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Analysis on the Effect of Private Equity（PE）Buyouts to Industrial Security

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Abstract. This paper discusses the effect pattern of portfolio of private equity to industrial security of China mainly from the foreign currency direct investment perspective. In terms of four dimensions, including currency, pattern of buyout, effect cycle and subject of buyout, the paper focuses on the effects which foreign currency buyouts exert on the culture industry of China. The effects can be classified as two kinds: the horizontal ones, including short-term effect, middle-term effect and long-term effect; the vertical ones, including microscopic effect, meso effect and macroscopic effect.

Keywords: Private Equity; Portfolio; Industrial Security; Effect Pattern

1. Introduction

Since the beginning of Reform and Opening, the economy of China has met a tremendous development with the introduction of capital and technology from foreign countries. With development of China’s macroeconomic situation and the rising of salary of Chinese people, the needs of Chinese people have diverted from the basic food and clothes to various items, including the spiritual ones. It was under this condition that China’s cultural industry has witnessed a great development. As we can see in Figure 1, the culture, sports and entertainment investment in fixed asset has been risen steadily from 53.12 billion RMB in 2004 to 509.92 billion RMB in 2013, which demonstrate that the market of cultural industry in China has become bigger and bigger. Moreover, the family annual consumption expenditure of urban residents in education, culture and recreation services has also met a huge increase since 2004. In 2004, the annual expenditure is 560.81 billion RMB, and the number was nearly tripled in 2013 to 1665.20 billion RMB. This shows the increase of salary of Chinese families, because they will expend more money on culture and recreation only when they get more, and it also means that the potential for the cultural industry in China is quite strong. Besides, we can see how fast the market in China has been growing from the growth rate of the family annual consumption expenditure, mostly, the growth rate was above 10%, and in 2012, it even reached to nearly 30%.

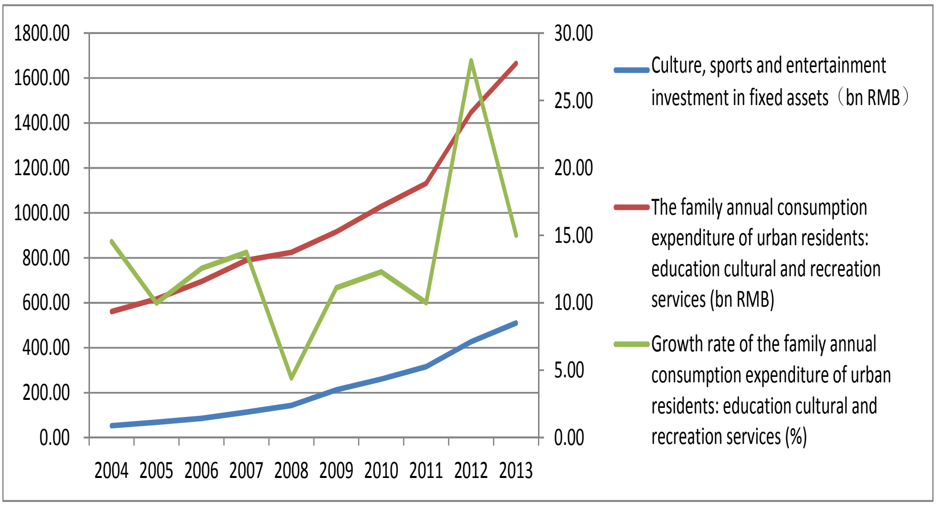

Figure 1 Investment and Consumption of Cultural Industry in China.Data resource: China Statistical Yearbook, Wind

In the 1990s, the private equity investment fund (hereinafter referred to as 'PE'), which has developed many years in the international financial market, arose in China. And with nearly twenty years' development, it met a blowout in China around 2010. All types of PE popped out in a very short time. In the same period, China was introducing massive foreign investment from other countries. In 2000, foreign PE started to enter the financial market of China. Foreign PE, with their strong financial strength, mature operation pattern and extensive industry experience, has played a significant role in the financial market of China.

