Institutional Investor

Private Equity Slows in China as Investors Can't Find the Exit

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China's once-booming private equity industry is facing a logjam as a dearth of exit possibilities is slowing the flow of new deals in the sector, analysts and industry executives say.

The volume of private equity activity slowed dramatically last year, with some $17 billion invested in more than 700 companies, down from more than $30 billion invested in more than 1,700 companies in 2011, according to China First Capital, a Shenzhen-based investment advisory firm. Virtually all deals in China are minority equity investments in fast-growing private companies rather than buyouts of public companies as in the West. The industry was virtually nonexistent in China at the start of the 2000s but grew rapidly as Western investors rushed to participate in the country's economic boom.

"You had an industry that grew very quickly but is not yet fully matured," says Peter Fuhrman, chairman and CEO of China First Capital. "The PE firms raised huge money from LPs around the world and now face the challenge of not being able to exit their investments before the life cycle of their funds run out," Fuhrman says.

Out of the 9,000 publicly disclosed private equity deals done in China in the past 11 years, some 7,500 deals with a total investment of about $103 billion remain "unexited," according to Fuhrman. Most of these deals were done with the expectation that the company would one day go public, enabling private equity investors to cash out. Most private equity funds have been established with five- to ten-year life spans, so the pressure to find ways to exit deals is bound to grow.

Almost 100 companies have received CSRC approval to make IPOs this year but have not yet listed their shares because of poor market conditions, says Fuhrman. Another 850 companies are seeking regulatory approval for IPOs, but some companies have withdrawn their applications because of long waiting times, he adds.

The imbalance between investment demand and exit potential looks set to worsen. Fuhrman estimates that private equity firms are sitting on more than $30 billion of dry powder, capital raised specifically to invest in China. “This exit crisis will likely become more acute in the months ahead,” says Fuhrman. “At the same time, Chinese private companies, which rely on both IPO proceeds and PE investment to fuel their growth, are facing a potentially long period without sufficient capital to fully capitalize on the opportunities in China’s still-booming domestic market.”

The IPO backlog should spur the development of a secondary market in China, says Fuhrman. His firm published a recent report, “China Secondaries — The Necessary and Attractive Exit for Private Equity Deals in China,” that identified at least 200 highly profitable companies that could be ripe for secondary sales. “Quality secondary transactions in China will involve PE investors cherry-picking good companies at fair valuations,” the report says.

AIF Capital is looking to do just that. The firm recently raised $320 million for its fourth China-oriented fund, and Amour says he intends to invest at least part of the money in secondary deals.

“The firms I’ll be looking at will have to be highly profitable, have strong positions with competitive advantage in the market — companies that need additional new capital and can grow fast enough to achieve regulatory approval [for an IPO] within my fund’s ten-year life cycle,” Amour says.