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Chinese Market Loses its Bite

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A stagnant exit market is likely to cause problems for firms that ventured into China in the boom years

Statistics rarely tell the whole story. However, as China celebrates the Year of the Snake, the most recent figures for private equity exits in the country make sobering reading for those who were convinced that the surge in private equity in the world's most populated nation was the ticket to easy returns.

In the final quarter of 2012, there was no capital raised by sponsors through primary initial public offerings of companies they backed, no capital raised through sales to strategic buyers and just $30 million from secondary buyouts, according to data from Dealogic.

That collapse in the exit market is creating a huge backlog of businesses in private equity hands that could force many companies to the wall and drive a shakeout in the industry, losing investors billions in the process.

Global private equity firms, from large buyout specialists TPG Capital and Carlyle Group to mid-market players like 3i Group, all flooded into the Chinese market raising capital from international investors for deals on the expectation of outsized returns as the economy opened and boomed. They were joined by thousands of domestic players that raised capital in local currency from the growing band of China's wealthy individuals eager to get a slice of the market.

Incredible Success

Peter Fuhrman, chairman and CEO of investment bank China First Capital, said: "In the course of the last five years China has grown into the largest market by far for the raising and deploying of growth capital in the world. It has been an incredible success story when it comes to talking investors into opening up their wallets and allocating much-needed capital to thousands of outstanding Chinese entrepreneurs."

High-profile deals, such as Baidu, billed by some as a China's Google and backed by Providence Equity Partners, have drawn attention to the opportunity, and helped attract billions of dollars in capital. There is more than $100 billion currently invested in companies in China – largely in minority stakes – and some $30 billion in dry powder still available for deals in China, according to Mr. Fuhrman's estimates.

However, the sheen has started to come off the Chinese growth story. Slowing GDP growth, expected at 7.8% in 2013, may be the envy of Europe and the U.S. but is below the 10-year average and is chipping away at faith that the economy can continue to be a global engine room for growth.

Meng Ann Lim, regional head for China and Southeast Asia at Actis, said: "Investors are increasingly concerned by private equity returns in China; GDP growth rates are slowing but will continue to be strong. What worries investors is the capital overhang."

Too much capital chasing too few deals has pushed up prices and forced down returns to investors, according to various people.

The recent lack of exits, caused predominantly by frozen IPO markets in Hong Kong and Shanghai which have succumbed to the global volatility affecting listings, is adding to the pain by cutting off the flow of capital back to investors. Primary listings generated just $531 million in all 2012, compared with $4.3 billion in 2011 and more than $8.5 billion in 2010, according to Dealogic.

"The IPO market is frozen over there and that creates problems. There is large number of portfolio companies that are being held in private equity funds in China and it is really hard to find an exit strategy for those," said Jeff Bunder, global private equity leader at Ernst & Young.

There are some 7,500 private equity-backed companies in China, according to China First Capital estimates. Some 100 have approval to list and a further 850 are awaiting approval from the China Securities Regulatory Commission to list, with many more waiting for the stock markets watchdog to start accepting applications again.

In the best years, no more than 150 Chinese private-equity backed companies floated, Mr. Fuhrman said. So even if the listings market picks up, it could take more than six years to list the companies that have already had approval or are awaiting approval to IPO.

Deprived of Capital

Not only is the lack of IPOs starving private equity houses and their investors of cash returns, but it is also depriving privately-owned Chinese companies of capital they need to grow, with potentially catastrophic consequences for the businesses.

“Without that capital, the companies will begin to drift off and slowly, slowly die,” said Mr. Fuhrman. “The Chinese boss who dreamed of riches of Croesus through an IPO will likely, in many cases, end up managing into senescence what was a pretty good business, with little or no return for private equity investors or their LPs [investors].”

That crisis could herald a cull of the vast universe of domestic managers – put in some estimates at up to 10,000 – and lead to a smaller group of better private equity groups.

With new listings confined to the freezer, private equity executives and their advisers are beginning to pin their hopes on other exit routes, such as secondary buyouts and trade sales that form a large part of North American and European private equity deals but are virtually unheard of in China.

“If there is anything that is going to let any of these deals get out in the next three to four years and return money to LPs, it’s probably going to be [secondary buyouts]. But the only companies that are going to be sold from private equity to private equity are the good ones, the jewels in PE portfolios,” said Mr. Fuhrman. He hopes secondary buyouts could top 100 in number in 2013 and generate in excess of $2 billion.

That would be a significant leap compared with previous years. Sales to other private equity firms brought in just $502 million in 2012, and nothing at all in 2011, according to Dealogic data.

“It will be a sign of increasing maturity in the market, and we see signs every now and again of it starting to happen. There are companies that have scale but need capital and there is only so far some of the groups can take them,” said Brian Lim, partner and head of private equity investor Pantheon’s primary fund investments in emerging markets.

And with the opportunity to grow through another period of private equity ownership, more companies could reach a scale and a level of profits that will make them attractive to trade buyers – in part domestic enterprises with international ambitions, but increasingly international groups with an eye on growth markets.

But first that will require private equity investors to help alter the mindset among entrepreneurs and majority owners.

“A lot of them are first generation entrepreneurs who don’t want to give away control to a multinational,” said Mr. Lim. “I think it is something that will change. It has happened in many markets and it will happen here as many multinationals need access to growth markets.”

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