As the comprehensive national strength increases, the development of national economy has been less relying on foreign investment. At the same time, questions about the industrial security of China have also been put on the agenda. According to reports from the press, the number of investment cases in the cultural industry of China in the year of 2009, 2010 and 2011 was 52 in total, and the total amount of capital was no more than 10 billion RMB. In 2011, the number of newly raised cultural private equity funds was 16 and the total capital is 66 billion RMB. Since China's entering of the World Trade Organization in 2001, the cultural industry of China has been gradually open to foreign capital. Before 2011, the share of foreign capital in the cultural industry of China was above 60%, and in 2013, the number had been down to no more than 40%. Foreign capital has been interested in various fields of the specific area of China's cultural industry, such as movies, traveling, television and automation. Although the entering of abroad PE has brought adequate capital for the development of Chinese companies and triggered a series of buyouts in China, a potential threat also arose in terms of the industrial security of China. As we can see in Figure 2, the number of registered foreign-invested enterprises in culture, sports and entertainment has been rising firmly in the last 10 year. The number was above 2100 every year, and it was 2400 in 2012 and 2013. Additionally, although the rate of foreign capital in urban entertainment industry investment has been decreasing since 2004, but basically, the rate was around 1% to 2%, which can not be ignored. Furthermore, the share of the actual amount of Foreign Direct Investment in culture, sports and entertainment in culture, sports and entertainment investment in fixed assets also met a downturn from 2004 to 2013. However, the influence of foreign capital should not be overseen in terms of the amount of foreign direct investment.

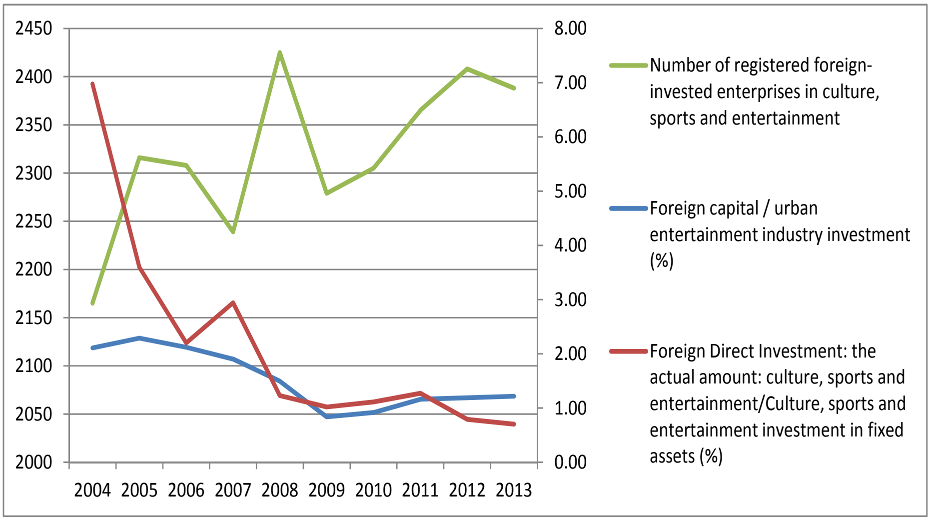

Figure 2 Foreign Investment in Cultural Industry in China. Data resource: China Statistical Yearbook, Wind

2. Literature Review

There are different definitions of Private Equity Fund. British Venture Capital Association (BVCA) defines PE as an investment fund that provides long-term committed equity to help unlisted companies grow. National Venture Capital Association (NVCA) divides PE as the general ones and the narrow ones. The general ones include venture capital, buyout fund, mezzanine fund, fund of fund and secondary market investment fund, and the narrow ones refers to general ones without venture capital.

As to investment portfolios, Markowitz (1952) pioneered the modern portfolio theory, which means that the utility of investors is the function of the expected return and standard deviation of portfolio. A rational investor will either pursue the maximizing of yield under certain risk or the minimizing of risk under certain yield level. Investors will achieve the expected utility maximization by selecting effective portfolio[1].

