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Chinese PE Firms Too Tech-Focused: Report. AsianInvestor

By Elva Muk | 28 July 2014

Company valuations are being pushed up as PE firms chase the same targets, and market domination by big players like Alibaba is squeezing profit, says China First Capital.

Spurred by the success of the likes of Tencent and Alibaba, Chinese private equity and venture capital firms have become too focused on technology and e-commerce investments, argues a new report.

Nearly all publicly announced deals this year have been in the technology sector, says the *China Private Equity 2014* report from China First Capital, a private capital markets advisory firm. They include online shopping sites and mobile travel, game and taxi-booking services.

Though China has restarted its initial public offering process after a hiatus of more than a year, US listing also provides an effective way for PE firms to exit their investments. Chinese internet and mobile companies Zhaopin, Cheetah Mobile, Sina Weibo and Qihoo 360 have already floated in the US market this year.

Though Tencent and Alibaba are shining examples of success, the investment outlook for newly established technology companies may not be as rosy, the report says. These firms do not enjoy a technological barrier to entry and rely "on the same prayer-for-low-profitability outcome: a purchase down the road by China's two internet leviathans, Tencent or Alibaba".

But China First Capital forecasts that the duo will soon lose their appetite for buying smaller Chinese internet firms.

Moreover, domination by the major players has squeezed the growth potential of newcomers. Alibaba commands close to 50% market share of the country's online shopping in terms of transaction volume, while Tencent is similarly dominant in online gaming. Almost all the money goes to these two firms, the report notes.

Further, the investment landscape in China is less dynamic than some elsewhere. The US has a greater number of venture capital trade buyers for successful VC-backed companies, and less monopolistic internet and mobile industries and a richer early adaptor market to tap, the report notes.

In China over the past two years, PE firms have invested heavily in Chinese shopping sites that follow a model similar to Groupon. However, some projects have lost money because monetising the sites has proved difficult.

Another obstacle in China for private equity in building up investment is the high cost of acquiring clients. In most VC-backed companies in the US, the head of business development is responsible for generating growth at the cheapest cost.

This approach is uncommon in China. A typical method of acquiring customers in the mainland is to pay for a high-ranked listing on search engine Baidu, which handles over 60% of search requests in the country.

"The 'pay to play' rules of China's internet [industry] lead to companies taking lots of expensive shortcuts, often burning a lot of PE and VC firms' cash," the report said.

Further, PE firms are chasing the same investment themes and companies, resulting in rising valuations. "It is an ongoing example of inadequate diversification by industry or stage," it added.

China's PE capital raised has grown five-fold to over $100 billion since 2005, while the number of firms has grown to 1,000.

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