Due diligence in China's private equity market

When it comes to doing due diligence, Yibing Wu, the President of CITIC Private Equity Funds Management, believes in leaving "no stones unturned," especially as financial statement of Chinese companies tend to be "less trustworthy" than those of western companies.

China's budding private equity industry is booming, with new firms springing up every other day to tap the country's vast economic potential. But even as competition for deals heats up, investment firms should be wary about being too hasty in concluding their corporate due diligence.

Henry Ines, a partner at venture capital firm DragonVenture, says private equity fund-raising has been growing rapidly in China in recent years, along with a significant influx of private equity practitioners. Consequently, privat e equity investment firms are under pressure to invest.

"In the earnest effort to go out to find the best deals and deploy that capital, you (PE fund managers) might be quick to make some judgments and accelerate that due diligence process when maybe you should … slow it down a little bit," Ines told INSEAD Knowledge on the sidelines of the SuperReturn Asia private equity conference held recently in Hong Kong.

Indeed, when it comes to doing due diligence, **Yibing Wu**, a speaker at the conference, believes in leaving "no stones unturned". Wu, the President of CITIC Private Equity Funds Management (a subsidiary of the Chinese state-owned conglomerate CITIC Group), says financial statements of Chinese companies tend to be "less trustworthy" than those of western companies. To discover the truth, Wu relies on the global 'big four' accounting firms to audit target portfolio firms, as well as on CITIC's own due diligence measures.

"We interview the suppliers, we interview the customers, the competitors, and we do cross-checking on inventory," says Wu. "We do cross-checking on receipts and we talk to (employees) at various levels of the company."

Wu adds that having a sufficiently sizeable due diligence team focused on doing their job thoroughly for a sufficiently long period of time would enable investment managers to decide whether their target portfolio companies are trustworthy and merit investment.

When it comes to deal valuations, however, entrepreneur-owners of target portfolio companies often have the upper hand in setting prices. That's because a significant amount of investment funds are chasing a limited pool of investment opportunities, says **Claudia Zeisberger**, Academic Director of the Global Private Equity Initiative at INSEAD.

In addition, difficulties in accessing valuation benchmarks for emerging markets, such as China, make it hard to evaluate and price potential investments, Zeisberger says.

According to several private equity fund managers at the SuperReturn Asia conference, private equity investment managers are often pushed to conclude their due diligence in China within two weeks, compared to an average of two months to three months in the rest of the world, adds Zeisberger.

"It clearly raises concerns that the entrepreneurs (owners of target portfolio companies) are just not willing to sit and wait until the GP (general partner or investment manager) has gone through his proper due diligence process," says Zeisberger.

For all the challenges of investing in China, Yibing Wu of CITIC Private Equity Funds Management says China's macroeconomic outlook is more compelling than that of other countries, as its industrial sectors have been enjoying highly robust growth in the past decade and would likely continue to grow strongly for the decade ahead.

But LPs (limited partners or investors) should be mindful in their selection of GPs, as even in the US, the top quartile of GPs make the most money while the bottom 75 per cent of GPs lose money, says Wu.

For **Doug Coulter** (MBA '98J), a private equity principal at LGT Capital Partners, LPs need to be working with the top 10 per cent of GPs in Asia to generate respectable returns. To that end, LPs have to rely on local experts in sourcing for top-performing GPs, says Coulter, who oversees Asian investments for LGT Capital Partners, a fund of funds with $20 billion under management globally.

Investors, says Coulter, have to find out which investment firms have access to the necessary business networks, the proprietary deal flow, as well as examine the track records of individual investment managers.

"There have been plenty of home-run deals in Asia, China specifically over five to 10 years, but you really have to get specific into really who is responsible for them, which firm are they working at now and then, of course, get into the normal aspects of strategy and so on," says Coulter.

Investors should also ideally be conversant in Mandarin because of the growing proliferation of domestic Chinese private equity funds, says Coulter. While there are some top GPs who speak English, investors need to be fluent in Mandarin to "really go behind the story" by talking to the dealmakers, junior private equity executives and senior corporate executives.

In any case, INSEAD's Zeisberger expects capital inflow into Asian private equity markets to remain strong into the future, as two thirds of professional investors (LPs) in the west currently have no investments in Asia. But as emerging markets in Asia enjoy a more favourable economic outlook than markets in the west, western capital will increasingly shift to the East.

Furthermore, the success of the IPO (initial public offering) market in Asia is bolstering a positive western perception of the private equity sector in Asia. In the wake of the global financial crisis post 2008, IPOs in Asia – particularly in China – have been outperforming IPOs in the West, notes Zeisberger.

In the absence of satisfactory corporate due diligence in Asia, IPOs provide a degree of confidence to western investors seeking to invest in stable, reputable companies in Asia.

"Exits are an important part in the equation of private equity. Without a regulated, safe exit environment and clear exit strategies, it will be very difficult for even the most skilled GPs to deliver on the promise of private equity in Asia," says Zeisberger.

"Nevertheless, driven by the preference of the local entrepreneurs and considering the listing requirements of Asian exchanges, IPOs clearly will remain the top choice of exit for private equity vehicles in Asia."

SuperReturn Asia was held in Hong Kong September 27-30, 2010.

This article was written by Kevin Tan based on interviews for INSEAD Knowledge.