As for industrial security, List (1841) systematically expounded the idea of protecting and developing the infant industry of a country in his book The National System of Political Economy[2]. Theories about industrial security can be divided into four categories: the industrial control theory, the industrial competitiveness theory, the industrial development theory and the industrial interest theory. Jing Yuqin (2004) summarized several typical concepts on the industrial security. The first one is the concept which emphasizes the dominance of national economy, which means that to reach the best portfolio of the total national industrial interests and their domestic share in international competition. The second one is concept which underlines the controlling power whose core is emphasizing the ability that the capital of one nation to control its own industries. The third type of concept focuses on competitiveness, which refers industrial security to the ability of one nation to control its core industries and the ability of those industries to protect themselves from oversea threats, which mainly appears as the international competitiveness of industries[3]. Provided that PE seldom plays the role as a controller in the operation of a company, and this paper will take the third view of industrial security, which refers to the view that emphasizes competitiveness.

The portfolio of a PE refers to the portfolio of share of different companies or assets that a PE holds, especially the portfolio of one particular industry. The major influence of PE have on industrial security is that they will affect the decision making process of production and operation of companies by acquiring part of their shares or even all the share. Moreover, PE, especially those industry investment funds, influences the industrial security of certain industry by the layout of the entire industry.

The culture industry has seen a rapid development these years with its output value taking more share of the GDP. In 2011, the total output value of the culture industry is 3.9 trillion RMB, which took 3% of GDP of that year. And when it comes to 2013, the culture industry of China is entering into a fast increasing path in view of the skyrocketing development of the film industry. The index of culture and media sector of China A-share stock market witnessed a 90% increase in 2013, and the culture industry has become more and more indispensible in economy of China. Besides, as a strategic industry in China, culture industry has exerted a special influence to protecting our cultural tradition from invasion of the unhealthy oversea culture. Therefore, the layout of culture industry of foreign PE funds will threat the security of China's culture industry and even the ideology of the whole nation, which we should take seriously.

3. PE Portfolio

PE portfolio can be divided into two kinds according to the currency, including the RMB investment and the foreign currency investment. In addition, PE portfolio can be divided into horizontal buyout, vertical buyout and mixed buyout in terms of the mode of buyout. Additionally, it also can be divided into short-term, mid-term and long-term investment in view of the investment cycle. Lastly, it can be divided into microscopic, meso and macroscopic investment. This paper will study China's industrial security from the perspective of foreign currency investment, and the dimensions of the portfolio we study focus on buyout objects, investment cycle and modes of buyout.

3.1 RMB Direct Investment

The biggest threat that RMB direct investment has on industrial security is that their large-scale buyouts could lead an emerging industry into oligarchy or monopoly, and then impede the development of the industry and its international competitiveness.

3.2 Foreign Direct Investment

Foreign currency investment includes direct investment and indirect investment, and this paper mainly study direct investment. And the Foreign Direct Investment (FDI) includes Greenfield investment and foreign currency merger.

3.2.1 Greenfield Investment

Greenfield investment, in other words, initiating investment, refers to that multinationals acquire part or the whole share of one company according to the law of the host country.

The basic form of the FDI in China is Greenfield Investment. There are three modes of foreign Greenfield Investment: Sino-Foreign Joint Ventures, Sino-Foreign Contractual Joint Ventures and Wholly Foreign-Owned Enterprises. There remain several issues in Greenfield Investment. First, it needs a lot of preparatory work, which leads to its long-term building cycle, low efficiency and lack of flexibility, so it has set high standard for multinationals in terms of capital and operational experience. And it is not suitable for the rapid development of multinationals. Second, in the process of initiating a company, multinationals will take full risk, which may cause huge uncertainty. Third, multinationals need to develop target market in the host country after their enterprises started. And they often face up with problems as management pattern can not adapt to the routine of the host country and lack of managerial and technical staff. In accordance with issues above, the influence that Greenfield Investment exerts to the industrial security of China will be limited.

3.2.2 Foreign Currency Merger

Foreign currency merger refers to that foreign companies, economic organizations or individuals acquire domestic companies by buying the share or the asset of those companies. Since the amount of investment from foreign individuals is small, the majority of the buyers in foreign currency mergers are industry investors like multinationals and foreign currency PE.

