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Study: Secondaries may soar in China

As other exit avenues for private equity dry up in China, GP-to-GP secondaries could be the only option for the 7,500 unexited portfolio companies, according to a recent study from China First Capital.

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China has 7,550 unexited private equity investments totaling $100 billion that will soon have to be realised through routes other than the traditional IPO, according to a recent study from China First Capital.

As fund lives begin to expire, Peter Fuhrman, chairman and chief executive of CFC, believes the standout option will be GP-to-GP secondary transactions. This is especially true for RMB funds, which have a three-to-five year life rather than the ten years typical with US dollar funds.

RMB funds assumed an IPO exit, he explained, but that window has mostly closed. The number of successful Chinese IPOs dropped in 2012 to 150 from the usual 350, according to Fuhrman. Applications for listing submitted to the China Securities and Regulatory Commission have ballooned to 800 companies – a backlog of almost five years.

“This kind of holdup is unprecedented in private equity history,” he said.

Apart from the IPO, private equity only has three other exit options: mergers and acquisitions, buybacks, or secondaries. The former two are unlikely in China, Fuhrman believes, because most investments in China are minority deals (the firm has no authority to do M&A), and companies do not have the liquidity to do a buyback.

Secondaries, on the other hand, should become an attractive option, he said. The GP seller should be able to get good returns because the companies are still growing well. The GP buyer will not have to pay as high of a premium, while getting an easy-to-close deal with much lower due diligence risk. The companies themselves will get a new influx of cash.

This isn’t great news for everyone. Fuhrman said that half of the unexited investments will have no interested buyers, and most of those funds will be looking at a 100 percent write-off. For the other half, however, “something will happen. It’s just a question of when,” Fuhrman said.

However, Doug Coulter, partner at LGT Capital Partners, is unsure if a move to secondaries can happen so suddenly. Experts have been predicting an increase in the secondaries market for some time, so he expects at least some activity. He pointed out that a similar situation exists in India, but no sharp increase in secondaries has occurred because GPs are still waiting and hoping for better markets.

Disagreements on price will probably be the biggest barrier to secondaries, and it might be just as possible to see an upswing in public markets.

"The reason we didn't see a significant number of Asian secondaries in 2009 [after the crisis] was because there was a big spread between what buyers were willing to pay and what sellers were willing to take," Coulter said.