markets, where companies are looking to maintain reserves in the event of lean times ahead.

Notable exits to Chinese firms in 2016 included 3i’s sale of Tommee Tippee producer Mayborn Group to Shanghai Jahwa Group, and Chinese investment firm Creat Group Corporation’s purchase of British biotech firm Bio Products Laboratories from Bain Capital for $1.21 billion.

The private equity industry has kept a keen eye on the sectors that Chinese buyers are most willing to invest in, and those looking to sell assets in tech, industrials, infrastructure, healthcare and automotive sectors are set to benefit from further Chinese attention.
Of the sectors expected to attract most interest from Chinese buyers in the coming year, healthcare stands out as a growth area of particular relevance.

According to Deloitte's 2016 global health care outlook, China's healthcare market is expected to grow rapidly, driven by government policy focused on enhancing healthcare accessibility and affordability, and the emergence of new technologies and care models. The sector clearly has significant expansion potential, however healthcare traditionally requires a high level of industry-knowledge and operational nous. This does not tally with the dim view that the private equity community takes on Chinese GPs' ability to drive growth in their investments – only 38% believe Chinese firms possess the requisite skills to do so.

However, confidence grows once results are delivered. As Chinese private equity matures, the tide of global opinion may turn. GPs were initially cynical about direct investments made by Limited Partners, but are now starting to see a number of them realize healthy returns.

Just as interesting as a predicted rising demand for healthcare assets is a predicted decline in interest for real estate. Private equity firms with dedicated real estate strategies have reaped the benefits of Chinese investment in recent years. Blackstone has reportedly sold at least $16 billion in real estate assets to Chinese buyers since 2013. This year could mark a turning point in this trend, as domestic attitude to Chinese property investment tightens, due to more sophisticated acquisition strategies and regulatory confinements.

There are clear opportunities for Chinese private equity firms to invest in overseas businesses and expand them into their domestic market. Indeed, given the traditional barriers to entry for firms looking to enter China, local GPs are best placed to expand these assets, taking advantage of their knowledge of domestic market dynamics and culture to fine tune assets to realize the opportunities amongst China's rapidly growing middle classes. This could translate to lucrative exits for those currently holding well-suited assets.

Which particular sectors have you noticed Chinese buyers targeting?

- **Industrial / Manufacturing**: 53% Last 12 months, 52% Next 12 months
- **Tech**: 50% Last 12 months, 48% Next 12 months
- **Real estate**: 34% Last 12 months, 36% Next 12 months
- **Infrastructure**: 38% Last 12 months, 36% Next 12 months
- **Food / Processing**: 26% Last 12 months, 26% Next 12 months
- **Automotive**: 29% Last 12 months, 33% Next 12 months
- **Travel**: 24% Last 12 months, 26% Next 12 months
- **Banking / Financial services**: 33% Last 12 months, 26% Next 12 months
- **Healthcare**: 36% Last 12 months, 24% Next 12 months
- **Consumer goods**: 19% Last 12 months, 21% Next 12 months
- **Media & Entertainment**: 21% Last 12 months, 24% Next 12 months
- **Oil / Gas**: 16% Last 12 months, 26% Next 12 months
- **Retail**: 16% Last 12 months, 14% Next 12 months
- **Education**: 16% Last 12 months, 14% Next 12 months
- **Telecommunications**: 19% Last 12 months, None of the above
- **Shipping**: 12% Last 12 months, None of the above
- **None of the above**: 7% Last 12 months, 2% Next 12 months

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2 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Life-Sciences-Health-Care/gx-lshc-2016-health-care-outlook-regional.pdf
OPPORTUNITIES

Investor diversification

How likely or unlikely are you to proactively seek Chinese investments to your funds over the next 12 months?

Half of the GPs we spoke with intend to proactively seek Chinese commitments for new funds this year

During 2016 a number of Asian insurers handed out large mandates, and are expected to continue to do so in the coming months. Cathay Life Insurance, based in Taipei, is looking to invest around $1 billion in private equity and hedge funds over the next year, in addition to the $3 billion it has already committed. Ping An is a major backer of a 100 billion yuan Sino-Singapore fund, set up by United Overseas Bank, Singapore’s third largest lender. So the potential to build a base of Chinese investment is clearly significant.

Although according to our findings, 50% of GPs will seek Chinese investment, only 34% believe they will receive more commitments. The challenge for funds looking to secure backing from Chinese LPs will be communicating their strategy and differentiating themselves in a crowded fundraising market.

Oppportunities

Investor diversification

Unlikely

Slightly likely

Don't know

Very likely

Sum: Likely = 50%
Although Chinese outbound investment has been on an upward trajectory for years, 2017 presents a number of factors that could impede this climb.

GPs think the biggest potential catalyst for change will be government intervention, as domestic authorities in China look to stem certain overseas acquisitions, in an attempt to avoid a “capital flight” as companies move their money out of the country at a rate that could damage domestic growth.

The regulators are also seeking to curb “irrational” acquisitions, scrutinizing any deals worth more than $1 billion outside any investor’s core business, and monitoring cross-border deals involving land, hotels, film production and entertainment assets.

This new regulation could divert more capital away from direct investment and towards Chinese GPs, as domestic investors look to private equity as a way to access international investment while avoid facing excess scrutiny from the government. Capable GPs will be able to compile investment theses that are sophisticated enough to navigate the new restrictions.

Despite challenging trade environments at home and abroad, 60% of GPs believe that Chinese investment activity will increase in 2017. And, according to our research, mainland Europe is set to attract most interest.

**Outlook**

Which of the following factors do you believe could particularly hinder Chinese buyers’ attempts to make significant investments abroad over the next 12 months?
In which of the following markets do you expect to see Chinese investment activity over the next 12 months?

- Mainland Europe: 79%
- US: 59%
- Africa: 55%
- Australia: 48%
- UK: 50%
- South America: 45%
- Canada: 33%
- None of the above: 3%

These predictions reflect strong appetite for markets such as Germany, as witnessed in 2016, and also point to more difficult approaches into the US and UK.

Underneath these changes lies a strong middle class in China, able to consume more products and services than are currently available to them.

Chinese society as a whole is wealthier, savvier and less risk adverse than it has ever been, which can only add to the groundswell of activity. Chinese GPs that identify, acquire and grow overseas assets that can be expanded into this market will prosper.

Methodology

We collected responses from 58 private equity firms, with a combined $440 billion of assets under management, including large buyouts and mid-market firms, to gauge current sentiment among GPs towards the increase in Chinese outbound investment. 100% of the survey respondents have six or more years’ experience in the private equity industry, with the majority (80%) having over ten years’ experience.

We targeted funds investing across five continents to compile a global perception audit.

This report was developed in collaboration with London Business School.
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