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## The China flipper

### Tom Bagley is a long way from Deerfield

It's dinnertime at an elegant restaurant in the southern Chinese city of Zhuhai, and Tom Bagley gazes at the plate of chicken feet in front of him. The appendages are slightly cooked, but more or less appear as they would if they were still attached to their owners.

Chopsticks in hand, Mr. Bagley gingerly hoists one from the plate. Nobody's staring, but in a sense, all eyes are on him.

The Chinese factory owners and managers he's dining with don't think twice about digging into the local delicacies. Mr. Bagley hesitates, then decides to join in. He lightly takes a bite, but just one.

"All you have to do is try it and if you don't like it, that's okay," he'll explain later. It's an acquired taste, akin to "raw chicken fat," he says.

Eating chicken feet is one cost of doing of business in China that you won't find on any balance sheet. But dinner — eating in general — is a major part of conducting commerce in the Middle Kingdom.

**As the senior managing director** of Pflingsten Partners LLC, a private-equity firm based in Deerfield, Mr. Bagley is getting used to mystery platters and enigmatic entrees. Negotiating dinner — not to mention an arcane bureaucracy, unusual tax codes and a Tower-of-Babel language barrier — fits in with his plans to cultivate a base for doing business in China.

Mr. Bagley, 53, and his managing directors, James Norton and John Underwood, have a simple goal: buy up mid-sized U.S. manufacturing, distribution and publishing companies, boost their efficiency and sell them — typically at a 20% profit. A big part



Eyes on the prize: A China Tec employee inspects her work.

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of this plan is to shift more of the companies' operations to factories in China.

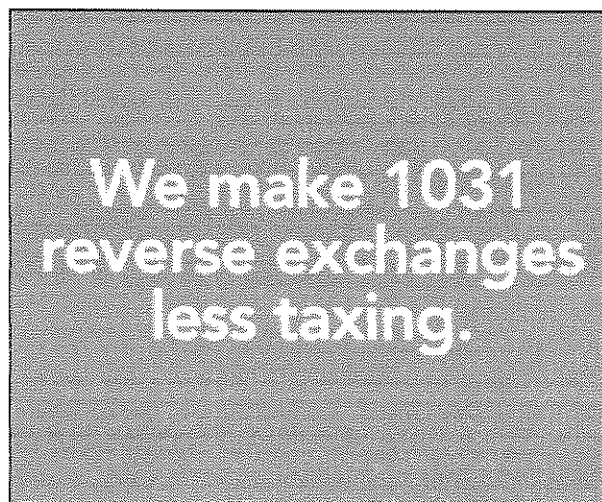


Tom Bagley tours the factory with China Tec owner "Mr. Lee."

A quick look at the numbers and it makes perfect sense: Labor costs are typically \$1 an hour in China vs. \$20-plus in the U.S. Salaries for Chinese engineers are less than \$10,000 a year, vs. upward of \$50,000 in the States. Machine tooling can be had for 25% of U.S. costs.

What's more, the time is ripe for forging alliances with Chinese manufacturers and factory owners. Over the past decade, the Chinese business environment has become more sophisticated as more Western money — and Western-style scrutiny — pours in. There's more playing by the rules and less emphasis on short-term gains.

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Pfingsten, which Mr. Bagley founded in 1989, is poised to take advantage of this development. It has six companies in its portfolio, with 12 add-on acquisitions and \$570 million in capital. Since 1999, it's been using Chinese factories to manufacture products for some of its companies. But there was one problem: The time between making a product in China and getting it delivered was too long — 18 months, to be exact.

"We wanted to compress the time cycle," Mr. Bagley says. In 2004, Pfingsten started exploring its options.

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**When Mr. Bagley comes to Hong Kong**, he stays at the Peninsula on Kowloon, across the harbor from Hong Kong Island. The swanky property has a James Bondish decadence that evokes old Hong Kong, when the city was still the sole gateway for financial dealings with the Chinese.

This April morning, he's en route to China Tec, a factory in Zhuhai that makes 70% of the gaming machine parts for Happ Controls, a company in Pfingsten's portfolio. It's a 45-minute ferry ride followed by a 45-minute drive.

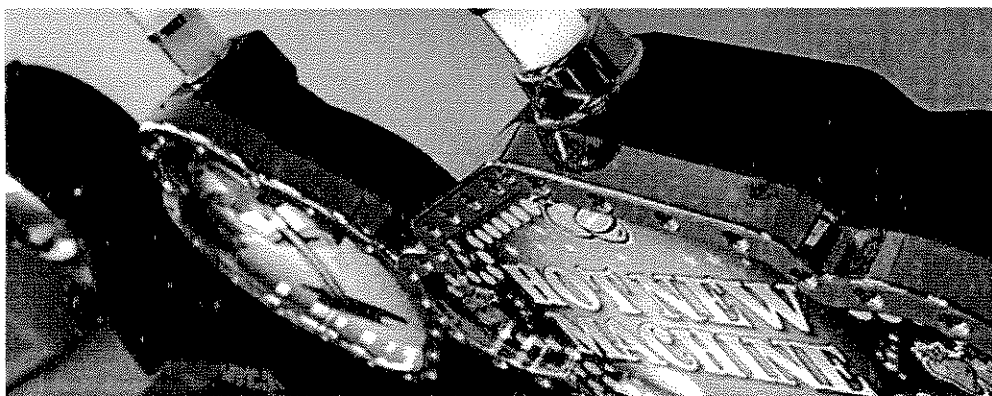
Upon his arrival, Mr. Bagley is greeted warmly by the factory owners. He's visited before, but today he'll get a more comprehensive tour.

