**INTEGRATIVE CASE STUDy 1**

**3i GROUP’S PRIVATE EQUITY INVESTMENT IN CHINA’S LITTLE SHEEP**

overview

In 1999, an entrepreneur called Zhang Gang founded Little Sheep Catering Chain Co. in Inner Mongolia, one of the most remote and underdeveloped corners of the world. Zhang managed to open two additional restaurants within two months, with a very enthusiastic customer response. Notwithstanding this success, To prepare for an initial public offering (IPO), he believed that the company needed to attract not only additional capital, but also a partner with the capability to provide much-needed industry knowledge and expertise. Little Sheep’s extraordinary growth and brand name recognition attracted many willing investors, including such prestigious investment banks as Morgan Stanley and Goldman Sachs. Private-equity firm 3i noted Little Sheep’s success and approached the company. 3i demonstrated its industry expertise and the benefits it could offer Little Sheep, subsequently beating rivals Morgan Stanley and Goldman Sachs.

CASE DISCUSSION QUESTIONS

1. From an industry-based view, identify some of the competitive forces affecting the Chinese restaurant industry.

*Analyzing the competitive forces in the Chinese restaurant industry using Porter’s five forces will involve considering (1) the intensity of rivalry among competitors, (2) the threat of potential entry, (3) the bargaining power of suppliers, (4) the bargaining power of buyers, and (5) the threat of substitutes. Based on the information in the case, the intensity of rivalry among competitors seems to be high, as it was the threat of competition that caused Zhang to expand rapidly and seek trademark protection for the brand name. The threat of potential entry, too, would seem to be high, as the restaurant industry does not require as much investment or specialized knowledge as other industries do, and trademark protection seems to be low. The bargaining power of suppliers in the industry is difficult to determine from the case, but it is not likely that this is high, considering that the ingredients that go into restaurant food are widely available from numerous suppliers. The bargaining power of buyers, too, is not likely to be high, as there are probably a number of competitors in the restaurant industry, offering food at various prices. The threat of substitutes is likely to be extremely high, especially considering the slow processes for obtaining trademark protection in China.*

1. What are the key factors that explain the success of Little Sheep? What are the main obstacles associated with its continued growth?

*Little Sheep’s primary product was a simple, everyday food product that Zhang improved and marketed. The popularity of this product offering allowed the chain to expand initially. The key was the simplicity of Little Sheep’s business model: The Chinese restaurant business is fragmented because it is difficult to standardize. In most restaurants the largest cost component is the chef, but it is difficult to achieve consistency. Little Sheep is different because customers cook their own food in the hot pot, which eliminates the need for a chef. This do-it-yourself style of dining and the ease of standardization made this business capable of scale. The lack of trademark protection was as much a driver of rapid expansion as the founder’s entrepreneurial talent, as the company had to move fast to grab market share. Otherwise, anyone could start a Little Sheep and the company had no legal recourse to fight.*

*The main obstacles associated with its continued growth were the difficulty in scaling up the management to meet the needs of expansion. While the rapid expansion had been primarily driven by an aggressive franchise strategy, the company’s thin management ranks resulted in very weak oversight of the franchisees. The problems were aggravated when media reports began to appear claiming substandard quality and service in certain Little Sheep franchise stores, inevitably damaging the brand.*

1. From a resource-based view, explain the non-financial benefits that 3i can bring to Little Sheep. In other words, why did 3i win the competition against other private equity suitors such as Goldman Sachs and Morgan Stanley?

*A public listing would give the company a diversified source of capital as well as brand recognition and subject it to market discipline, but Zhang recognized that sustaining the company’s growth would require not only financial resources but, more importantly, additional industry expertise. To prepare for an initial public offering (IPO), he believed that the company needed to attract not only additional capital, but also a partner with the capability to provide much-needed industry knowledge and expertise—* *high level professionals from the food and beverage industry who could help take Little Sheep to the next, higher level.*

*On its part, 3i had been studying the food and beverage sector in China and had decided upon Little Sheep as a suitable prospect for investment. In winning the competition against other private equity firms, 3i demonstrated that it could meet Little Sheep’s need for industry knowledge. The 3i team spoke with a number of research analysts covering the Hong Kong and Chinese restaurant sector to learn more about the sector and shared its findings with Little Sheep senior management. The team also tapped into 3i’s network of industry experts (via 3i’s People Program) and identified Nish Kankiwala, former president of Burger King International, as a suitable advisor for Little Sheep. As the top executive at one of the world’s largest fast-food restaurant chains, Kankiwala would bring a wealth of sorely needed knowledge about the franchise business.* *This was the first time that Little Sheep managers had direct access to a world-class expert with a deep understanding of their business, and they were impressed by 3i’s commitment and ready access to this caliber of expertise. This persistence gave 3i an edge in the competition against other private equity firms that also demonstrated an interest in Little Sheep.*

1. Compare and contrast the similarities and differences between the typical mid-size private equity investment in the West and such investments in China (as captured by this case). If you were a manager working for a Western private equity firm (such as 3i), what lessons would you draw from this case?

*From the case, it can be concluded that many firms in China are not familiar with the intricacies of private equity funding, and have difficulty distinguishing between private equity funding and investment banking. The other differences could be a lack of management and marketing skills in Chinese firms. Here, unlike in the West, private equity firms may have to provide management and industry expertise in addition to financial resources. Other differences may relate to cultural differences in the way Chinese and Western businesses operate. For instance, Chinese firms are often less transparent than Western firms.*

*As a manager working for a Western private equity firm, the lesson learned would probably be to explore all the ways in which the private equity firm can help a customer create value and maximize its profits, whether it is just financial resources, industry expertise, or improved management techniques.*

1. If you were an entrepreneur at a firm in China (such as Little Sheep) or in emerging economies in general, what lessons would you draw from this case?

*Entrepreneurs could draw a number of lessons from this case. In terms of product strategy, the simplicity of the company’s product offerings enabled it to quickly standardize its products and carve a niche for itself in the market. The case also covers the perils of unrestricted expansion without a definite control process. Little Sheep’s experience with expanding beyond its management and control capacity is a clear lesson for entrepreneurs who are very successful within a short span of time. In addition, Little Sheep’s response to the quality issues it faced illustrated the importance of forgoing immediate profits in order to build a solid operational base. The case also demonstrates the importance of expert knowledge of an industry for entrepreneurs. Though some might be able to succeed without expertise in an industry, having an experienced opinion can help a company avoid the common pitfalls new ventures face, and scale up faster. The case also illustrates the positive results that stem from closely aligned interests between a private equity investor and the management of a portfolio company.*