Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

PE Firms Play With Fire In Chinese Co. Buyouts

By **Samuel Howard**

Law360, New York (January 13, 2012, 3:06 PM ET) -- Chinese companies that raced to go public in the U.S. a decade ago are now scrambling to escape an inhospitable market, giving private equity firms the chance to make a killing if they can maneuver past the pitfalls and take the right company private, attorneys told Law360.

Chinese businesses stampeded to the U.S. for the prestige of listing here as well as access to abundant capital, but a series of highly publicized fraud cases have cast a radioactive pall and decimated stock prices, leading many businesses to pursue management buyouts as a way to escape the hostile and costly U.S. market.

The management teams want to take their companies private and are beckoning to private equity firms to provide the cash to buy out shareholders. The offer is tantalizing because many companies have sturdy revenues and would be warmly received upon relisting in markets like Hong Kong or mainland China, or even in the U.S. once the climate improves, attorneys said. And many pillars of the industry, like Bain Capital Partners LLC and Abax Global Capital, have taken the plunge.

“There’s tremendous financial opportunity for private equity in taking some of these companies private, provided they partner with the right company,” said James Chapman of Foley & Lardner LLP.

The trick for private equity, however, is to sort the golden geese from the white elephants, separate the companies that are casualties of a prejudiced market from those that harbor real problems.

“You not only have to find the undervalued companies but avoid the companies that resist transparency and have other serious flaws, ” Chapman said.

Serious flaws include unreliable financials and possible fraud, as epitomized by the scandals at timber company Sino-Forest Corp., which essentially wiped out $3.7 billion of stock value, and Longtop Financial Technologies Ltd., a software firm that once had a market capitalization of $2.4 billion.

Even though some of the fraud concerns are valid, runaway fears have condemned virtually all Chinese companies to a listed purgatory where they undervalued, unable to raise capital and held to expensive reporting requirements, according to Joseph Chan of Sidley Austin LLP.

“Right now, Chinese companies are getting indiscriminately hammered by investors,” Chan said. “As long as you are from China, it’s guilt by association, regardless of industry or background or performance.”

And many private equity firms recognize that the spillover from the fraud scandals have tarnished many viable companies and created excellent arbitrage opportunities. The firms can purchase a large stake cheaply, provide solid financial and business acumen, and set the firm up to relist profitably in the U.S. or abroad, Chapman said.

“That’s a true private equity play,” Chapman said.

Several major private equity firms have already dipped their toes in these waters. PAG Asia Capital invested $250 million to take wireless device retailer Funtalk China Holdings Ltd. private in September, Bain has pledged $265 million to China Fire & Security Group Inc.’s management buyout, Primavera Capital Group is funding chemical company Chemspec International Ltd.’s privatization, and Abax Global Capital is involved with both Fushi Copperweld Inc.’s $350 million buyout and electric motor company Harbin Electric Inc.’s $470 million transaction.

Those deals could prove either the tip of the iceberg or the standouts in a sea of stillborn buyouts, attorneys said. Either way, there is no shortage of Chinese companies eager to leave the U.S. and plenty of private equity firms alert to the investment opportunities.

“If a business has solid fundamentals, a depressed stock price and a management team with a sufficient stake, it’s a good candidate to go private,” said Kurt Berney of O’Melveny & Myers LLP. “Bankers are always scouting for deals, so every company worth its salt is probably getting a pitch to go private.”

But no matter how enticing a candidate might be for a management buyout, there are a lot of factors for private equity firms to ponder before partnering up with a Chinese company, Berney said.

Takeovers invariably trigger a salvo of shareholder suits, and management buyouts are particularly problematic because of the apparent conflict of interest, where insiders with a duty to investors are seeking to buy the company at a bargain, Berney said.

Once a company goes private, there is often no rock-solid exit strategy for the private equity investment, and this fundamental uncertainty is very hard for deal makers to tolerate, attorneys said. The difficulties of doing business in China add to that uncertainty. Even if a business manages to secure official favor and go public in the country, investors are barred from selling their shares for a mandatory three-year period — a lifetime for private equity, Chapman said.

“Bear in mind, you can’t just snap your fingers and get listed in China or go public in Hong Kong,” Chapman said. “In mainland China, there’s a two- or three-year waiting list and no guarantee of ever relisting, as the process is highly political.”

Although some fraud allegations may have been overblown, accounting irregularities have sunk more than a few Chinese companies in the last couple of years. Would-be investors struggle with the reliability of the Chinese businesses because so many went public through the reverse merger structure, which carries less rigorous reporting requirements.

“From 2001 to 2009, we turned many companies down because we were not comfortable with the financials, accounting infrastructure, and business practices,” Chapman said. “Even then, it was obvious that a lot of the Chinese companies that went public had shaky financial statements, unorthodox business practices, and that this would backfire.”

Ultimately, the management buyout might not be very appealing for all private equity firms because it is expensive and complicated, requiring a degree of transparency and collaboration that many candidates are unable to provide, said Gordon Caplan of Willkie Farr & Gallagher LLP.

“Private equity doesn’t like dealing with opaque and remote businesses, especially, if they are just going to be a minority partner,” Caplan said. “There are much more straightforward ways for private equity to pursue opportunities in China.”

--Editing by Kat Laskowski.