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ASIA PRIVATE EQUITY REVIEW

A MONTHLY REPORT ON DIRECT EQUITY INVESTMENT IN ASIA

Greater China Edition

亞洲直接投資評論 大中華版

CONTENT 內容提要

Voices of the Consumers

The shadow of the tainted milk scandal in September 2008 that engulfed China's dairy industry appears to have returned. In April, three children in Gansu province died and 36 fell ill after drinking milk bought directly from local farmers. News of this milk-poisoning incident came only days after the General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China ('GAQQ') disqualified nearly half of the country's 1,176 dairy products producers that failed to pass a recent inspection.

This situation even prompted China's premier Wen Jiabao (温家寶) to comment on the country's food safety in his speech to the members of the Counselors' Office and the Central Research Institute of Culture and History on 14th April, according to a *Xinhua News Agency* report. "These virulent food safety incidents have shown the grave situation of the degradation of morality and the loss of credits," he was quoted as saying. "A country without the improved quality of its people and the power of morality will never grow into a real mighty and respected power."

Woes continued in late April, with 26 tonnes of melamine-contaminated milk power seized, the largest for the year. The latest possible poisoning scare involving China Mengniu Dairy Co., Ltd. (中國蒙牛乳業有限公司)('Mengniu'), in which primary school students fell ill after drinking the company's milk, also sent Mengniu's stock price sharply lower.

Reflecting a lack of investors' confidence of China' dairy industry, infant milk formula producer BeingMate Group Co., Ltd. (貝因美集團有限公司)('BeingMate') also suffered a downbeat start when the company was listed on the Shenzhen Stock Exchange in mid-April. Backed by a prestigious list of domestic investors, including China Everbright Group (中國光大控股集團), China International Capital Corp. (中國國際金融有限公司) and PingAn Caizhi Investment Management Co., Ltd. (平安財智投資管理有限公司), BeingMate's public debut was untimely. The stock ended its first day of trading below its offer price.

In an effort to breathe life into and improve the standards

Production of Milk Products in China (2006 - 1Q/2010)

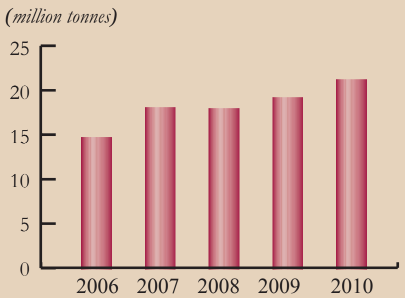


Fig. 1 *Source*: National Bureau of Statistics of China
Graphic: ASIA PRIVATE EQUITY REVIEW

Analysis 本期關注

The Alternative

A new exit route available

The reality is pressing and omnipresent. With managing renminbi funds fast becoming a must credential for foreign fund management firms, disposal of China assets in the A-share market is a reality. In less than half a decade, China's A-share market boasted a market capitalisation of US$4.2 trillion as at the end of March. In 2010, there were 85 enterprises that had previously raised capital from venture or private equity investors that have successfully gained quoted status on the A-share market. Of this, 15% were known to have included interests of non-domestic investors. The percentage, when compared to that recorded for 2009, is a decrease of 4% (fig. 5).

While most investors of A-share companies did not sell their interest at the companies' initial public offerings ('IPOs'), on the books the exit performances have been outstanding. Invariably, domestic investors have been greeting each new A-share stock with an enthusiasm that sent the newly listed companies' price earnings ratios to giddy heights, especially those at ChiNext. At the end of 2010, the monthly average price earnings ratio for companies on various boards in China's bourses ranged from 19.6 to 72.9 (fig. 6).

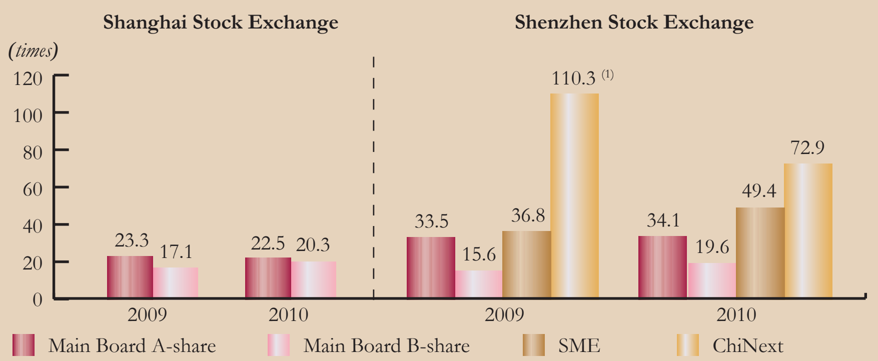
To capitalise on the soaring value for quoted stocks in the A-share market, in February a wholly foreign-owned enterprise ('WFOE') that had earlier raised capital from non-domestic private equity investors was successfully listed on ChiNext. HAND Enterprise Solutions Co., Ltd. ('HAND') is the first known WFOE with private equity backing that changed its status that ultimately facilitated it to secure a stock code on ChiNext. The watershed listing has set a precedent and may herald a new trend in China private equity.

