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Private Equity in China: Which Way Out?

By NEIL GOUGH

HONG KONG -- Welcome to the private equity game in China: you can buy in anytime you like, but you can never leave.

At least, that is how it is starting to seem for many of the firms that bought in big during the boom of last decade.

Starting from a base of almost nothing in 2000, global private equity funds and their start-up local counterparts rushed into the Chinese market - completing nearly 10,000 deals worth a combined $230 billion from 2001 to 2012, according to a report released this week by China First Capital, a boutique investment bank based in the southern city of Shenzhen.

But of those deals, some 7,500 remain "unexited," according to the report, meaning the private equity investors have yet to find a way to cash out of their investments and pocket their profits.

In the West, private equity firms make money by selling to peers in a given industry, selling to other private equity funds or recouping their outlay via dividends that the target company pays by taking on new debt. But the Chinese private equity market has been overly reliant on one well-trodden exit route: the initial public offering.

In retrospect, that has proved to be a bad choice.

Beijing flashed a regulatory red light at new stock listings last summer, and since then, the backlog of applications for companies waiting to list on the Shanghai and Shenzhen markets has grown to nearly 900. Many of those include private equity investors seeking to cash out.

At the same time, interest among investors in American stock markets for new offerings from China remains scant after a series of accounting fraud scandals that triggered a crackdown by theSecurities and Exchange Commission and, more recently, prompted a standoff between the regulator and the Chinese affiliates of the world's biggest auditing firms.

"In China, historically the exit route has been an I.P.O. on the U.S. markets, but at the moment that route is not looking very encouraging," Lucian Wu, managing director of Paul Capital, which has $6 billion in assets under management, said at an industry forum in Hong Kong on Thursday. "With the domestic market essentially shut until the regulators decide otherwise, the I.P.O. market in China is not really there."

Exits are crucial because private equity funds typically raise money to invest over a fixed period - often a comparatively short three to five years in China - after which it must be returned to investors. Because of the lack of exit opportunities, pension funds, university endowments and other big institutional investors in the United States, Europe and Asia have taken a more cautious approach toward investing more money.

"There is increasing skepticism about the ability to put large amounts of money to work here in Asia. The exits haven't been there," David Pierce, the chief executive of Squadron Capital in Hong Kong and the chairman of the Hong Kong Venture Capital & Private Equity Association, said at the forum, which was organized by Mergermarket and Ernst & Young.

"There are good reasons why institutional investors will continue to put more money out here, but they are more cautious," he added.

Some industry players see so-called secondary deals, or a sale of an asset between two private equity firms, as a viable exit path from Chinese investments given the chilly market for I.P.O.'s. But those deals, too, bring challenges because the institutions that invest in private equity funds may have stakes in both the buyer and the seller.

For them, a secondary deal is "like moving something from your left hand to your right hand - and at a higher price," said Mr. Wu of Paul Capital.

For private equity firms in China, domestic and foreign, the net effect is that there is no easy way out.

"If you need to or want to do an exit in 2013, you will need to be more creative, because the I.P.O. route, with a few exceptions, is probably not going to be available - and if it is available, it won't be at an interesting valuation," said Tim Gardner, a partner at the law firm Latham & Watkins in Hong Kong who specializes in private equity and mergers & acquisitions.