

**PRIVATE-EQUITY INDUSTRY IN CHINA:
THE SUCCESS OF BOHAI INDUSTRIAL INVESTMENT FUND MANAGEMENT COMPANY**

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ABSTRACT

This paper examines the private equity financing sector in China and then looks at the growth and success of the Bohai Industrial Investment Company. It emphasizes the significance of the Bohai Fund's success and then highlights some of the challenges still facing the growth of the private equity sector in China's financial market.

Keywords: Private equity, Bohai Industrial Investment Fund, China, regional development

1. INTRODUCTION

This paper traces the growth of the private equity (PE) sector in the financial market in China, breaking down the historical development in to four phases. Section 2 presents a brief Literature Review. Section 3 outlines the four phases of the PE development in China. Section 4 then looks at the successful growth of the Bohai Industrial Investment Fund (BIIF). Section 5 highlights the importance of BIIF's success. Finally, section 6 summarizes the findings of the paper and ends with some of the challenges that face both BIIF and the PE sector of the financial market in China.

2. LITERATURE REVIEW

While our paper specifically looks at the success of one fund as an industrial private equity investor and the historical growth of the PE sector, authors Naqi and Hettihewa (2007) make a case for the treatment of Venture Capital (VC) in Asia as being somewhat similar to what is commonly referred to as PE in the West. With this view in mind, and having scarce research on PE, we present some recent research findings on VC – with the notion of treating the implications as being equally applicable to PE in China.

The importance of VC on the development of an economy in general – and on innovation and technology in particular is well documented. The effects of VC – both by its presence and absence has been presented by many scholars.

Hellmann and Puri (2002) in examining the decline of the VC industry in the U.S. in 2001 state that their data supports the notion that venture capitalists, besides contributing money, also add value by their services to the companies they finance. However, they note that their sample of firms is pre-Internet and caution that currently, the environment has changed in the VC industry.

The importance of VC is also mentioned by Cao (2004) in a study of China's high-tech parks. While it is definitely not the only reason – but the author states that the lack of VC did play a role in retarding the

efforts of these technology parks to emulate Silicon Valley's success.

Similarly, Wu (2007) cites that lack of VC investment may hamper Shanghai's ability to maintain innovation and growth in to the future.

However, Cyranoski (2005) in an article in *nature* magazine states that progress is being made for foreign VC investments in China.

Vaughn (2002) does an excellent job of looking at the historical development of VC in China and then examines the regulation of this industry in China and outlines details for a regulatory framework.

Bruton and Ahlstrom (2003) interview venture capitalists in overseas firms that are investing in China. The authors report that the cultural and institutional differences in China need to be acknowledged and managed. The paper also looks at how value can be added to the firms being provided VC, thus supporting Hellmann and Puri (2002) in the context of China in a post-Internet world.

Manhong Liu, Zhang and Hu (2006) present the most recent and detailed look at the VC industry in China. The authors make a comparison between foreign VCs and China's domestic VCs. Then, the authors highlight how VC in China is a more potent force for change and improvements, given that it is acting as a more efficient substitute for bank financing. This paper supports the contention then of Naqi and Hettihewa (2007).

Given the above research and its findings about the power of VC / PE to generate and support growth in any economy, China's burgeoning PE sector needs to be paid attention to by all participants, private, institutional and governmental. In this regard, our paper is a first step in documenting the success of the first Yuan denominated PE domestic fund. Its success story and its future growth and prosperity should be an encouragement for other companies to follow.

3. THE DEVELOPMENT OF THE PRIVATE EQUITY SECTOR IN cHINA

A Private-Equity (PE) fund is a fund which invests in the shares of high growth companies that are not publicly traded (unlisted on stock exchange). The fund typically is involved in the operation and development of these private companies and helps manage their growth. Eventually, the fund sells its shareholdings for capital gains after the companies are matured enough to become publicly traded (get listed on an exchange). The growth of PE in China has accompanied the reform and opening of financial industry in China to overseas investment. Historically, one can segment the PE growth in China in to four development phases:

3.1 Inception phase

The inception phase of PE in China was from 1993 to 1995. During this phase, the operation of financial securities companies in China shifted from stock-brokerage to stock underwriting. To realize higher yields, some securities companies started investment funds for large clients, with the intention of using the money as primary market funds to subscribe to new shares. These funds then were the initial entrants in to what became the PE sector in China.

3.2 Formation phase

The formation phase of PE was from 1996 to 1998. There appeared a lot of underground funds in this phase, which were closer to the strict definition of PE. The listing companies entrusted their idle

funds to securities companies to invest; in a sense, the PE was manipulated by numerous consultant companies in the name of commission financing.

