China Secondaries

Investment Universe

ABRIDGED VERSION

The entire contents of the report are available on a complimentary basis to:

- ***Partner-level and other senior staff at LPs, GPs active in China***
- ***Lawyers, investment bankers, consultants and others assisting transactions in private equity industry***
- ***Media representatives***

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Direct secondary opportunities in China private equity: segmented by deal size, PE tier, currency, industry

CHINA FIRST CAPITAL
中国首创

Executive Summary

Secondary directs, the purchase from GPs of individual investments or a select portfolio of China private equity investments, potentially offer some of the **better risk-adjusted investment opportunities** in China for PE firms and LP direct investors. Based on *China First Capital*'s research of both publicly-disclosed PE investments in China and entries from our deal log, the universe of unexited PE-invested deals in China is over 7,500 investments, representing an aggregate PE investment of over USD$100 billion. While deal size, fund vintage, currency, hold period, IPO prospects and industry all vary, a substantial percentage of PE-invested deals will likely become available for direct secondary purchase. The percentage of the 7,500 unexited PE-invested deals actionable by a direct secondary buyer will likely increase markedly over a three to five year horizon, due to extinguishing fund life and limited exit possibilities through IPO, trade sale, recapitalization/buyback.

As our earlier research report concluded, the greatest potential for direct secondary buyers across the short to medium term is in a group of select companies we term "***Quality Secondaries***". These are China PE investments that fulfill four criteria:

1. *unexited and not in IPO approval process, domestically or internationally*
2. *investee companies have grown well (+25% a year) since the original round of PE investment, and have continuing scope to expand enterprise value and achieve eventual capital markets or trade sale exit in 3-6 year time frame*
3. *businesses are sound from legal and regulatory perspective, have effective corporate governance, and a majority owner that will support secondary sale to another PE institution*
4. *Current PE investor seeks secondary exit because of fund life or portfolio management reasons*

We estimate there are now **at least 200** actionable "Quality Secondary" investment opportunities. This number will likely grow by approx. 15%-25% a year, as funds reach the latter stages of their lives and assuming other exit options remain limited.

Deal supply is more than adequate to justify an investment strategy focused on Chinese direct secondaries. The critical issues will be **deal-sourcing, price and deal complexity**. These factors have blocked the development of a stable, liquid and efficient market in direct secondaries in China. Bid/ask spreads have generally been unbridgeable. PE-to-PE negotiations too easily run aground due to mutual distrust and pricing gamesmanship.

We believe, however, that the environment is changing quickly, for the better, from the perspective of direct secondary buyers. Fund life issues and the enormous overhang of unexited private equity-invested deals are both catalyzing events in China. We expect a lot of attractive direct secondaries **inventory** to come to market in the next 24 months, at current market valuations of 6-9X last year's audited or this year's guaranteed net income.

At those valuations, these direct secondaries certainly represent some of the better values to be found in growth capital investing in China. DD risk is significantly lower than in primary deals, and contingent risks (opportunity costs, and legal risks of pursuing other non-IPO exits like "delist/relist") are lower. We would expect a portfolio of Quality Secondaries to **meaningfully outperform** other private equity strategies and asset classes in China over the medium term.

Direct Secondary Deal Universe

In compiling our assessment of direct secondary opportunities in China, we rely on our proprietary matrix of 7,500 unexited PE-invested deals. In this research note, we divide the deal universe into **nine value quadrants**, based on original investment size and tier of invested PE firm. The nine quadrants are then further broken down by date of investment, industry sector, invested currency and investment round.

shading reflects # of unexited deals per quadrant, darker the shade the greater the number

Guidance: Given the complexities in securing deal flow, valuing, purchasing and managing a diverse portfolio of minority investments in China, the successful direct secondary strategy will likely benefit from disciplined **targeting** of several, though not all, of these quadrants. Aim before firing.

In sourcing Quality Secondaries, original investment size provides guidance for current acquisition cost. So, for example, firms looking to invest +$30mn per deal, should look not only at investments originated at over $30mn, but also selectively target deals in the $7mn-$30mn range. Date of original round and subsequent profit performance are the main drivers of current valuation.