The Litmus Case

Founded in 1996, HAND is a business process outsourcing company ('BPO'). Its core business is providing enterprise resource planning implementation services. It counts Oracle Corp. and SAP AG among its customers. In 2007, it received an aggregate US$6.1 million from the Singapore-based OWW Capital Partners Pte. Ltd. ('OWW'), as well as from China Fund Inc. The latter is a closed-end fund with a fund pool of US$756.7 million that is listed on the New York Stock Exchange. It is managed by the UK-based fund management firm, Martin Currie Inc.

HAND has proven to be a solid BPO company that has successfully captured China's burgeoning BPO market. For 2009, HAND reported operating income of Rmb312 million (US$45.77 million) and net profit of Rmb46.29 million. It is in fact a smaller rival of Camelot Information Systems Inc. ('Camelot'), which was listed on the New York Stock Exchange in July 2010.

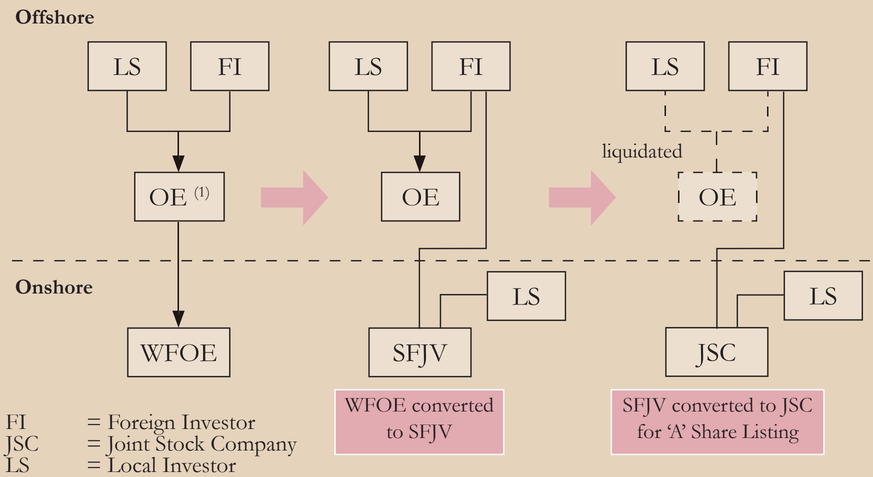
PE Ratio Ranges of the A-Share Market (2009 - 2010)



N.B.: monthly average P/E ratios
(1) period from October to December
SME = Small and Medium Enterprise Board

Fig. 6 *Sources*: Shanghai Stock Exchange, Shenzhen Stock Exchange
Graphic: Asia Private Equity Review

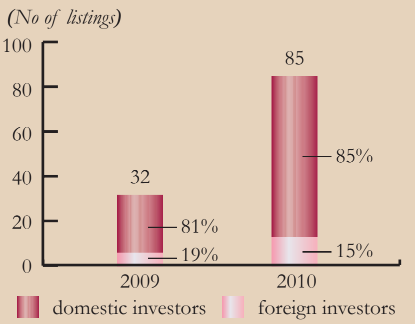
From WFOE to Joint Stock Company



FI = Foreign Investor
JSC = Joint Stock Company
LS = Local Investor
OE = Offshore Entity
SFJV = Sino-foreign Joint Venture
WFOE = Wholly Foreign-Owned Enterprise
(1) domicile address could be Bermuda, British Virgin Island, Cayman Islands, Hong Kong and Singapore

Fig. 7 *Source:* OWW Capital Partners Pte. Ltd.
Graphic: Asia Private Equity Review

A-Share Market as an Exit Route (2009 - 2010)



N.B.: number on top of each bar denotes the total number of listings in 2009 and 2010

Fig. 5 *Source*: Asia Private Equity Review

With the A-share market becoming increasingly vibrant in recent years, as far back as 2009 the management of HAND had felt the company's value could be better appreciated if HAND could become a quoted stock in the domestic stock market, instead of seeking such status abroad. Ironically, it is HAND's status as a WFOE, a status that was once much courted by China's private enterprises, that was the roadblock to its public listing goal.