3.3 Blind development phase

This phase lasted from 1999 to 2000. In this phase, there were conflicting forces. On the one hand, comprehensive type securities companies in China had been approved to engage in the operation of asset management. On the other hand, a lot of trained employees left the securities companies and entered the work-force of the private-equity industry. These workers, due to their professional knowledge and marketing skills, had a huge impact on the development of the PE industry in China.

3.4 Rationalizing and developing phase

This phase started from 2001 and is continuing till now. With the rationalization of the securities market, modification and promulgation of Chinese company law and the law of Chinese security investment funds, China has deregulated the PE industry.

At present, PE in China includes private security investment funds and private industrial investment funds. In recent years, with the fast development of securities market in China, the private securities investment funds managed to develop rapidly. However, the private industrial investment funds have been developing relatively slowly. At present, there are only four industrial investment funds which have received state approval. Of the four, there are three Sino-foreign Joint Funds, and one Chinese-capital funds - Bohai Industrial Investment Fund.

4. THE SUCCESS OF BOHAI INDUSTRIAL INVESTMENT FUND

4.1 The Bohai Industrial Investment Fund Story

Bohai Industrial Investment Fund (BIIF) was established in Tianjin City on December 30 of 2006. The fund was close-end contract type fund; the term of the fund contract was 15-years. The total size of the fund is RMB 2 billion Yuan, the capital collected in the first period was RMB 0.608 billion Yuan. The investors in the fund include the National Council for Social Security Fund, China Development Bank, China national post office, Jinneng Investment Company of Tianjin, China Life Insurance Corporation, China Life Insurance Company Ltd., Bohai Industrial Investment Fund Management Company and Bank of China Group Investment Limited.

The BIIF general meeting of the holders of fund units is the highest power authority in the firm. This committee makes all the important decisions, including the appointment of management company and custody bank of the fund. BIIF will invest to the shares of unlisted companies, and will cash out their investments at the time the company's stock is listed on an exchange. As a PE fund, BIIF plans initially to invest in the common stock, preferred stock, convertible preferred stock, convertible bond of the companies in Tianjin City, regions around Bohai Sea and other regions according the proportion of 5:3:2 in 3 to 7 years.

The management of BIIF's assets were entrusted to the Bohai Industrial Investment Fund Management Company (BIIFMC). Bank Of China International Holdings Limited and Taida Investment Holding Company of Tianjin owns the 48% and 22% equity of BIIFMC relatively. The chairman of

BIIFMC is Lihui Li, who is also the president of Bank of China and the chairman of Bank Of China International Holdings Limited. The president of BIIFMC is Au Ngai from Hong Kong, who has been appointed by China International Holdings Limited.

In sum, the features of BIIF can be highlighted as having achieved "four firsts in China". It is the first RMB industrial investment fund of China approved by the State Council in China. Next it is the first industrial investment fund of China to be marketed. Third, it is the first contract type industrial investment fund. Fourth, BIIF is the first industrial investment fund of China which has been established specifically for Chinese investors.

4.2 The operation of BIIF

Operating formally from April 2007, BIIF has investigated and selected carefully numerous projects to invest in Binhai New Zone of Tianjin City, around Bohai Sea regions and nationwide. Meanwhile, BIIF constituted a Decision Committee to perform rigorous scrutiny of prospects and make informed investment decisions. This Committee includes five board directors and general managers. All investment projects must be approved by the Decision Committee.

After careful deliberations and study, on November 2 of 2007, BIIF invested RMB 1.5 billion Yuan to buy a minority shareholding in Tianjin Pipe Group Corp. from Tianjin Pipe Investment Holding Company. Tianjin Pipe Group Corp. now is the largest Seamless Steel Tube producer in the world and its economic dynamics make it an outstanding firm amongst the main iron and steel enterprises. BIIF's investment in Tianjin Pipe Group Corp. is the implementation of the desired strong union of financial capital and industrial capital in China. This step demonstrates the development of Chinese industrial investment funds potentially entering a new phase, which should lead to stronger growth of the economy.

On November 22 of 2007, BIIF declared that it had purchased 10% shares of Chengdu City Commercial Bank Co., which was worth RMB 1 billion Yuan. This investment made BIIF the third largest stockholder of the bank. Established at the end of 1996, Chengdu City Commercial Bank Co. now is the biggest city commercial bank in the west cities of China.

On November 26 of 2007, BIIF decided to invest RMB 1.2 billion Yuan in Taiyang Securities Company and this proposal has been submitted to the China Securities Regulatory Commission for the necessary approval. The share price of Taiyang Securities Company is only RMB 8 Yuan, which was equivalent to the market price to net assets ratio of about 2, and price-earning ratio was about 4. With its investment, BIIF will hold 14.29% of the total shares of the securities company.

