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China Strategy Is Key For U.S. Buyout Firms

Some Funds Now Avoid Manufacturing, Others Embrace Low-Cost Labor

By TIMOTHY AEPPEL

These days nearly every private-equity fund looking to invest in U.S. manufacturing has to have a China strategy.

But what strategy? Competition from the growing Chinese economy and its huge pool of low-cost labor is causing a split in the investment community. Some private-equity firms are turning away from manufacturing, to service industries such as restaurants, while others are buying U.S. manufacturers and moving the production to China.

Chinese investors are involved, too. "This is the way forward in manufacturing private equity," says Raphael Joory, whose recently formed Opera Capital Ltd. has \$70 million from 25 Chinese investors, all manufacturers of consumer goods such as toys, air conditioners and clothes, who are eagerly looking for the most promising American manufacturing investments.

"Many of the [U.S.] funds we speak with are very concerned about not having an effective China strategy, and want to team with us to make investments," says the 30-year-old former banker who was born in Hong Kong, carries a British passport, and lives in New York.

There is a lot at stake. U.S. buyout funds, which raise money from state pension funds, university endowments and rich individuals, had a combined total of

approximately \$91 billion waiting to be deployed as of March 31, 2004, according to Thomson Venture Economics. Because funds typically return unused money to investors after a set time period—say, five years—there is pressure on funds to do deals. That, in turn, can drive up prices and make the business less lucrative.

More private-equity firms are hiring experts who know how to help U.S. manufacturers buy products and parts from low-cost foreign factories—a common strategy for dealing with the challenges of Chinese competition.

Private-equity firms once viewed manufacturing as a relatively simple affair, with most companies having a few production locations and regional customers, says Deepak Agrawal, managing director of Gotham Consulting Partners LLC, New York. But now even smaller manufacturers tend to be more geographically dispersed, with customers scattered around the globe and more complicated supply lines, all of which require specialized management expertise.

John-Paul Ho, managing partner of Crimson Investment Ltd. in Palo Alto, California, a private-equity firm with \$565 million under management, says many of the U.S. manufacturers he looks at are family-owned businesses, under pressure from their large customers to shift production to China.

"We look at the risk regarding Asia as an opportunity for significant wealth creation," says Mr. Ho. His company's strategy is to shift production to the Far East

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China Strategy Plays Key Role In Buyout Firms' Deals in U.S.

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in order to maintain a company's competitive position and expand its market share, which ultimately protects and creates higher-end jobs in the U.S., he says.

The electronics industry went through this process in the 1990s, Mr. Ho says, and now the opportunity has shifted to more traditional manufacturing industries such as auto parts and industrial equipment, often situated in the U.S. Midwest. Indeed, more of Crimson's acquisitions are now originating in cities such as Cleveland, Detroit and Pittsburgh.

Reacting Effectively

But many firms are taking a different approach. "If you look at any portfolio, you'll see decreasing share of manufacturing, and more service," says Béla Szigethy, managing general partner of Riverside Co., a New York private-equity firm with \$1.3 billion under management. "The recession and China have both hit manufacturing hard, so we've moved rapidly to increase service companies in our portfolio."

Today, 13 of 30 Riverside portfolio companies aren't manufacturers, compared with two of 11 five years ago. "We still love an old-fashioned manufacturing company," says Mr. Szigethy. "Or, better yet, a company that has reacted effectively to China."

Of course, some see the rise of China as a prime opportunity, because companies that encounter problems with global competition often end up distressed and on the auction block. Mr. Szigethy notes that many U.S. manufacturers have gone through the process of shuttering plants, outsourcing production to low-cost locations, and are now looking for a buyer.

Riverside also looks for companies that are relatively insulated from China. One of their firms, Nordco Inc. in Milwaukee, makes huge equipment used by railroads to pull up old tracks and lay new ones. The machines are not only complex, but custom-built and "damn heavy," says Mr. Szigethy, all of which helps shield it from foreign competitors. Another Riverside company makes porcelain insulators for the electric

power industry. Riverside has guided that company to outsource a small part of its production to Thailand and China.

Mr. Joory's Opera Capital doesn't need to look at a U.S. company's existing factories before deciding whether to invest. Opera's strategy is to take a product, find what it sells for, then figure out how much it would cost to make in China in a factory owned by one of the group's investors.

If the price is right, they buy the U.S. producer, shift its production to China, and use a scaled-down U.S. operation purely for distribution and product design.

"Through the Roof"

Still, Mr. Joory says it has proven harder than he expected to win bids since he started looking for acquisitions earlier this year. "There's so much money out there, they're just bidding these things through the roof," he says.

Opera has acquired two companies so

Opera finds a product then figures out how much it would cost to make in China.

far. One is clothing importer Old Toledo Brands Inc., based in New York, which previously bought 90% of its products from plants in North America. After buying the company, Opera switched to sourcing most of the clothes from one of its Chinese industrial backers.

The other company was a clock maker in Germany. Mr. Joory says that acquisition taught him that his strategy is much easier to implement in the U.S., where more-flexible labor laws make relocating production facilities to Asia or other low-cost locations much easier. "The labor laws in Europe make it very hard to do this kind of business," he says, "which we discovered to our chagrin."