tim.burroughs@incisivemedia.com

When push comes to shove

China GPs are under pressure to return cash to investors but IPO exits are challenging. Secondary sales are emerging as an option. Who best placed to deliver on the US dollar and renminbi sides?

AT FIRST IT JUST SLOWED TO A TRICKLE. As of mid-2012, China's securities regulator was still willing to approve applications to list in Shanghai and Shenzhen, just not in the same volume as the boom years. Then in October the door closed and it has yet to be reopened.

The regulator went a step further earlier this year, asking the brokerages and accounting firms to review the listing applicants in their stables and remove those with suspect financial statements. The plan was to thin out the backlog of around 900 companies awaiting approval, but it will still take years to clear and no indication has been given as to when approvals might resume. Last week the regulator scotched rumors that it would happen as soon as April.

Many of these listing applicants are running out of time. Private equity backers are restless, keen to return capital to investors who were promised their money back – plus a handsome return – within three years. Unfortunately, such ambitions can only be realized in a market on steroids and China started to run out of juice as far back as 2011.

The subsequent drop in fundraising is indicative not only of how investor sentiment has turned against private equity but also of how a normalized asset class and the short-term outlook of the high net worth individuals who backed these funds were always hopelessly mismatched. Now they want out, and in many cases the fund managers who took their money are also contemplating a change of direction, driven by disillusionment or by an acceptance that they will never raise more capital.

"Funds have raised more than $70 billion over the past five years and the data show that there are more that 3,000 GPs," says Stephen Sloan, managing director with Cogent Partners in Shanghai. "Many of these managers will not be able to raise subsequent funds and there are concerns over the potential exit opportunities for portfolio investments given the slowdown in the IPO market. This will lead to an increase in secondary opportunities for both direct and fund investments."

This is the renminbi side of the China private equity story. For those with US dollar-denominated funds, the pressure is nothing like as extreme. Certainly compared to India, international LPs are prepared to be more patient with their China interests because they have made money there before. Nevertheless, the clock is ticking.

"If you look at the timeframe, the peak for China fundraising was 2006-2008 so most of these funds have yet to reach the end of their lives," says Lucian Wu, managing director at Paul Capital in Hong Kong. "We are getting close to the end of the investment period, which means we are approaching the point where GPs have exhausted the IPO options and pressure is building to look for alternative exit strategies. We are getting to a point where we should be seeing more secondaries out of China."

Cogent's Sloan and Tim Flower, a principal at HabourVest Partners, agree that it is still early days for China secondaries, noting that the country accounts for a small percentage of what they work on region-wide. China assets – either as LP interests in funds or direct stakes in companies held by GPs – do come onto the market but they tend to be pockets within larger portfolios.

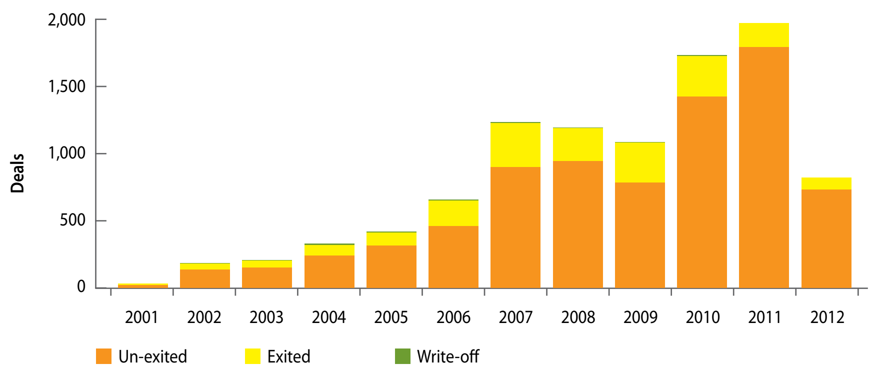
Darren Massara, managing partner at NewQuest Capital Partners – a specialist direct secondaries GP created when Paul Capital, HarbourVest, LGT Capital Partners and Axiom Asia backed the spin-out of Bank of America Merrill Lynch's Asia PE unit – adds that the hunt for assets takes him far beyond traditional GPs. Hedge funds, investment banks, corporations and family offices are among those looking to monetize assets, and for a variety of reasons.

How big an opportunity?

In this sense, pinpointing the exact scale of the opportunity is difficult. According to a recent report by specialist investment bank China First Capital, 7,500 domestic companies lurk in the portfolios of PE firms. Of these, 200 were identified as "quality secondaries" likely to appeal to investors, and the number is expected to grow 15-25% per year as funds approach the end of their lives. However, Peter Fuhrman, China First Capital's chairman and founder, notes the calculations are based on deals that are either publicly disclosed or those of which his team has been made aware. The figure could represent a fraction of what is really out there.

And while there certainly are Chinese private equity portfolios in distress, this isn't necessarily the norm. Comparisons are readily drawn between the squeeze expected in China and the situation in Silicon Valley after the dotcom bubble burst. In both cases, a wave of euphoria gave birth to thousands of PE firms that were able to raise capital and didn't have the wherewithal to deploy it effectively. But the dotcom bust exposed unsustainable business models; in China, the crisis is at GP level, created by a lack of liquidity, and the underlying portfolio companies might be doing fine.

China private equity by exits



Source: China First Capital

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"Most of these companies have taken the VC money, spent it well and doubled in size," says Fuhrman. "They have made the difficult transition from non-compliance to tax and legal compliance. They are doing well because the economy is doing well. The majority are pretty well-established by the time of investment and they got where they are with zero capital."