China Tec got its start 20 years ago making joysticks for Atari. Today it is operating at 80% capacity, almost exclusively for Happ. It could be any factory in the Midwest, except the workers, mostly women in their teens and 20s, aren't unionized and earn about \$100 a month, plus room and board. By Chinese standards, China Tec is a good job for those who might be relegated to far worse, for far less.

A stout American businessman and former college jock, Mr. Bagley has a strong presence. He's full of curiosity about the factory, which is divided between a tooling area and assembly area, with various rooms devoted to quality control, administration and circuit board production.

As one of the factory owners leads him around the floor, Mr. Bagley is all eyes and ears. "This place is impressive," he says, noting the spotless floors and constantly humming machines. There's even an exhaustive filing system — shelves of binders full of spec sheets and instructions.

"This kind of documentation would be rare in a small company in the Midwest," says Mr. Bagley, who worked for Citicorp North America and Continental Bank before launching Pflingsten. "You'd see this in a Fortune 500 company."



Bright lights and big dreams: Signage to entice gamblers.

**Pflingsten's current stake in China** represents an evolution of sorts. The firm toyed with everything from building a factory from scratch to partnering with people it had done business with to making an acquisition.

In 2004, Pflingsten ended up taking over a small Hong Kong sourcing firm it had been working with run by Greg Glass, a 15-year Hong Kong resident originally from Des Moines, Iowa. Mr. Glass had a solid grasp of South China's factories — not to mention a keen understanding of local dinner etiquette. (His wife is Chinese.) Mr. Glass is in frequent contact with the 100 or so factories that produce material for Pflingsten's portfolio companies.

Three factors determine whether a product should be outsourced to a Chinese factory, Mr. Bagley says. One is volume — the more you produce, the more China makes sense. Then there's lead time — the longer the lead time, the easier it is to weather volatility and snags in the Chinese market. The third is production cost — the bigger the labor component, the bigger the savings, and the more advantageous it is to move here.

But even if a product meets these criteria, that doesn't mean it's easy.

"There are many unknowns and risks when it comes to investing in China," says Bernie Filler, senior vice-president of mergers and acquisitions in Asia for the Kinsella Group, a Chicago investment bank that focuses on the middle market. "It's not a no-brainer to do business over there because of the government, the culture and mentality. It takes

people a while to decide to put their toe in the water and risk some money."



Clad in yellow to "improve their spirits," China Tec workers assemble parts in Zhuhai.

Pfingsten cultivated its China Tec connection through a series of deals starting in 2004. That's when it acquired an ownership stake in Elk Grove Village-based Happ Controls, a gaming parts maker. Then in January 2005, it bought an add-on company called Suzo International, a Dutch gaming parts maker that outsourced most of its manufacturing to China Tec. With both Happ and Suzo now under the same umbrella, Pfingsten decided to consolidate much of its gaming-parts manufacturing at the Zhuhai factory.

**Among the U.S. private-equity firms** focused on middle-market acquisitions, Pfingsten is one of about 10 that has a significant China connection — and the potential to keep it growing. That gives Pfingsten a competitive advantage. Owners of the companies Pfingsten is looking to buy are realizing that selling to the firm may determine their viability in a global economy, Mr. Bagley says.

"They could eventually figure out a way to do this, but if it takes them five years, they may be out of business before they can even make the leap," he says. "We've already done all the work and can do it faster and more efficiently."

And Pfingsten is looking beyond just sourcing. It's also trying to hire staff to sell its companies' products throughout China and may even start buying Chinese companies. One of its peers, Jordan Industries Inc., a private-equity firm with an office in Deerfield, has already gone down that road.

"We're looking at new stand-alone investments in China that have nothing to do with our portfolio companies," says Andrew Rice, senior vice-president of Jordan Industries.

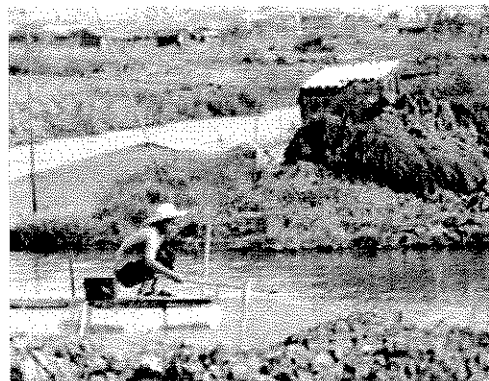
Until a year ago, foreign companies weren't allowed to distribute products in China that they hadn't manufactured. Then came China's 2001 entrance into the World Trade Organization, which required the country to start playing by international rules.

"Now you can sell other people's products and set up your own manufacturing, distributions and service," Mr. Rice says.





The workers are making parts for Happ Controls, a leading gaming parts maker based in Elk Grove Village.



A Guangdong fisherman at work near the China Tec factory.

**Back at China Tec**, workers are cranking out everything from push buttons to toppers — the brightly lit signage that sits on top of casino games to catch the attention of passing gamblers.

Everywhere Mr. Bagley looks, there's a sign of big dollars. The topper for one of the games reads "Cash Fever." Another says "Hot New Machine" and another screams "Millions."

Some of the most sophisticated items China Tec produces for Happ are "hoppers," machines that count coins paid out to lucky winners. They need to be durable and precise. Since they count money, money is very much at stake.

To check reliability, a prototype is rigorously tested; 5 million coins are run through it, a process that takes six weeks. Something as simple as the wrong kind of grease can create extra heat and interfere with its counting accuracy.

Ultimately the hoppers will be used in casinos around the world.

Like those end customers, Mr. Bagley is also enticed by the prospects of a big payday. Standing over one of the hoppers, he watches as the coins drop loudly from the feeder into the holding bin. They clink against each other in a jackpot symphony.

Mr. Bagley looks up and smiles. "That's the sound of money."

*Photos by Erik Unger*

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