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Attractive China secondary targets rising at 25% per year – study

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At least 200 private equity portfolio companies in China are attractive targets for potential secondary buyers and the number is likely to grow 15-25% per year as funds come to the end of their lives and find that exit options are still limited.

These companies represent the cream of a much larger pool of investments that are as yet un-exited by Chinese PE investors, according to a proprietary study by specialist investment bank China First Capital. It estimates that more than 7,500 portfolio companies remain in private equity firms' portfolios from investments made since 2000.

"Despite the current lack of significant deal-making activity in this area, secondaries will likely go from current low levels to gain a meaningful share of all PE exits in China," the study says.

It adds that these secondary investments could be transacted at attractive valuations compared to many growth capital deals currently available, while the due diligence and contingent risks are lower than for primary deals.

China First Capital identified the "quality secondaries" likely to appeal to PE investors based on four criteria: the companies are un-exited and not in the IPO approval process; they have grown by at least 25% a year since the original investment and could be ready for an IPO or trade sale exit within six years; the businesses are sound from a legal, regulatory and corporate governance perspective, and have majority owners open to a secondary sale; and the current PE investor is seeking an exit.

China's secondaries direct market is expected to follow a slightly different development trajectory to that of the US.

Companies that have underperformed or distressed are unlikely to be of interest to prospective investors, who will cherry-pick stand-out players at fair valuations. This is because the primary motivation for selling is funds are expiring and other exit channels are not available within the desired timeframe.

It is worth noting that there are currently almost 1,000 companies on the China Securities Regulatory Commission's (CSRC) official waiting list for domestic IPOs. The CSRC has never approved more than 150 private equity-backed offerings in a single year. In 2012, there were fewer than 100.

The study adds that sales of all or most of PE firms' portfolio are not destined to become the norm in China because specialist secondary investors do not currently have the experience or people on the ground to execute complex transactions.

According to AVCJ Research, in the past 12 months there has been a 10-fold increase in China secondary sales by value, although 80% of the $2.9 billion total came from Goldman Sachs selling its minority interest in Industrial and Commercial Bank of China to Temasek Holdings.

The statistics are more notable for the jump in secondary sales that saw control of an asset pass between private third-party investors. These deals included MBK Partners' exit of Luye Pharma to a consortium of Chinese private equity investors and Actis' sale of Xiabu Xiabu to General Atlantic.