Secondaries

The Necessary & Attractive Exit For Private Equity Deals in China

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The entire contents of the report are available on a complimentary basis to:

- ***Partner-level and other senior staff at LPs, GPs active in China***
- ***Lawyers, investment bankers, consultants and others assisting transactions in private equity industry***
- ***Media representatives***

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THE WALL STREET JOURNAL.

The New York Times

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AVCJ ASIAN VENTURE CAPITAL JOURNAL

PEI PRIVATE EQUITY INTERNATIONAL

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Introduction

In the current difficult market environment for private equity in China, secondary transactions provide a valuable way forward. **Secondaries** potentially offer some of the best risk-adjusted investment opportunities, as well as the most certain and efficient way for PE and VC firms to exit investments. And yet these secondary deals still remain rare. As a result, GPs, LPs and investee companies, as well as China's now-large private equity industry, are all at risk from serious adverse outcomes.

This research paper is an examination of the potential market for secondary transactions in China, the significant scope for profit on all sides of the transaction, as well as the no less significant obstacles to the development of an efficient, liquid, stable long-term market in these secondary positions in China.

Executive Summary

Our conclusion is that secondaries have the potential to benefit all three core constituencies in the China PE industry -- GPs, LPs and investee companies. The universe of deals potentially available for secondary exit is large, over 7,500 unexited investments made in China by PE firms since 2000.

However, the greatest potential for both PE sellers and buyers across the short to medium term is in a group of direct secondaries we term "***Quality Secondaries***". These are PE investments that fulfill four criteria:

1. *unexited and not in IPO approval process, domestically or internationally*
2. *investee companies have grown well (+25% a year) since the original round of PE investment, and have continuing scope to expand enterprise value and achieve eventual capital markets or trade sale exit in 3-6 year time frame*
3. *businesses are sound from legal and regulatory perspective, have effective corporate governance, and a majority owner that will support secondary sale to another PE institution*
4. *current PE investor seeks secondary exit because of fund life or portfolio management reasons*

Our analysis reveals that the potential universe of "*Quality Secondaries*" is at least 200 companies. This number will likely grow by approx. 15%-25% a year, as funds reach latter stage of their lives and if other exit options remain limited.

At the current juncture, in this market environment and assuming direct secondary deals are done at market valuations, these investment represent some of the better values to be found in growth capital investing in China. DD risk is significantly lower than in primary deals, and contingent risks (opportunity costs, and legal risks of pursuing other non-IPO exits) are lower.

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 secondaries market in China will likely have unique factors compared to the US, Europe and elsewhere. We expect there to be limited investor interest in any secondary deal involving a Chinese company or a portfolio that has underperformed since PE investment, or could otherwise be characterized as a "distress" situation.

Quality Secondaries transactions in China will involve PE investors "**cherry-picking**" good companies at fair valuations. The primary motivation for selling PEs is misalignment between its remaining fund life and the time required and risk inherent in achieving domestic or offshore IPO or trade sale exit during that shortened time frame.

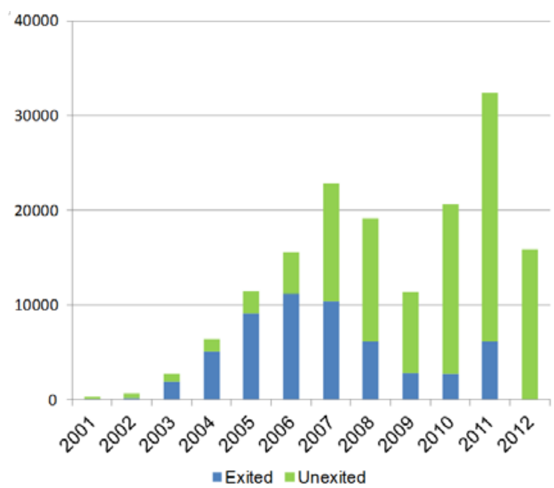
In contrast with secondary deals done outside China, we do not expect to see much activity involving the sale of all or most of a PE firm's portfolio of investments. Specialist secondary firms operating elsewhere (e.g. Coller Capital, Harbourvest) do not currently have the experience or manpower in China to take on the complexities of managing and liquidating all or most of an existing portfolio of minority investments. Buying an entire portfolio also creates contingent and reputational risks.