HAND decided to venture into untested territory. It was to abandon its WFOE status, by first converting itself into a Sino-foreign joint venture, and subsequently into a joint-stock company. The latter company structure thus legitimised HAND to apply to become a quoted stock on ChiNext. The entire process took no less than 18 months, according to OWW (fig. 7)(fig. 8).

Changing from WFOE to Joint Stock Company

The following are extracts from OWW Capital Partners' 2Q11 Newsletter -	
Investor rights	Preference investor rights will have to be surrendered on conversion to SFJV and JSC
Transfer value	The transfer value may be set at a low valuation to facilitate the payment by local shareholders. This also means that foreign investors are "resetting" their cost down which could inflate future capital gains tax
IPO process	The entire IPO process is dependent on the local shareholder. For the foreign investor there is a moratorium of one year but could also be three years if they are classified to have an operating role. In the event that the planning IPO is not approved, the local entity can never revert back to the previous WFOE status. Thus foreign investors' interest in this local entity is locked, while having surrendered their investors' rights
Board representation	This carries different risks in a local entity, e.g. company disclosure, penalty for breach of directors' duties, etc. If there is no board representation by the foreign investor, their interest in the local entity may not be protected
Restructuring period	At least 18 months, during which foreign investors would have surrendered most of their investors' rights and are totally dependent on the local shareholder, not only to continue to manage the company, but also to deliver the IPO

IPO = initial public offering
SFJV = Sino-foreign Joint Venture
JSC = Joint Stock Company

Fig. 8

Source: OWW Capital Partners Pte. Ltd.
Compiled by: Asia Private Equity Review

Closing the Gap: HAND & Camelot

	2009 Financials		Listed Status		Market Capitalisation	
	Revenue	Profit	Bourse	Amount Raised	At IPO	26th Apr 11
Camelot	118.0	13.0	NYSE	147.0	482	900
HAND	45.8	6.8	ChiNext	115.5	445	450

All amounts in US$ m
Camelot = Camelot Information Systems Inc.
HAND = HAND Enterprise Solutions Co., Ltd.
NYSE = New York Stock Exchange

Fig. 9

Source: Asia Private Equity Review

The Compromises

In recounting this grilling process, Mr Tan Bien Chuan, a founding partner of OWW, warned that foreign investors must be prepared to undertake a certain level of risk as part of the compromise required for a WFOE to be considered for a listing status by the China Securities Regulatory Commission. "A foreign investor will have to surrender most of its rights (during this conversion period) and is totally dependent on the local party", commented Mr Tan. In particular, he was referring to board representation in a local company which could carry a different set of risks, such as penalty for breach of directors' duties, etc. The alternative is to relinquish board representation which would leave foreign shareholders' interests unprotected.

At this juncture, the risks taken by both OWW and China Fund Inc. appear to be worthwhile. Although HAND is a smaller competitor to Camelot, its status has been substantially boosted by being a quoted stock on ChiNext.

In 2009, Camelot posted US$118 million in revenue and a profit of US$13 million, virtually double those recorded by HAND. Yet the amount raised by HAND at its public offering, at Rmb760 million, or around US$115.5 million, was only 25% less than the US$147 million garnered by Camelot. Significantly, HAND is closing the gap between its market capitalisation and that of Camelot. As at 26th April, that for HAND stood at around US$450 million, while Camelot's was US$900 million (fig. 9).

Comments

By February next year, China Fund Inc. and OWW, which each currently hold a 7% stake in HAND, shall be able to dispose of their interest. Based on HAND's prevailing share price, these two investors' interest in HAND would represent US$65 million. It is a hefty gain of 10 times their original investment.

HAND's changed status offers an alternative for foreign private equity investors to exit their existing assets. According to market sources, a growing list of investors with portfolio companies in WFOE status are actively exploring this option as China's burgeoning A-share market offers substantially higher valuation to companies. The caveat, as Mr Tan pointed out, is that "if the foreign investor can stomach the risks and take a leap of faith … then the returns can be rewarding". ■