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Five Minutes with Peter Fuhrman

The chairman of research firm China First Capital discusses China's growing exit problem, and its possible impact on private equity in 2013.

Michelle Phillips

A growing concern for private equity in China is the lack of IPO exits. How do you see that playing out in 2013?

I don't expect any substantial improvement or change in the problems that are blocking IPO exits domestically and internationally. And because the China private equity industry is significantly over-allocated to IPO exits, along with diminishing fund life, [this] will be a time of increasing difficulty for GPs. At the same time, the inability to exit will also continue to prevent [GPs] from doing new deals, and that is where the greatest economic harm will be done. Of course I don't trivialise the importance of the $100 billion that's locked away in unexited PE investments, but the real victims of this are going to be the private entrepreneurs of China. At this point, over half of all [China's] GDP activity is generated from the private sector. The private equity money and the IPO money is what [businesses] need to grow, because private companies in China basically can't borrow. They need private equity money and IPO proceeds to continue to thrive.

The image problem of Chinese companies overseas persists, hindering performance of all Chinese businesses on foreign exchanges. How do you think private equity can help address it?

[The image problem] couldn't be worse than it is, and I do not anticipate any sudden onset of amnesia among international investors. Accounting frauds in China are becoming an even more widespread problem [than private equity exits]. Caterpillar is in the midst of its own substantial crisis caused by rampant accounting fraud in a Chinese business they bought. When a big company like Caterpillar says they are writing off around half a billion dollars because of accounting fraud in a Chinese company, that's big! And I don't think private equity firms will have any mechanism to [address this problem]. That is beyond the scope of even the richest and most powerful private equity firms. That sounds dramatic, but [if] the private equity firm is the seller, it's like they're selling their used car. The problem now with [overseas] China IPOs is there are no buyers. They may be saying, 'No, no, my used car is a good used car' [but] there is nobody who will go near it.

The Chinese government has recently been making a lot of regulatory changes affecting private equity. Will these changes help ease the exit problem?

To give an analogy, worrying about regulations now is like if your house were burning down, you're worried whether you still have that steak in the freezer. The changes in regulations are so inconsequential compared to the problem that there are billions of dollars stuck in investments that GPs can't get out of, and time is running out. The only way the Chinese government could solve this would be to say, 'We'll buy all your unexited deals,' and I promise you they're not going to do that. Anything else just doesn't address the fundamental problem. For example, the problem with no IPOs in China is not because the waiting list [for IPO approval] is 800 or 8000 or eight. The problem is there are no IPOs. The key thing the [China Securities Regulatory Commission] would need to do would be to start allowing companies to IPO. So why are they trying to lower the size of the waiting list? Because it's extremely embarrassing for them as an organisation. So they can [reduce] the numbers, but even if they cut the pipeline in half, it's still a three-to-four year backlog. Now, I think there will be some domestic IPOs in 2013, but they will be substantially weighted towards large private companies or companies with direct or indirect state ownership and support. In other words, the IPOs that occur will often be companies with no private equity investment in them.

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