Rather, we expect those PEs with strong operating performance in growth capital investing in China to exploit favorable market conditions by becoming active buyers of ***direct secondaries***. GPs that prefer larger deals, (+USD25mn/Rmb200mn), should be particularly interested in *Quality Secondaries,* since company scale and investment amount will likely be larger, on average, than primary deals in China.

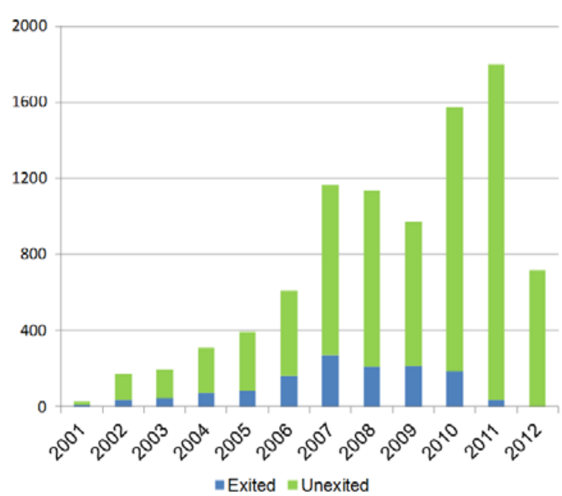
Selling PEs can pursue exit strategies based on option of selling either part or all of a successful unexited deal. A part liquidation in *Quality Secondary* transaction can mitigate risk and return capital to LPs while still retaining future upside. A full exit through secondary can increase fund's realized IRR and so assist future fundraising. Importantly, a selling PE needs to act before **pricing leverage** is transferred mainly to buyers -- generally this means secondary deals should be evaluated and priced in the market when the PE fund still has minimum of two years left of active period.

While clearly the most acute need for exit will be investments made before 2008, more recent investments need also to be assessed based on current challenging market conditions. Many GPs are adopting what looks to be an ***unhedged*** strategy across a portfolio of invested deals waiting for capital markets conditions to improve.

China Private Equity Since 2001 (USD mn)



Number of Closed Deals



China Private Equity Since 2001 (USD mn)

Year	Unexited	Exited	Bankrupt
2001	187	40	6
2002	496	159	148
2003	840	1,861	32
2004	1,292	5,054	22
2005	2,330	9,126	1.5
2006	4,394	11,147	14
2007	12,426	10,427	36
2008	12,992	6,130	30
2009	8,581	2,806	0
2010	17,927	2,756	72
2011	26,241	6,111	10
2012	15,842		
Total	**$103,548 mn**	**$55,615 mn**	**$371 mn**

Number of Deals

Year	Unexited	Exited	Bankrupt
2001	21	9	2
2002	134	39	4
2003	152	47	4
2004	234	75	8
2005	312	82	5
2006	450	162	8
2007	889	274	8
2008	964	212	4
2009	814	217	1
2010	1428	187	4
2011	1788	38	1
2012	719		
Total	**7,905***	**1,342**	**49**

** includes companies with IPO applications pending with CSRC*

Methodology

We have completed a detailed data analysis of the universe of 9,000 publicly-disclosed deals done since 2000 between PE firms and Chinese companies -- both dollar and Renminbi, by deal sizes, investment stage and industry. Public data was supplemented with China First Capital's internal deal log entries. All deals were cross-referenced by IPO status, using CSRC data. *(See end notes, p16.)*

There are two datasets: the first is "***Unexited PE Deals***". These are all PE-invested deals in China that have neither exited nor filed for IPO with the CSRC. The total number of *Unexited PE Deals* is 7,500.

We then screened the *Unexited PE Deals* into a second data set, which we identify as "*Quality Secondaries*", a smaller number, of over 200. These are deals we believe meet the **prime investment criteria** of top tier PE firms and represent some of the better actionable investment opportunities for PEs in China. (We do not share the list of *Quality Secondaries* in this report.)

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This report's data tables are drawn from the *Unexited PE Deals* data. They are further segmented by date of original investment, deal size, industry and our subjective ranking of "**PE Tier**". A PE firm is considered "Top Tier" where the fund is investing on behalf of larger, professional LPs, and operating within a framework of internationally established standards of GP fiduciary duty. About one-quarter of all PE investments in China over the last five years have been made by such top tier investors.