Assuming static p/e multiples and +25% cagr, a typical quality secondary will **double in value** every 2 to 2.5 years. Average deal size in quality secondaries will be significantly larger than for primary deals in China, with **many of the more attractive opportunities in "large-cap" $50mn -$75mn deal range.**

Guidance: The objective of a China secondary direct strategy should be to **"*capture created value*"**. That is, to buy into businesses that since the time of the original PE investment have delivered sustained robust operational improvements through EBITDA margin expansion and revenue growth.

Crucially, in China private equity investing there is a **systematic difference** between the value as an asset class of private companies with and without private equity, between primary and direct secondary transactions. And yet, that "*created value*" difference is not currently reflected in asset valuation.

In a separate research note to be circulated in following weeks, we quantify this differential by risk-scoring primary and direct secondary deals. Our analytics suggest direct secondaries should enjoy a **valuation premium** of at least 30%-50% over primary deals. And yet, in the current market, no such price premium exists. So long as this pertains, direct secondaries will likely outperform.

At its root, the risk-scoring captures the actual and contingent costs (in time, money, frustration, process failures) of transitioning a private Chinese company to full legal and tax compliance. In China, these costs are generally always high and always borne by the primary PE investor.

The underlying investment thesis for much of Chinese private equity, over the last ten years, amounts to **arbitraging large valuation differentials** between compliant and non-compliant companies. In direct secondaries, the large arbitrage remains, but the actual risks of a primary deal are substantially reduced.

This implies well-chosen direct secondaries offer strong defensive capabilities. For successful direct secondary investors in China, deal sourcing and selection will be key. They need to build their strategy on **proprietary and substantial deal flow**, coupled with highly professional and swift, confidential closing process. (*China First Capital has this capability to assist GPs in executing a successful direct secondary strategy. For details, click here.*)

Methodology

Our nine value quadrants are profiled in depth in this paper. Original investment size, though rendered in dollars, includes both dollar and Renminbi deals. Renminbi were converted using a fixed, rather than current, exchange rate of Rmb7 = $1.

Our "PE Tier" ranking system, though subjective, is based on the quality of inputs rather than outputs. In other words, a PE firm is considered "Tier One" where its LPs are established institutions investing across multiple funds and geographies. Tier One firms also follow international norms of third party due diligence, and focus post-investment on implementing corporate governance and operational improvements. A PE fund's historical returns or unexited deal quality are ***not*** used in assigning tiers.

Broadly understood, Tier One firms are international, investing primarily in dollars but occasionally both dollars and Renminbi. Tier Two firms are mainly well-established Renminbi funds with over Rmb 2 billion in assets and an active investment profile in China of at least five years. Tier Three are recently-founded Renminbi funds, or others with purely SOE background or investors.

Guidance: There are good opportunities across the deal spectrum, regardless of PE tier. Indeed, some of the best values available for purchasers of direct secondaries will be in deals initiated by Tier Two and Tier Three firms. As a rule, Tiers Two and Three have shorter fund life than Tier One PEs. Blocked access to domestic IPO exit mean many Tier Two and Tier Three firms are already facing significant **liquidity and fund life** pressures.

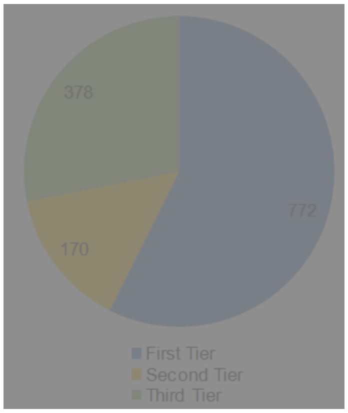
Guidance: We expect Tier Two and Tier Three PE firms to be significant **net sellers** into the direct secondary market in China. Tier One firms generally have longer fund life. But, that does not confer immunity from the **severe challenge of liquidating unexited deals**. Dollar invested deals represent the majority of capital in unexited investments in China. The GPs holding these deals often have an unhedged exit strategy of waiting for Hong Kong or US IPOs to resume.

Tier One firms may reach the **inflection point** later than Tiers Two and Three. But, all confront the same scenario where unexited deals become wasting assets. Fund life isn't the only challenge. Should investee company earnings momentum slow, exit through IPO or direct secondary becomes more unlikely.