He cites a growth investment made by a large Chinese PE firm as an example. The target company is a leading specialty retailer and the capital was used to expand its store network, resulting in a 600% increase in profit over a three-year period. The plan was to file for an IPO in late 2012 but there was uncertainty about the length of time required to get approval. Given the private equity firm wanted to launch a new fund in 2013, it was keen to deliver some cash returns to investors and so completed a partial exit to another GP, getting back the original investment.

GP to GP

It is Fuhrman's view that China-focused GPs will be the principal beneficiaries of the emerging secondaries opportunity because they have the local knowledge, team and resources to carry out due diligence, as well as existing funds that can pick off and manage individual or groups of assets directly.

But when the assets in question are healthy as opposed to distressed, this has implications for pricing. If a private equity firm invested $15 million in a company four years ago and it has since grown at an annual rate of 25%, buying it at the same valuation multiple would require $50 million. While there may be a discount because the seller is getting liquidity immediately rather than at an unknown point in the future, it is unclear how many private equity firms could accommodate that size equity check.

Furthermore, as NewQuest's Massara observes, there aren't many of these GP-to-GP transactions currently taking place in China. General Atlantic's acquisition of hotpot restaurant chain Xiabu Xiabu from Actis last year is a high-profile exception to the rule. According to AVCJ Research, it was one of just five such deals in 2012 and the cumulative proceeds amounted to less than $600 million, which was actually a record high.

"Generally speaking, the primary guys have been reluctant to look at direct secondaries on a pure play basis," Massara explains. "There is a stigma to doing anything second hand. They ask, 'Where was it? What don't I know about it? What do these guys know about it that I don't?' Primary guys are a bit suspicious."

This suspicion manifests itself in challenging negotiations with little trust on either side. Indeed, the Chinese GP that made a partial exit from the specialty retailer would only consider two potential buyers, and one of them was runner-up in the bidding war for the primary deal four years previously so had a strong grasp of the business.

A GP that spends too much of its time on secondary deals might also end up having difficult conversations with its LPs. In Europe, for example, investors responded to a spate of post-global financial crisis secondary buyouts by questioning the balance between capital and opportunities.

"For the traditional GP in the growth equity space there is a disincentive to sell assets via secondary buyouts," says Jason Sambanju, managing director at Paul Capital. "The LPs ask why you are selling to another GP with a similar cost of capital. Are you leaving some value on the table? On the buy side, they ask why you are buying from another GP instead of sourcing deals yourself. There is a negative perception."

The general expectation is that other versions of NewQuest will emerge as the secondaries market matures in China. The LPs behind the NewQuest spin-out are approached by other groups – typically GPs that can't raise new funds and are looking for plan B or executives from the proprietary desks of investment banks who have identified orphan portfolios – looking for people to back them in direct secondary deals in Asia. India sees the most activity but there are also China-focused players.

The renminbi space is more complicated. LP positions in local funds are off-limits to foreign participants, with Vincent Huang, a partner at Pantheon, recalling how the Limited Partners Association of China broached the subject with regulators as part of efforts to address renminbi-US dollar conflicts through the Qualified Foreign Limited Partner (QFLP) program. "We were advised that under the current legal framework, investing into renminbi funds by foreign investors in any form would change the nature of the fund and therefore was not practical," he says.

Direct secondaries are seen as more feasible – it involves restructuring the portfolio companies offshore with a joint venture onshore – but industry participants warn of lengthy approvals processes.

Who's buying?

The government is trying to facilitate sales of LP interests in renminbi funds by setting up forums for exchange, although this doesn't solve the problem of where willing buyers will come from. One option is the local fund-of-funds. Magic Stone, which has a secondaries allocation within its existing comingled vehicle, is one of several participants examining opportunities in this space.

"A large number of high net worth individuals and companies, who are new and small investors, invested in the sector irrationally," a Magic Stone spokesperson tells *AVCJ*. "As time goes by, some of these LPs may find that VC and PE funds are not suitable investment assets for them. This is especially true since liquidity tightening began in the second half of 2011, and some LPs have sought to sell their shares in funds."

While foreign secondary investors don't dispute the logic, they question the ability of fund-of-funds to operate effectively, citing a lack of experience handling these kinds of transactions. According to Cogent's Sloan, there are a few renminbi-focused secondary funds currently being raised and he expects many of the large domestic fund-of-funds to play an active role on the secondary buy-side in this market. Industry participants suggest that the likes of Noah and China International Capital Corporation, which can rely on large distribution networks to raise funds, could feature prominently.

A more fundamental issue is who will provide the capital for these renminbi secondary vehicles. Unless these fund-of-funds can introduce credible long-term investors then the chronic short-termism that has plagued Chinese private equity can't be addressed. The problem is delayed, not solved, and all that is created is deal churn.

"The only long-term capital in China to date is the social security fund and insurance companies, and they need to see real returns from renminbi secondaries before getting involved on a large scale," says Pantheon's Huang. "Most of the LPs will therefore still be individuals, exactly the same type of investors who went into renminbi funds in the first place. It is a structural issue – using short-term capital replacing short-term capital."

Portfolio companies that have yet to join the queue for listing approval could take as long as seven years to go public, once the lockup period is taken into account. This means a long wait for LPs that are unable to find an alternative solution, but the risks don't stop there. Several industry participants suggest that zombie funds might not materialize in China as in the West. Renminbi managers entered the industry opportunistically and they might leave in the same way, leaving their investors high and dry.

"They will go to the LPs and say, 'The fund has a life of 7+3 years, we are in year seven and there are still assets to exit, so we need more management fees,'" Fuhrman explains. "If the LP doesn't agree they could say, 'We have no more money to manage the portfolio, won't do it for free, so we will distribute out to you your share in the un-exited companies and let you manage them.' It's the original Hobson's choice, that is where we are heading."