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Seconds out, round two

Private equity specialist says IPO drought means investors must rethink

With China's IPO gusher now reduced to a trickle, prospects for some of the privately-owned companies which have traditionally boosted much of China's economic growth could be at risk.

So says Peter Fuhrman, founder and chief executive at China First Capital, a boutique investment bank and advisory firm. His firm has just released a new report warning that new private equity investment has basically come to a halt in China since the middle of last year.

Fuhrman talked to WiC this week about the reasons for the slowdown, and why he would like to see more investors considering alternative exits, including sales in the secondary market.

Your report talks about difficult market conditions in China…

The bigger picture here is that China's private equity landscape has been transformed from almost nothing a few years ago into one of the strongest investment stories in recent record. Funds have poured their money in. But now we're facing a perfect storm. The exit opportunities seem to have dried up and the previous model for cashing out looks broken.

The overhang is really significant. My firm, China First Capital, researched 9,000 investments disclosed publicly by private equity firms in China since 2001, as well as ones from our own deal log. We estimate that 7,500 of them currently haven't been exited. That's at least $100 billion of initial capital. The money is now stuck.

So the closing of the IPO channel has had an impact?

Yes, but relying almost exclusively on initial public offerings for exit was always going to be a problem.

Even in better times, there were at most 150 PE-invested IPOs happening every year. But there are so many more companies than that wanting to list that it can only lead to years of backlog. Plus there is more money wanting to come into Chinese private equity all the time. It can't all get out the same way.

This has created some huge problems, especially for funds premised on what we call the valuation arbitrage. Traditionally, they would invest in a private company at eight times its previous year’s earnings, inject some capital to grow profits, and then sell out at 60 to 80 times earnings in the public markets in China a short period later. It was a fantastic opportunity while it worked. But what happens when the route is closed off, especially when investors often struggle to persuade the majority owner, usually the person running the company, to consider alternatives like selling out alongside the PE in a trade sale?

What we are seeing is plenty of funds with unhappy investors, who were promised substantial returns on much shorter timeframes. Now they’re asking where their money is.

And you think secondary market sales are a way of breaking the logjam?

At the moment we see it as the most viable exit. We’ve identified over 200 companies that we’re calling ‘Quality Secondaries’ as candidates for sale to other PE firms, in part because their original investors are facing liquidity and fund life pressures.

The good news is that these ‘Quality Secondaries’ are all excellent firms, that have been growing well (more than 25% a year) since the original PE investment, and which look capable of achieving a capital markets or trade sale exit within six years. We’re talking about the jewels in a PE firm’s portfolio here, not the garbage. They’ve been through years of audits too, which makes them less of a due diligence risk than some of the primary deals undertaken by private equity buyers.

Have sales been happening in the secondary market?

The challenge is that there are a lot of firms unwilling to sell holdings that they were expecting to be worth much more. They’re still holding out for the miracle: that the IPO markets might revive within the lifetime of their funds. While I think that’s possible for investors with 10 years of fund-life left, most don’t have anything like that long, especially some of the shorter duration renminbi funds that have been raised from Chinese investors. Their backers are rarely as patient as the pension companies or university endowments that invest in the global firms.

But the secondary market is new. There isn’t even a good Chinese word for ‘secondaries’ so we’re working on explaining the benefit to potential sellers. These come down to one word, “exit”, that secondaries are the way that chips can still be cashed in.

We’re also telling them that they need to act while they still have pricing leverage. Generally, we think that secondary deals should be evaluated and priced in the market when the fund still has at least two years left of active life.

Can you give an example of a secondary deal that has worked out?

One of China’s top jewellery chains received PE money four years ago. Profits went up six-fold over the next three years and they are still growing substantially now. But the original investors had fund life issues. So they sold a percentage of their ownership to another buyer on the profit growth story, rather than the valuation multiple theme. They still did well, making a substantial return, and were able to return funds to their investors. Plus, they have a success story for when they go out to raise new money.

And you'd like to see more companies considering this route?

Yes. The issues with exiting via IPO means that private equity firms are holding off on new deals too, which is harming a lot of great companies which need investment. Bank loans remain difficult, so when PE firms stop putting money in, private companies are deprived of capital.

But today's China would be unrecognisable had no private equity industry emerged. Virtually all of the country's largest and most dynamic private businesses were financed by private equity or venture capital.

Hopefully, our report will help to generate some activity across the sector. And if a few more transactions are completed in the secondary market, we might see more primary investments happening. I'm certain now that the industry appreciates the scale of the problem.