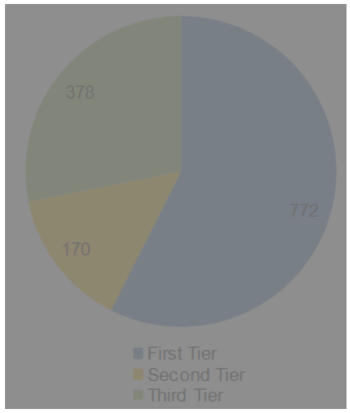
Then, too, there is the sheer weight in numbers and sunk capital of unexited investments across all PE tiers, currency and deal sizes. Absent a significant revival in the IPO market, pricing leverage will be steadily transferred to direct secondary buyers. The **supply-demand ratio** is fundamentally out of alignment, and will only grow more so over time. Direct secondaries in China are and will remain a *buyer's market*.

Under $7 mn Original Investment Size

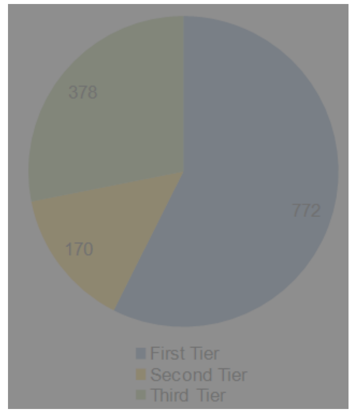
PE Tier # Deals



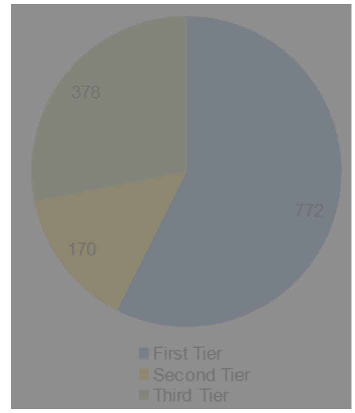
PE Tier $ Invested



Currency # Deals



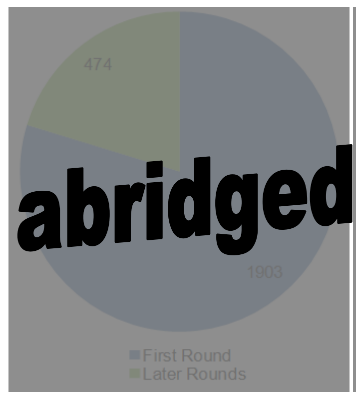
Currency $ Invested



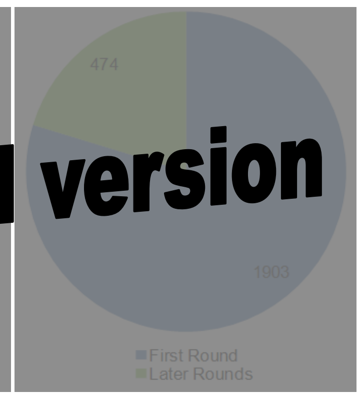
Industry # Deals

Industry $ Invested

Round # Deals



Round $ Invested



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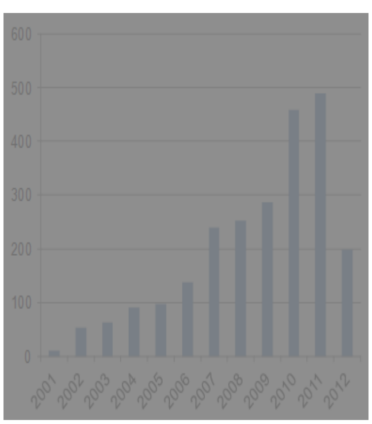
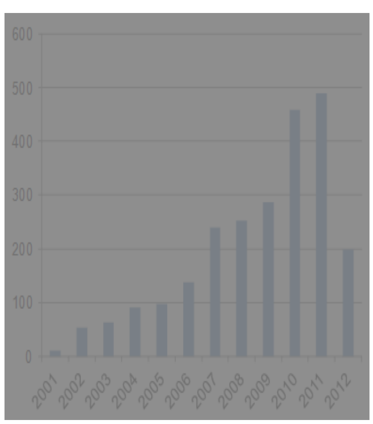
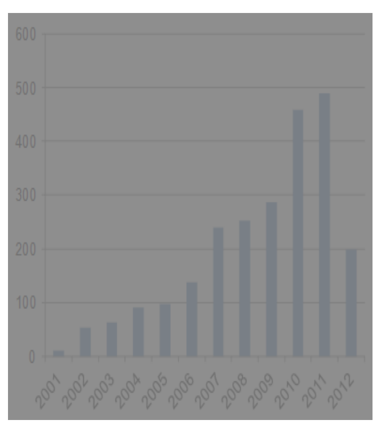
Unexited Investment # Deals