In December 2007, BIIF announced that the RMB 1.4 billion Yuan second period of capital collection would begin and the capital collection would be completed by 2008. In the second period, the fund announced that it would continue to seek investing in excellent Chinese enterprises, not but outside of the Bohai Sea regions.

5. THE EVALUATION OF BIIF

5.1 The significance of BIIF

As the first industrial investment fund approved by the Chinese government, BIIF has been the experimental unit, as a prototype for future industrial funds, which lends great significance to its growth

and success.

Firstly, BIIF may promote the reform of investment and financing system of China, and push the establishment and improvement of the multilevel capital market.

Secondly, BIIF may promote the rapid development of PE funds industry.

Thirdly, BIIF may improve the governance of Chinese enterprises, and increase the efficiency of social capital.

Fourth, its support of the development of Binhai New Zone of Tianjin City and around Bohai Sea regions, leads it to promote the harmonious development of the regional economy in China.

5.2 The advantages of BIIF

Compared with overseas PE funds and other Chinese PE funds, BIIF has many advantages that are likely to ensure its continued success.

Firstly, as a governmental backed PE, BIIF has obtained the enthusiastic support and guidance from National Development and Innovation Committee of China, from its conception and approval to establishment and development. Its largest advantage lies in that it faces no industry policy limitation which may be imposed on foreign capital and there does not exist any industry security issues such as may arise due to foreign monopoly.

Secondly, as a Yuan-denominated private-equity fund in China, at the time that more and more state-owned medium and large size enterprises return to national securities market, the withdrawal mechanism has more advantages for local investors.

Thirdly, as a Chinese domestic PE, the obstacles facing BIIF's operations may be less cumbersome than that faced by foreign PE funds. This means that comparing with US dollar PE fund, BIIF has fewer regulations to handle from the authorities, and the procedural complications may also be less burdensome.

Fourth, even from the beginning, BIIF has complied with the principles of institutionalization, specialization and marketing; it has established a normative operating structure, and appointed a very experienced management team. This is just what has been the lack of many domestic PE funds.

5.3 The obstacles to the future development of PE in China

Firstly, the mechanisms for withdrawal of investments are not well set up. At present, the main withdrawal channels for industrial investment funds in China are Shanghai and Shenzhen Securities Exchange. However, owing to the strict listing standard, few medium and small size enterprises are able to list on these two exchanges. Although there are many property right market in many big cities, these market are in segmentation and relatively lower liquidity.

Secondly, there is a lack of relative law and regulation. BIIF has just received a trial basis approval by the State Council before the launch of "The Law of Industrial Investment Fund". Due to the lack of relative law and regulation, currently there is not only no accurate definition of an industrial investment fund, but also their capital-raising mechanisms and procedures, organizational structure, operational mechanisms and the right guarantee of the litigant rights and interests. This creates a huge void in the area of supervision on the PE industry and industrial investment funds.

Thirdly, double taxation. This is the main problem confronting fund investors at present stage in China, and this considerably cools their desire to invest in such funds.

6. SUMMARY

The PE industry has been developing in China for more than ten years, and can now be thought of as having entered into a Rationalizing and Developing phase. As the first wholly domestic Yuan denominated PE approved by the State Council of China, BIIF has been established for just over one year. Nowadays, BIIF is operating very successfully. By deliberate investigation and prudent selection, BIIF has invested in Tianjin Pipe Group Corp., Chengdu City Commercial Bank Co. and Taiyang Securities Company. These companies all have good growth and development potential. Now, BIIF will begin its second period of capital collection, which will raise a total amount of RMB 1.4 billion Yuan.

The establishment and operation of BIIF may promote the reform of investment and financing system of China, push the construction of multilevel capital market in China, and also promote the rapid development of investment fund industry. It should create advantages for the perfection of the governance of enterprises, increase the efficiency of social capital, and eventually support the development of Tianjin City and around the Bohai Sea region.

Having government backing, BIIF is not restricted by any industry policy, and it does not pose a threat to industry safety. As a Yuan-denominated PE fund, BIIF is subject to less regulation and need for approval by the authorities, compared to foreign PE fund. As compared with other domestic PE funds, BIIF has established a normative operational structure, and appointed a very experienced management team.

However, at present, BIIF does face some potential constraints to its future success. These are the lack of an established withdrawal mechanism to cash out its investments in companies, the lack of relative law and regulation and double taxation. Policy makers need to reflect on how to solve these problems as soon as possible, not only for the continued development and success of BIIF, but also for the development of PE industry in China.

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