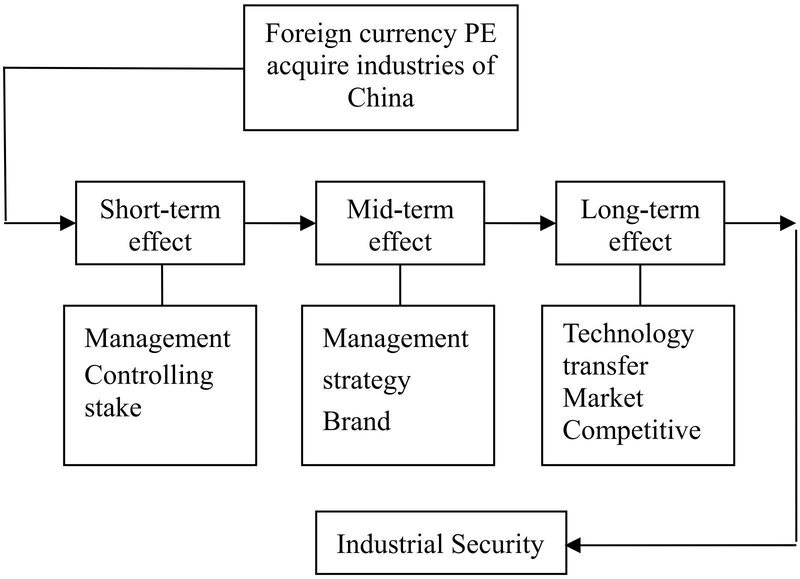

Figure 3 Effect of Foreign Currency Mergers

We can divide foreign currency mergers into different kinds from different perspectives. And the portfolio of PE will play various roles in different kinds of mergers. There are three kinds of effect that foreign currency mergers can affect the industrial security: short-term effect, mid-term effect and long-term effect.

Short-term effect refers to the effect exerted a short term period after a PE acquires the share of a company, including the weakening of the controlling power of a company, loss of the majority ownership, the weakening of the controlling over significant subsidiaries and management policy making. Mid-term effect is the effect exerted a comparatively long period after a PE acquires the share of a company, including influence on the management strategy of a company, influence on the merger and acquisition activities of the company, the influence on the brand of the company, and the influence on the overall competitiveness of the company. Long-term effect refers to the long-term influence on a whole industry based on the short-term effect and mid-term effect after PEs acquired a series of companies of an industry, including the influence on the competitiveness of an industry, the transfer of technology of an industry, and the influence on the market structure of an industry.

3.2.3 The Comparison between Greenfield Investment and Foreign Currency Merger

There are two major differences between Greenfield investment and foreign currency merger. First of all, the currencies used in these two types of foreign direct investment are totally different. For Greenfield investment, the currency should be RMB, because, mostly, the form of Greenfield investment is that multinationals and local corporations in China cooperating to found a new joint-venture. And since the joint-venture should run in China, the capital that multinationals invest should also be RMB. As for foreign currency merger, either would the foreign buyers invest with foreign currency under the rules of Qualified Foreign Institutional Investors (QFII) by the regulators of China, or would they buy the offshore divisions of the Chinese companies. In addition, the second major difference is the form of investment. For Greenfield investment, as is stated above, its basic form is joint-venture instead of buy the share of certain Chinese companies. And for the foreign currency merger, on the contrary, its basic form is to buy the share of Chinese companies instead of founding joint-ventures.

3.3 Modes of Buyout: According to the Market Relationship of the Acquired Companies

Buyouts can be divided into the horizontal ones, the vertical ones and the mixed ones in terms of the market relationship of the acquired companies.

3.3.1 Horizontal Buyout

Horizontal buyout is buyout that a PE acquires one company or several companies of an industry. Take the culture industry as an example, the portfolio of PE refers to the portfolio of the culture industry formed by acquisitions of different cultural companies such as entertainment companies, media, and traveling companies. The path that horizontal buyout influences the industrial security is that it will exert a comprehensive effect to the whole industry by acquiring companies which have the same or related business and thus producing the short-term, mid-term and long-term effect in time dimension and microscopic, meso and macroscopic effect in scale dimension. In that way, the security of China's culture industry will be influenced. The effect of horizontal buyout is shown in Figure 4.

