

Tech Opportunities in China

An Interview with David Liu

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Q: What trends are you seeing globally that are attracting your clients to Asia?

A: The drive to access growth-oriented investments is at the core. Both U.S. and European tech markets are maturing.

The U.S. market has some pockets of growth while in selected segments such as semiconductors, medical devices, and Internet-related companies many of the technology areas that we previously associated with growth are now in a state of maturation and consolidation.

Asia is a key driver of the global economy today with enormous growth potential in virtually every segment. For our clients on the “buy-side” (i.e., institutional investors or companies seeking to make acquisitions), Asia has been the focus because opportunities to find above-market returns have been plentiful. For our Asian “sell-side” clients (i.e., companies seeking capital or sale) they have seen the virtues of partnership or investment from non-Asian sources and so we are helping them access European and U.S. companies and investors.

Q: Where are the major opportunities in Asia right now?

A: Historically, our primary focus in Asia has been servicing the Japan markets through our Tokyo operation, but in the long run we expect China and India will be our core Asian growth markets. We are looking to open a marketing office in Shanghai and have made a long-term commitment to the India market as well.

Regarding China, we believe that it is not only a significant source of productive labor for outsourcing, it is also a country ripe with investment opportunities; it offers the powerful combination of both

“supply-driven” and “demand-driven” growth, with a population four times that of the United States.

“Supply-driven” growth refers to growth created by the overwhelming supply of labor, capital, and entrepreneurship in China. A historical example is manufacturing, but going forward, we anticipate emerging sectors such as bioscience and semiconductors also to benefit from these supply-side features. “Demand-driven” growth is that which comes about as a result of the rapid modernization and industrialization of the Chinese economy. One historical example is consumer electronics (primarily wireless) but in the future, everything from retail to entertainment will be good areas of growth.

Q: What specific types of transactions are taking place in the China market?

A: Three types of transactions in China are finding the most receptivity among our clients. The first is the equity listing of Chinese companies on U.S., European, or Japanese exchanges. This form of capital has been readily available in the U.S., E.U., Hong Kong, and Japan—though not in China. Despite having one of the highest economic growth rates in the world, Chinese companies are looking overseas for equity capital because China’s indigenous stock market has not performed well, largely due to structural problems. This paradox provides opportunities to foreign investors because it makes high-growth Chinese companies seek capital through foreign listings—particularly on exchanges such as the Nasdaq. In 2004 we acted as a manager on two such Nasdaq listings (i.e., Ninetowns, China Finance Online).

The second type of transaction that is becoming more and more common in China is pre-IPO, late-stage equity financings—basically a bridge to foreign listings. In these transactions, Chinese companies seek corporate governance, branding, and strategic and global insights from a foreign minority investor willing to put up

significant funding that also helps the company prepare for an eventual IPO. Many late-stage U.S. private equity firms such as General Atlantic LLC, Softbank Asia Infrastructure Fund, and Warburg Pincus LLC have been playing an increasing role in this type of transaction.

Third is M&A, which has historically been Jefferies Broadview’s forté in the U.S. and European markets. In a growth market like China’s, companies are typically less interested in selling so buyers have a hard time finding inexpensive targets. However we’re starting to find not only foreign buyer interest for Chinese companies but also Chinese buyer interest for U.S. or European assets and technologies. In fact, we’ve been involved with deals of Chinese companies buying in the U.S. including the sale of the wireless handset division of Audiovox Corp. (to UT Starcom Inc.) and the sale of Ross Systems Inc. (to CDC Corp.).

Q: What are the trends to watch in China?

A: A very interesting trend in the China market is what I like to call “Chinese-style M&A.” This is the sale of minority positions in Chinese firms to foreign strategic investors. A good example of this was the \$1 billion transaction between Chinese online portal Alibaba.com and Yahoo Inc. In exchange for selling a minority position in the Chinese company, Alibaba gets strategic backing and branding from a top-tier U.S. Internet company but does not cede control. It is important to note that M&A is usually a value-terminating event for the seller but this model enables the seller to obtain some liquidity while still retaining control and upside for the future. Another example is search engine Baidu’s raising of \$100 million, some of which was from Google.

We are also seeing more late-stage private equity placements with secondary shares sold prior to an IPO. This is important to Chinese entrepreneurs who need liquidity.



Often we have to educate our Chinese clients about overseas listings and their relation to liquidity. They often don't fully appreciate that IPOs are not a full liquidity event for them because IPO investors do not like to see share sales by insiders. Other than through Rule 144 sales, which allows the gradual sale of insider shares over time after the standard lock-up period, which typically ends 180 days after an IPO, such sales are discouraged. Late stage private equity placements are a good option for entrepreneurs seeking some immediate liquidity and all the benefits of private equity financing (i.e., financing and expertise from leading U.S. tech firms). Until the market matures, we will see more of these variations on traditional M&A and pre-IPO financings.

Q: What are some of the risks of these deals for your clients?

A: I would say the number one risk is Chinese government policies that may have unintended effects on deals.

For example, last year China's State Administration of Foreign Exchange (SAFE) issued rulings to stop the transfer of Chinese assets offshore. This is a reasonable goal, particularly in light of what happened after the breakup of the Soviet Union where large-scale transfers of assets out of government control and into the hands of a few individuals had severely negative effects on the Russian economy and equality of wealth. China's SAFE rulings stated that any Chinese national in a control position in a company could not transfer that control position to a foreign entity without SAFE approval.

However, this had the unintended effect of stifling venture capital activity in China because a typical investment model for VC investors in China is to set up an offshore entity with some Chinese assets that then lists on overseas markets. All of the Nasdaq listed Chinese companies have used this structure in the past. The World Economic Forum's Venture Capital work-

ing group, of which I am a member, has brought this to the attention of SAFE and other related government officials. We believe that interfering with VC investment was never SAFE's intent, and the government is issuing clarifications to try to improve the situation. Nevertheless, VC investment in China has cooled quite a bit this year, after several years of strong growth.

A close second to this risk is the risk of U.S. government policy changes, which have the potential to make it difficult for Chinese firms to raise capital on U.S. markets. The failed bid by China's CNOOC Ltd. to purchase Unocal Corp. was a high-profile example of a deal that garnered significant U.S. political scrutiny. If the U.S. government travels this road and bars Chinese companies from seeking U.S. capital, it will only hurt the U.S. economy in the long run. Europe and Japan would love nothing better than to undertake transactions with China that are prohibited in the United States.

Q: Where else in Asia are you seeing interesting opportunities?

A: Japan is bearing the fruits of the restructuring of its economy after a long bear market that began in the early 1990s. Because of the resurgence in the Japanese stock market in the last few years, we have been educating Asian tech companies to consider Japan when looking to raise capital.

Taiwan also offers opportunities because of an interesting structural capital markets issue that results from political tensions with mainland China over reunification. We believe that this has created an artificial overhang on the Taiwan stock market. Thus, P/E values of companies in Taiwan are depressed relative to their peers in the United States and Europe, and trade at a discount. In fact, we know of several Taiwanese companies that compete directly with U.S. or European companies, grow more rapidly, and are more profitable, but

still trade at a discount to their U.S. or European peers. Thus, an acquisition of these Taiwanese companies by U.S. or European companies can be very accretive for the buyers. Taiwan firms gain liquidity and access to capital, while U.S. and European investors obtain a back door into China, since many Taiwan firms have operations on the mainland.



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