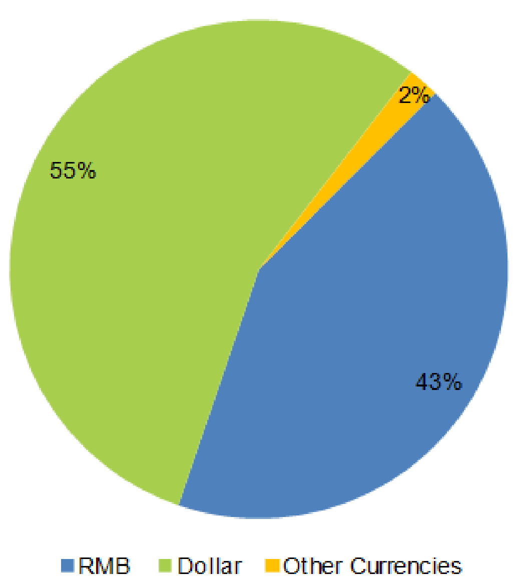
Our assumption is that investments by top tier PE firms will have undergone more rigorous pre-investment due diligence, and had more effective post-investment "value-add". These PE investments should in many cases deserve a "**tier premium**" valuation in a secondary transaction.

Guidance: There are good opportunities across the deal spectrum regardless of PE tier.

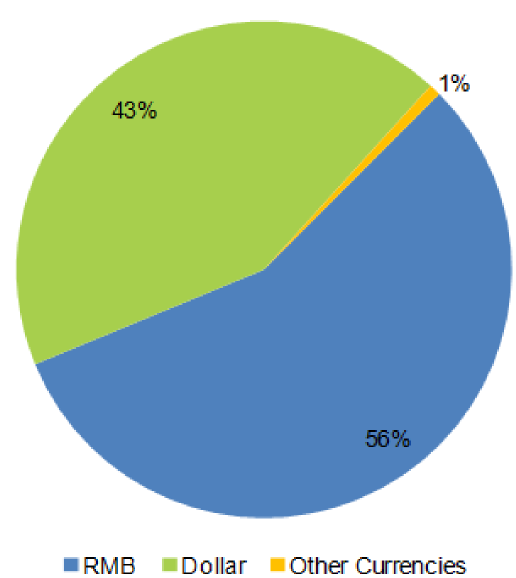
Indeed, some of the best values available for purchasers of *Quality Secondaries* will be in deals initiated by second and lower tier firms, including recently-established Renminbi funds. As a rule, Renminbi funds have a shorter fund life than top tier firms. Blocked access to domestic IPO exit mean many Renminbi firms are already facing significant **liquidity and fund life pressures**. They outbid top tier firms to win their way into some good companies. They will soon need to cash out at more reasonable prices, perhaps to one of the same top tier firms that lost out the first time around.

Guidance: We expect Renminbi and other second tier PE firms to be significant net sellers into the secondary market in China. Top tier PE firms will likely be net buyers. While China's gdp growth rate fell in 2012, corporate profits continue to grow strongly in better PE-backed companies, driving long-term sustainable asset appreciation.

Unexited China PE Investment Flow Since 2001
(By invested currency)



Unexited China PE Deals Since 2001
(By invested currency)



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Press Summary

Billions of Dollars of US Investment Trapped in China Private Equity Deals

The future of private equity and venture capital in China is threatened by a huge overhang of illiquid investments, according to China First Capital. US institutional investors and pension funds are at risk in a market that until recently was a source of significant investment profits. Private equity secondaries offer a potential way out

China's private equity industry, having grown in less than a decade from nothing into a giant rivaling the PE industry in the US, is in the early stages of a unique crisis that could undermine the remarkable gains of recent years, according to a newly-published research report by China First Capital, an international investment bank. Over $100 billion in private equity and venture capital investments is now blocked inside deals with no easy exit. A significant percentage of that capital is from Limited Partners, family offices, university endowments in the USA.

Private Equity firms in China are running out of time and options. Exit through trade sale or M&A, a common practice elsewhere, is almost nonexistent in China. One viable solution, the creation of an efficient and liquid market in private equity secondaries in China where private equity firms could sell out to one another, has yet to develop. As a result, private equity General Partners, their Limited Partner investors and investee companies in China risk serious adverse outcomes.

