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Private Equity In China – Time For A New Exit?

China was once one of the few bright spots globally for private equity. Now it's a quagmire – and investors are going to have to change the way they approach the market.

That's the finding of a new report by Shenzhen-based private equity advisory China First Capital (pdf). According to the company's own research, there have been about 9,000 private equity deals completed in China over the past decade, but in more than 7,500 of those instances – or $130 billion worth of investment – investors still haven't managed to cash out.

"Over the last 18 months, first the U.S. capital markets, then Hong Kong's and finally China's Shanghai and Shenzhen domestic stock markets have dramatically lowered the number of IPOs of Chinese companies," writes Peter Fuhrman, China First Capital chairman, in the report. "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 U.S., Hong Kong and China, is now over."

It's not a turn of events that will be easily remedied. A wave of fraud allegations leveled by auditors and short sellers against a number of small Chinese companies listed in the U.S. has destroyed investor confidence in the sector and all but frozen new IPOs. Listings in Hong Kong dropped off in 2012 owing to that market's poor performance, but even if it recovers many private-equity-invested companies are too small to clear the Hong Kong bourse's listing requirements. And in mainland China, the regulator has all but stopped new listings in Shanghai and Shenzhen for fear that new offerings would divert liquidity and drive lower two of the world's most underperforming markets.

Analysts tip China's domestic IPO market to come back to life this year. PricewaterhouseCoopers expects a combined 200 IPOs raising between 130 billion yuan ($20.7 billion) and 150 billion yuan on the Shanghai and Shenzhen stock exchanges in 2013, it said in a report. But that's not going to clear the private equity backlog.

About 100 companies have already been cleared by the China Securities Regulatory Commission to list their shares, but are waiting for the market to improve. A further 800 companies have already filed IPO applications and are waiting for regulator's nod. And according to Mr. Fuhrman, an additional 600 or 700 companies could be ready to apply as soon as the regulator signals it's fully ready to take new applications. With many funds needing to return cash to their investors in the not-so-distant future, waiting for an IPO slot to open up is looking like the financial equivalent of a Hail Mary.

Traditionally, IPOs have been the preferred way for private equity investors in China to get their money out of companies they invested in. That's in part because during the golden years of 2006 and 2007, sky-high IPO prices would result in a killing for investors that got in early. But it's also because finding another company willing to buy the company you've invested in – a popular exit for private equity investors in developed markets – is seldom an option in China. Private equity investors usually take only a minority stake in Chinese companies, often because the entrepreneur who founded the firm is unwilling to relinquish control.

"To achieve [a] trade sale exit, the [investor] would need to persuade the majority owner, usually the person running the company, to sell out," said the report. "Even in cases where that is possible, there is not an active market for corporate control in China. Few deals have been successfully concluded where a private entrepreneur, alongside a PE minority investor, has sold the business."

The answer to this investment exit quandary might be secondary deals, whereby one private equity fund sells its stake in a company to another private equity fund, or in some cases sells its entire stable of companies to another fund. So far there have been very few such deals in China, but Mr. Fuhrman thinks they could be the way of the future.

"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," says the report.

Secondary deals are usually unpopular among investors that give their money to private equity funds. Large investors who have allocated money to a number of private equity shops see them as a waste of their money, particularly if one fund they've invested in sells to another fund they've invested in – all the more so if it's at a higher price.

Secondary deals overseas often involve distressed assets – the kind a private equity fund is willing to sell at a loss just to be rid of them. But the deals Mr. Fuhrman foresees coming to the table in China would be of much higher quality, with funds forced to sell because they're due to return cash to investors rather than because of any underlying problem with the investment.

The current quagmire is a problem that's been building for some time, and private equity funds have so far proven reluctant to embrace secondary deals as an exit. But with the chances of getting an IPO done looking less like a bottleneck and more like the eye of a needle, major changes might be forced upon funds and the way they do business.

– *Dinny McMahon*