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Inside Business: China private equity bitten again by Fang

By Simon Rabinovitch in Beijing

Financier Fang Fenglei is betting on private equity recovery

China's unruly markets have vanquished many a savvy investor, but if one man knows how to play them it is Fang Fenglei.

From the establishment of the country's first investment bank in 1995 to the complex partnership that brought Goldman Sachs into China in 2004 and the launch from scratch of a $2.5bn private equity fund in 2007, Mr Fang has been at the nexus of some of the biggest Chinese deals of the past two decades.

Even his abrupt decision in 2010 to start winding down Hopu, his private equity fund, was impeccably well timed. Since he left the scene, the Chinese stock market has been among the worst performers in the world and the private equity industry, once booming alongside the country's turbocharged economy, has gone cold.

So the news that Mr Fang, the son of a peasant farmer, will return with a new $2bn-$2.5bn investment fund is more than a passing curiosity. The financier is betting that China's beleaguered private equity industry will recover – a wager that at the moment has long odds.

The most immediate obstacle for the private equity industry in China is a bottleneck on exits from investments. Regulators have halted approvals for all initial public offerings since October, a tried and tested method for putting a floor under the stock market by limiting the availability of shares. But a side effect has been eliminating the preferred exit route of private equity companies.

Even before the IPO freeze, the backlog was already building up. China First Capital, an advisory firm, estimates that there are more than 7,500 unexited private equity investments in China from deals done since 2000. Valuations may have appreciated greatly but private equity groups are struggling to sell their assets.

The backlog of unsold investments stems from the gold-rush mentality that characterised the Chinese private equity industry until only a year ago.

The world's major private equity groups, such as TPG, KKR and others, are bit players compared with the domestic entities that have sprung into action. First there are private entities such as CDH and Hony, which have styled themselves as theBlackstones and Carlyles of China. Then there are the children of top officials, including the son of Wen Jiabao, ex-premier, who have drawn on their connections to establish "princeling" funds. And local governments have also vied for a piece of the pie, with Chengdu, Tianjin, Shanghai and Beijing, among others, forming private equity funds.

The troubles have been compounded by a dispute between government bodies over how to supervise the industry. The securities regulator in February granted permission to private equity companies to invest in publicly listed companies. A month later the National Development and Reform Commission, a central planning agency, barred them from doing so.

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- Peter Fuhrman, founder, China First Capital

The U-turn provoked anger from investors and market-minded officials. "We shouldn't have to watch private equity companies like our own children," said Wu Xiaoling, former central bank deputy governor.

But there are a few glimmers of hope for China's private equity industry.

First, the weak stock market, while complicating exits, has made entries more feasible. The price/earnings ratio of the Shanghai stock exchange now sits at 11.5, down from nearly 30 in 2009.

Second, the downturn has also started to curb some of the more destructive competition in the industry. Upstart private equity funds have struggled to force their limited partner investors to put up the cash when deals have come into play.

A manager at a major US group said that several investors in a local government-backed fund had refused to heed a recent cash call, forcing the fund to offer a big slice of the investment on the table to the US group. "Having foreign pension funds as our LPs used to be seen as a disadvantage because they move slowly. But now that's given us stability. They actually answer cash calls," he said.

Finally, for all its woes, the base case for private equity in China remains compelling.

"There is an overwhelming and still unsated appetite among institutional investors around the world to increase their asset allocation in China," said Peter Fuhrman, founder of China First Capital.

Mr Fang weighed up the arguments for and against returning to the Chinese private equity fold. He concluded the time was right. And the record shows that whichever way Mr Fang goes, the market tends to follow.