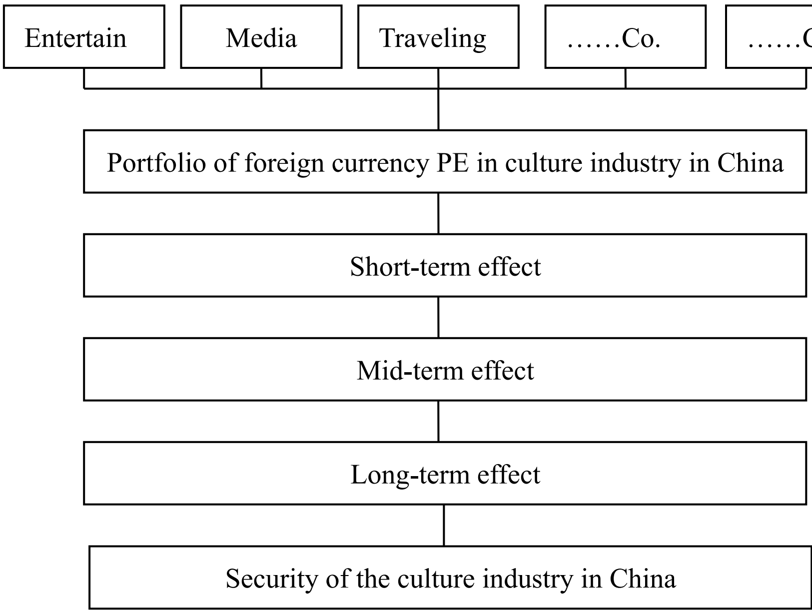

Figure 4 Effect of Horizontal Buyout

3.3.2 Vertical Buyout

Vertical buyout refers to the buyout that focuses on the acquisition of companies that have a strong relationship with the buyer in the production and operation process. The acquired companies are companies that produce the same products but in different stages, just like the relationship between the raw material suppliers and the products sellers. The vertical buyouts initiated by foreign PE to the culture industry in China refer to the buyouts of the upstream and downstream companies of the culture industry, in other words, buyouts on the industry chain. Take the traveling industry as an example, the upstream companies in traveling industry include resorts developing companies, midstream companies include all types of travel agencies, and downstream companies include the post development and sales companies of the cultural products related to the viewpoints. The vertical buyouts on the traveling industry initiated by foreign PE refer to the acquisition of resort developing companies, travel agencies and cultural products developing and sales companies in a certain period, and then the penetration in the industry.

However, the short-term, mid-term and long-term effect will be seen in the upstream companies, and then the midstream companies and the downstream companies. Vertical buyout influences the industrial security by the integration of the industry chain.

