Stagnant IPO Market Strangles Chinese Private Equity Exits

Richard Summerfield, February 2013

From humble beginnings in 2000, the past decade has seen the Chinese private equity (PE) market blossom into a global powerhouse. However, according to a new report released by investment bank China First Capital (China First), the Chinese market is in the formative stages of a crisis which could undermine all of the extraordinary strides it has made in recent years.

The report, 'Secondaries: A necessary and attractive exit for PE deals in China', notes that while there have been nearly 10,000 deals worth a combined $230bn completed within the Chinese market between 2001 and 2012, around 7500 of those deals remain 'unexited'. This has left approximately $130bn of PE and venture capital investment locked inside Chinese companies with very few exit options available.

Of the outstanding $130bn, approximately $22bn is tied up in 2200 deals which were all completed before 2008. Standard investment rules state that money must be returned to investors within a five to seven year period.

Accordingly, many PE firms in China are rapidly running out of time in which they can invest the cash which has poured into the region.

The most common form of exit for the Chinese PE market has historically been an initial public offering (IPO), particularly across US markets. The report, which examines over 9000 PE and venture capital investment deals completed in China since 2001, suggests that Chinese firms have placed too much emphasis on IPOs as a means of exiting deals. Crucially, the last 12 months have seen the once reliable IPO market begin to dry up. "It seems more likely than not that the golden age of Chinese IPOs, when over 350 companies were listing each year across public markets in the US, Hong Kong and China is now over", suggests China First.

Unfortunately the stagnation of IPOs has left the PE market with no real exit alternatives. Peter Fuhrman, chairman of China First said "Many of the same [PE firms] 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 reliance on IPOs as an exit strategy has meant that other traditional exit avenues, which are enjoyed elsewhere, have not reached sufficient levels of maturity in the Chinese market. Exits through trade sales or mergers and acquisitions are almost unheard of in China; furthermore, secondary sales between PE firms are also yet to develop.

One solution to the crisis proposed by the China First report would be the development of a secondaries market. "The creation of an efficient and liquid market in PE 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", said China First.

Rather than waiting to see how the IPO market recovers, pursuing secondary sales would provide a more attractive proposition for the market. According to the report, China First believes there is a genuine market need for secondaries as a viable, alternative exit strategy. Going forward secondaries will likely expand to "gain a meaningful share of all PE exits in China".

The development of a robust secondaries market would have many advantages for PE firms. Importantly it would enable them to acquire stakes from rival funds whilst avoiding large chunks of the usual due diligence processes, and the many pitfalls usually encountered in the Chinese market. These due diligences processes "have plague(d) primary private equity deals in China".

Recent financial irregularities and alleged accounting fraud scandals in particular have deterred investors in US stock markets from investing in Chinese firms.

Although the report does trumpet the potential for secondaries in the Chinese market, it also stresses that an emerging Chinese secondaries market would differ significantly from any other similar markets in Europe or the US. Due to a shortage of experience and manpower in the region, many secondary firms will 'cherry pick' the best deals, rather than purchase and struggle to manage entire portfolios. An emerging secondaries market will also be of benefit to sellers, China First suggests, as in many instances, sellers will be able to achieve significant rates of return via their secondary sales.

The firm concludes that while exit opportunities are the weak link in the Chinese PE market, excellent opportunities for profit will continue to exist in the region. As such "A well functioning secondary market is an urgent and fundamental requirement for the future health and success of China's PE industry", notes the report.