How and why this challenging situation arose, and how it might be resolved, are all subjects of the report titled "*Secondaries: A Necessary and Attractive Exit for Private Equity Deals in China*". The statistical analysis forecasts that secondary deals will likely go from current low levels to gain a meaningful share of all private equity exits in China.

The China First Capital report is the first of its kind on the large market opportunity for secondary transactions in China. It is based on dissecting over 9,000 private equity and venture capital investment deals done in China since 2001. In all, over $130 billion is now invested in unexited private equity deals in China. The unexited PE and VC deals are screened and analyzed across multiple variables, including date, investment size, tier of private equity firm, industry, price-earnings ratio.

The China First Capital report is available in abridged form in the Research Reports section of the company's website, www.chinafirstcapital.com. Additional information and analysis, particularly on deal opportunities and implementable exit strategies for private equity funds and Limited Partners is available to China First Capital clients, on a select basis.

Secondary deals potentially offer some of the best risk-adjusted investment opportunities, as well as the most certain and efficient way for private equity and venture capital firms to exit investments and return money to their Limited Partners, the report finds. The most acute need for exit will be investments made before 2008, since private equity firms generally need to return money to their Limited Partners within five to seven years. But, more recent private equity and venture deals will also need to be assessed based on current market conditions.

Over the course of the last twelve months, first the US stock market, then Hong Kong's, and finally China's own domestic bourse all slammed the door shut on IPOs for most Chinese companies. As a result, private equity firms can't find buyers for illiquid shares, and so can't return money to their Limited Partners.

"Many private equity firms are adopting what looks to be an unhedged strategy across a portfolio of invested deals waiting for capital markets conditions to improve," according to China First Capital's chairman and founder, Peter Fuhrman. "The need for diversification is no less paramount for exits than entries," he continues. "Many of the same PEs that wisely spread their LPs money across a range of industries, stages and deal sizes, have become over-reliant now on a single path to exit: an IPO in Hong Kong or China. By itself, such dependence on a single exit path is risky. In the current environment, with most IPO activity at a halt, it looks even more so. "

The China First Capital report underlines the fact that secondary activity in China will differ significantly from secondaries done in the US and Europe. Buyers will cherry-pick good deals, rather than buying entire portfolios, and escape much of the due diligence risk that plagues primary private equity deals in China. Sellers, in many cases, will be able to achieve a significant rate of return in a secondary sale and so return strong profits to their Limited Partners. PE-invested companies stand to benefit as well, since a secondary transaction can be linked to a new round of financing to provide additional growth capital to the business. In short, secondary deals in China should be three-sided transactions where all sides come out ahead.

But, significant obstacles remain. The private equity and venture capital industry in China has grown large, but has not yet fully matured. The industry is fragmented, with several hundred older dollar funds, and several thousand Renminbi firms launched more recently, some fully private and some state-owned with most falling somewhere in between.

Absent a significant and sustained surge in IPO activity in 2013, the pressure on private equity firms to exit through secondaries will intensify. According to the report, no private equity firm is now raising money for a fund dedicated to buying secondaries in China. There is a market need. As a fund strategy, private equity secondaries offer Limited Partners greater diversification across asset types and maturities in China.

Private equity has been a powerful force for good in China, the report concludes. Entrepreneurs, consumers, investors have all benefited enormously. Profit opportunities for private equity firms and Limited Partner investors remain large. Exit opportunities are the weak link. A well-functioning secondary market is an urgent and fundamental requirement for the future health and success of China's private equity industry.

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China First Capital *is a leading China-focused international investment bank and advisory firm for private capital markets and M&A transactions in China. We have a disciplined focus on -- and strive for a leadership position in -- four distinct business areas. These are:*

- *Private placement and equity financing for China's high-growth entrepreneur-led companies;*
- *Private equity Secondaries, buy-side and sell-side representation for acquisitions and early liquidity events;*
- *Strategic M&A transactions, domestic and cross-border acquisitions for Chinese clients;*
- *Restructuring, financings and advisory for China's SOE*

China First Capital's geographical reach and client mandates are across all regions of China, with exceptional proprietary deal flow. We have significant domain expertise in most major industries in China's private and public sector, structuring transactions for a diversified group of companies and financial sponsors to help them grow and globalize. We execute transactions across the capital spectrum to minimize dilution and optimize our clients' capital structure and returns. We are a knowledge-driven company, committed to the long-term economic prosperity of Chinese business and society, backed by proprietary research (in both Chinese and English), that is unmatched by other boutique investment banks or advisory firms active in China.