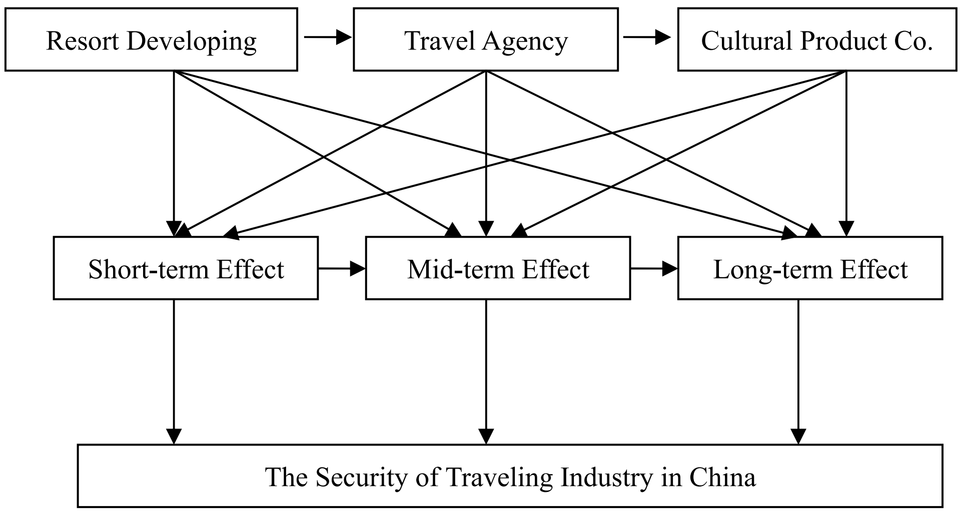

Figure 5 Effect of Vertical Buyout

3.3.3 Mixed Buyout

Mixed buyout, in other words, compound buyout, is buyout that focuses on the acquisition of companies that are not related in production and service. For example, the buyout of resort developing companies initiated by film production companies. Although businesses of these two kinds of companies are not quite related, there will be synergies after the buyouts. For instance, the viewpoints could offer the shooting scenes for the film production companies. Moreover, the releases of films will make the viewpoints famous. Thus, two sub-sectors of the culture industry will be influenced and the security of the two sub-sectors will be threatened with the following horizontal and vertical buyouts. The effect of mixed buyout can be seen in Figure 6.

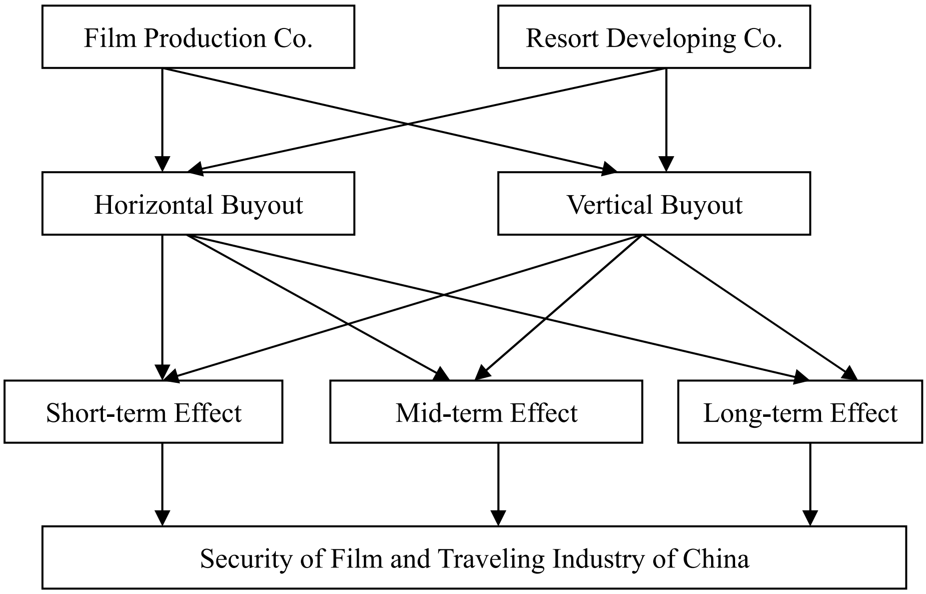

Figure 6 Microscopic Effect

3.4 Modes of Buyout: According to the attitudes of both of the sides during the process of the merger and acquisition

3.4.1 Friendly Takeover

Friendly takeover refers to buyout that has been agreed by the runner of the target company. Both sides can negotiate about the purchase conditions, price, payments, status of the acquired company after the buyout and arrangement of the acquired company. Friendly takeover is conduct based on that both sides are voluntary, cooperative and public. What is should be noticed is that even if the takeover of the foreign PE was a friendly takeover, it would still threaten the industrial security of China.

3.4.2 Hostile Takeover

Hostile takeover refers to buyout that does not get the permission of the board of the target company. To achieve the controlling stake, both sides will take different attacking and defending strategies. Although hostile takeovers will threaten the acquired companies, acquisitions will not threaten the whole industry only if the buyers take the hostile takeover strategy repeatedly in the process of horizontal and vertical buyouts.

4. Analysis on the Effect Pattern of Portfolio of PE to Industrial Security

The effect pattern that the portfolio of PE produces on an industry differs when the mode of buyout is different. But this is limited to the microscopic stage, which refers to the point effect of the company. In fact, with the portfolio of PE getting deeper and deeper in buyouts, the meso effect and macroscopic effect will arise, in other words, the linear effect on the industrial level and the planar effect on the macroeconomic level.

