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# private equity in the chinese interior

By Steve Mullinjer

Here is a tale of two investment paths in the untapped pre-IPO markets of inner China.

A U.S. buyout firm invested US\$100 million in a large PRC retailer. On paper, the foreign investors effectively gained control of the company and installed its new CEO. What should have been a lucrative marriage turned into a monster. The new CEO didn't spend sufficient time with the chairman, who in turn didn't trust this new manager to shepherd a company he and his family built from the ground up. Employees didn't really know who was running the company. Eventually, the CEO had to be replaced, at great cost to both time and money.

Another U.S. private equity company invested US\$60 million in an e-commerce company. The company was burning through its cash too fast, and the original management included family and founding members who were often at odds with each other. The private equity company established process by which all groups agreed a different leadership model was needed. A new chief executive was selected with input from all, and a path laid out for both sides to make sure expectations were aligned and common goals agreed upon.

Guess which path proved most successful.

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Investment in Chinese businesses is entering a new phase. As primary markets such as Beijing, Shanghai and Shenzhen are fished out, equity investors are migrating toward more fertile hunting grounds.

“Private equity is increasingly perceived and accepted as an important alternative to raising funds – it allows firms to diversify their investor base, especially in turbulent capital markets,” X.D. Yang, who runs The Carlyle Group’s Asia buyout fund, told *Business Week*. “The PE funds are getting larger and their number is increasing by the day.”

Choosing top executives to lead cash-injected companies requires a careful walk along the tightrope of expectations between private investors and company founders. Done well, and both sides survive and thrive the pre-IPO journey. Done poorly, and it’s a long drop down.

More private equity funds, both domestic and foreign, are getting into the action. Companies such as Pride Investment, a China-focused fund management group is raising US\$50 million for its latest China pre-IPO investment fund, is focusing on water bottlers, health food chains and selective bakery names for pre-IPO opportunities that tap into the rising power of Chinese consumption, as well as equipment makers in renewable power or environment-related technology companies. Fund founder Lewis Wan told *Asian Investor* “returns on investments over the long term could yield 10 times their value.”

More Chinese investors are looking for investment opportunities at home. “There are now (cash-rich Chinese) individuals and institutions who have made money through IPOs and investments coming into domestic funds,” said Neil Shen, founding managing partner of Sequoia Capital China, which has raised a total of US\$950 million to invest on the mainland.

Second and third tier cities in China are ripe with opportunities to invest in growing domestic firms and prepare them to join the burgeoning ranks of companies seeking IPO. Choosing top executives to lead cash-injected companies requires a careful walk along the tightrope of expectations between private investors and company founders. Done well, and both sides survive and thrive the pre-IPO journey. Done poorly, and it’s a long drop down.

### Align Expectations, Find The Right Leaders

What worked investing in pre-IPO companies in Beijing and Shanghai two decades ago won’t work in the provinces. Company owners are more suspicious of outside interference and the injection of new leadership (along with cash) is a bitter pill to

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swallow. Accepting the help of professional managers is considered a necessary evil, but unless the original owners are on-board with the new management, a “shadow management” culture inevitably arises – on paper, one manager is chief executive, but in practice the original management pulls the strings, usually in opposition of the new management. Patrimonial and nepotistic management culture derails the effectiveness and stability of external leadership.

Finding the right leaders for the company is compounded by the difficult situation on the ground in China. In the land of plenty, there is a deep shortage of qualified senior executives with the experience to be able to walk that tight rope between investors and company founders. Companies are poaching qualified leaders at a frenzied pace, lowering their expectations of CEOs while boosting compensation packages.

The global credit crunch only underlines the need for private equity firms to seek out good investment opportunities while taking steps to ensure that new company

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leadership doesn't bungle the fortunes of a company before it is able to reap its IPO rewards. “The current international market turbulence has produced unprecedented investment opportunities,” said Lou Jiwei, head of the China Investment Corp. at a Shanghai conference in June. The CIC is a US\$200 billion sovereign wealth fund, established in 2007 to earn higher returns on part of China's vast official foreign currency reserves – with most of the cash ear-marked for domestic investment.

In our first failed example above, both investor and founding parties made several mistakes. The private equity firm underestimated the management culture and its resistance to change, tried to manage versus facilitate the meeting of the two different mindsets, and had no structured review process to make sure all sides were on the same page along the way. As a result, the private equity firm struggled to find a balance between guiding the new management versus controlling them.

The company founders, on the other hand, had unrealistic expectations of what the new CEO would provide and a hidden level of skepticism about the management changes. Every decision by new management was second guessed, and the founding chairman didn't step in and show support for tough decisions new managers made – they were happy to see the new CEO made the “bad guy”.

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There are plenty of companies for private equity firms to find fertile investment opportunities in the growing interior of China, but the path toward IPO can be filled with rocks unless both parties are on the same page. Align expectations before new management is in place, and together all sides will reap handsome rewards.

### Lessons Learned

The second example, which had a very lucrative IPO, was able to build through a carefully thought-out plan and thorough on-boarding of all competing parties. These important steps were followed that serve as a template for all private equity firms and companies seeking pre-IPO investment:

- **Plan the First 100 Days.** Roles must be framed carefully. Conduct rigorous “first 100 day” reviews and coaching.
- **Facilitate, Don’t Control:** Owning the majority stake in a PRC company is not a real mandate to control. Leadership must be approached as a near-equal partner.
- **Realistic Expectations:** CEO shelf life is limited to three to four years. It’s highly likely at post-IPO, the new CEO will move on.
- **Candidate Protection:** To prevent early departure of the new CEO, make sure equity compensation is well-defined and protected for the new leader.
- **Align Expectations:** It’s vital the new management team has frequent talks and inputs from the company founder. Manage their expectations, and make sure to enlist their support.

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