For more information and to learn more about our strengths and capabilities, please contact directly our firm's senior management below.

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End Notes:

Data: *Our report's data is drawn from China First Capital's analysis of over 9,000 PE-invested deals in China, including both publicly-disclosed deals, as well as entries from our deal log. This data set, like any that attempt to capture private equity and venture capital deal flows, is by its nature incomplete. In every market, a percentage -- often a meaningful percentage -- of PE and VC deals are executed confidentially and remain undisclosed. Our experience over five years in China is that a great number of deals are undisclosed.*

We identify and parse 7,500 unexited PE-invested deals in China. The total number of unexited deals, and so the scale of the overhang, is certainly larger. We have also developed a separate database of so-called "Quality Secondaries", the unexited deals that should be of greatest interest to acquirers in direct secondary transactions. That list of Quality Secondaries is not included in this report.

In addition, publicly-disclosed deals often suffer from a number of deficiencies, including imprecision about valuation, date of close, investment instrument, investment size. This explains why the sample size for some deal metrics in the report (price/earnings ratio, invested currency) is sometimes smaller than the total set of PE investments.

Report's Purpose: *China First Capital has produced this report to measure and illuminate the approximate dimensions of the unexited overhang of private equity deals in China. In our view, the consequences of this overhang could be especially far-reaching. None concerns us more than the fact that new private equity investment deals in China since mid-2012 have basically come to a halt. Despite sitting on over $50 billion of "dry powder" capital that was raised to invest in private sector companies in China, and despite ongoing fundraising activities by GPs to raise an additional $50 billion in new Limited Partner commitments to China-focused private equity, PE investors, in most cases, have withdrawn from the market and stopped deploying capital.*

PE capital is now a main source of expansion capital for China's private sector companies. Bank loans remain difficult and costly. So, when, as now, PE firms stop putting money in, private companies are deprived of capital, impacting not only their expansion, but ultimately China's GDP growth as well.

PE capital in China has an especially high multiplier. In thirty years, China's private sector has gone from non-existent, to producing well over half of the country's entire GDP. PE money has in the last decade played an increasingly vital role in this, providing over $150 billion in capital as well as expertise and encouragement to entrepreneurs. Today's China would be unrecognizable had no private equity industry emerged. More so than in any other country, it is true to say that virtually all of the country's largest, most competitive, most famous and dynamic private businesses were financed by private equity or venture capital.

IPOs have also played an important, if little recognized, part of China's remarkable growth story over the last decade. They fueled the boom in private equity as well providing the mechanism through which stock markets in New York, London, Hong Kong and China could allocate far larger sums into China's private sector companies. Total IPO proceeds for Chinese companies over the last decade exceed $300 billion. IPOs and PE money have together fueled increased competitiveness, consumer choice and economic dynamism in China.

Now that gusher of PE and IPO money has turned to a trickle. When IPO markets will again welcome Chinese companies in large numbers is uncertain. But, the need to increase liquidity in PE investment is more urgent and more critical. The current imbalance, where exits for most China PE deals hinge on IPO transactions, needs to be redressed. The three other exit routes for private capital markets deals -- M&A or trade sale, secondaries, buyback/recapitalization -- need also to become fully operative and actionable for PE investors in China. Going forward, recaps/buybacks need to be better structured. A more active and competent buy-side for M&A exit needs to arise in China. Both will take time.

Secondaries offer the most immediate viable remedy to the intertwined challenge of the large unexited overhang and expiring PE fund life. Liquidity through direct secondaries, for at least a percentage of unexited deals, will benefit the three core constituencies in China private equity: GPs, LPs and investee companies. It will also perhaps help unleash the "animal spirits" of PE investors who are now unwilling, because of blocked exits, to commit to new investments in China.

Our firm shares the view that investing in China's dynamic entrepreneurial companies is among the world's best risk-adjusted investment opportunities. Within this asset class, direct secondaries should offer investors especially attractive values. More, not less, capital should be committed to Chinese private companies, not so much because China's economy requires it, but because the investments continue to produce outstanding outcomes, measured by robust growth in corporate profits and enterprise value.