4.1 Microscopic Effect

The microscopic effect of foreign currency buyout can be seen within one company or several companies. Since horizontal buyout focuses on companies running the same or similar business, analyze the effect of acquiring one company would be enough if we want to study the microscopic effect of foreign buyout. As stated above, the effect could be divided into microscopic effect, meso effect and macroscopic effect.

The direct short-term effect of foreign currency buyout is that it enables a PE to control the share of the acquired company, and thus finance, technology, product and the market would be controlled.

The mid-term effect of a buyout will be shown in several years after the acquisition is completed. Firstly, a PE will influence the management of a company by buying its share and thus controlling it. The strategy of the company will be further affected with the management decisions be influenced several times. And thus there will be a profound influence in the long run. Additionally, the merger and acquisition activities with its buyout strategy and buyout mode will be controlled with the management of the company bridled. Furthermore, as the idea of running business of foreign institutions is different from their Chinese counterparts, the brand influence of the acquired company will be different from the one run by the Chinese management.

The long-term effect of foreign currency buyout will be reflected in the technology transfer, market structure and competitiveness. First of all, buyouts initiated by foreign companies or PEs enable these institutions the get the information of the acquired companies. Once the technology be transferred, the technological security of certain industry of China will be threatened. In addition, foreign buyouts would shift the focus of the acquired companies such as the change in the market segment. Moreover, the competitiveness of the acquired companies will be tremendously influenced as the market, brand, merger and acquisition, technology and management are largely affected.

4.2 Meso Effect

The influence of foreign buyout is majorly reflected in the influence of the security of the whole industry. If a PE holds a portfolio of the culture industry by acquisitions, then there would be an industrial effect in the culture industry with the microscopic effect in the long run.

In the first place, the benign development of the culture industry will be curbed with the entering of foreign capital, and thus will weaken the competitiveness of culture industry of China. Especially, culture industry is the industry that gets big support of the government, which relates to the development plan and strategy of China. Besides, the entering of foreign capital is not good for the layout of industry of China. For example, the Chinese government is trying to support the culture industry. But the plan of the culture industry will be disturbed with the entering of foreign capital.

4.3 Macroscopic Effect

The macroscopic effect of foreign buyout refers to the overall influence to the economy of China. The basic path of macroscopic effect is from companies to industries, and then to the economy of China. Economy is an economic ecosystem that is combined organically by all the industries in China. Therefore, the security of the economy will be threatened if the security of its industry was threatened.

An industry will have some correlation with a number of other industries such as its upstream and downstream industries. Consequently, if the security of an industry is threatened under the disturbance of foreign capital, then the development of the upstream and downstream industries will be threatened as well. If this influence lasts, there will be a Domino effect, and an unexpected negative effect will be catalyzed to the economy of China.

5. Case Study: The buyout of Expedia of Elong Traveling

In May, 2011, the world's biggest online traveling company, Expedia, announced its share of Elong Traveling, the second biggest online traveling service provider in China, had been over 50%. There are three reasons why Elong Traveling wanted to be acquired. Firstly, the internationalization of Elong would be promoted with this buyout. Secondly, the stress of cash could be relieved. Thirdly, the popularity of Elong in international capital market would be leveled up. And for Expedia, three purposes could be achieved by this buyout. First, its business range could be widened, and the operational risk could be decreased. Second, by helping Elong operate and increase the value of Elong, its share of Elong would also be increased. Third, it would step into the Chinese market by acquiring Elong.

6. Conclusion

With the analysis of the effect pattern of the portfolio of PE to the industrial security of China, we can find out that there are three kinds of measures that foreign PE takes in buyout: horizontal buyout, vertical buyout and mixed buyout. Foreign PEs will conduct the multi-point distribution by acquiring the share of several companies running the same business or the upstream and downstream companies. Therefore, there will be the short-term effect, mid-term effect and long-term effect, and from points to lines and then surfaces. In conclusion, we should pay close attention to the merger and acquisition activities of foreign PEs and protect the industrial security of China.

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