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China's GPs search for exits

Premium

Chinese GPs are running low on exit options, but the barriers to unconventional routes – like secondary sales to other GPs – remain high.

Michelle Phillips

China's exit woes are no secret. With accounting scandals freezing the IPO route both abroad and domestically, the waiting list for IPO approval on China's stock exchanges has come close to 900 companies.

Fund managers have at least 7,550 unexited investments worth a combined $100 billion, according to a recent study by China First Capital. However, including undisclosed deals, the number of companies could be as high as 10,000, says CFC's founder and chairman Peter Fuhrman.

CITIC Capital chief executive Yichen Zhang told the Hong Kong Venture Capital Association Asia Private Equity Forum in January that because many GPs promised high returns in an unrealistic timeframe (usually three to five years), LPs were already starting to get impatient. He also predicted that around 80 percent of China's smaller GPs would collapse in the coming years. "The worst is yet to come," he said.

What ought to become an attractive option for these funds, according to the CFC study, are secondary buyouts. Even if it lowers the exit multiple, secondaries would provide liquidity for LPs, as well as potentially giving the companies an influx of cash, Fuhrman says.

Buyers would also be getting a great deal, he adds. Given the due diligence, operational improvement and compliance work that the primary investor typically puts into Chinese companies, the risk is much lower with secondary transactions.

It all sounds great in theory. But there's a catch: as yet, there hasn't been a single secondary deal in the RMB space. The inescapable problem, Fuhrman explains, is that this is fundamentally a buyer's market – and there are no buyers yet.

Some one hundred secondary deals are currently being marketed in China, but most are "rubbish", Fuhrman believes. Many funds only hold a number of minority stakes in businesses, and probably did little due diligence to begin with. His research only found 200 "quality secondaries", i.e. portfolios that show high growth, are legally compliant and seek a secondary exit. Finding those few diamonds in the rough won't be easy, Fuhrman says –and there's a danger the others might "clog up the market".

Another problem is that foreign buyers are being kept out of the market. Secondaries firms have been looking at the RMB space for a while, but China has strict regulatory barriers to getting such offshore money into the market, according to Jason Sambanju, Paul Capital's co-head of Asia.

Because secondaries firms operate partly like a GP and partly like an LP, by China's definition, the government is more sceptical about them. As such, no foreign firm has been able to work out the technicalities of executing an RMB secondary, Sambanju says.

"If you're a USD fund, you have to climb through hoops [to do secondaries]," adds Doug Coulter, partner at LGT Capital Partners. As of yet, there is no sign that the regulations will be relaxed.

For at least half of potential secondaries, Fuhrman believes there will end up being no interested buyers – which means those GPs will be facing a 100 percent write-off.

> "If you're a USD fund, you have to climb through hoops [to do secondaries]"
>
> *Doug Coulter*

But some of these ailing funds may have an option that wouldn't be available elsewhere:

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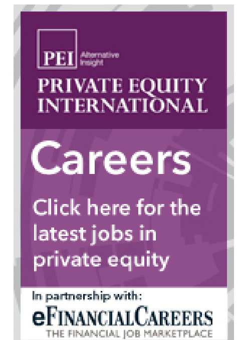

an LP takeover. RMB funds may have only a few high-net-worth individuals as LPs, many of whom already own businesses, according to Sambanju. So what we may see in China is a number of LPs choosing to dissolve the fund and take the direct equity stakes themselves.

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