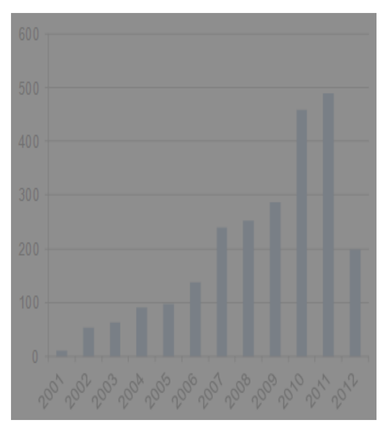
Unexited Investment $ Invested *($mn)*



Exited/Unexited # Deals



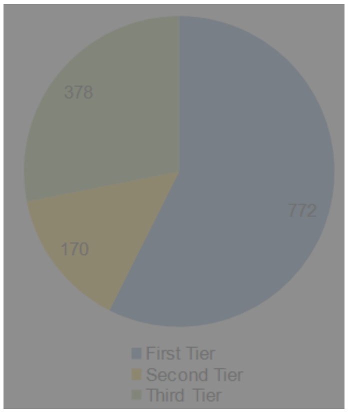
Exited/Unexited $ Invested *($mn)*



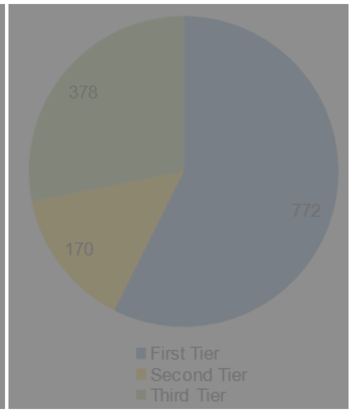
These tables condense results of China First Capital's proprietary research work. Further information and analysis, including on specific Quality Secondary deal opportunities, implementable exit and investment strategies are available exclusively to clients.

$7 mn - $30 mn Original Investment Size

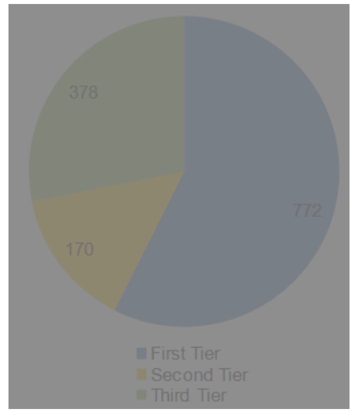
PE Tier # Deals



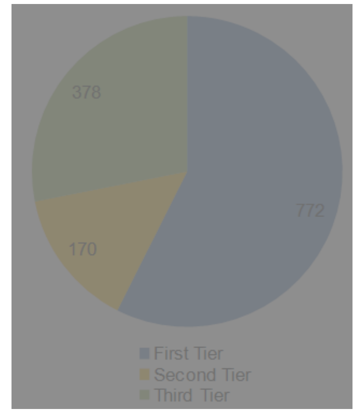
PE Tier $ Invested



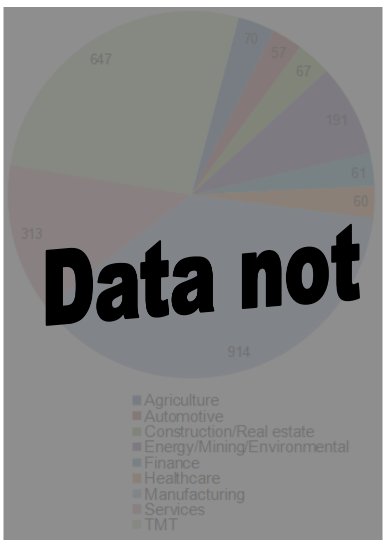
Currency # Deals



Currency $ Invested

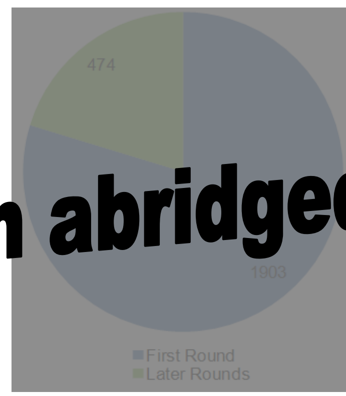


Industry # Deals

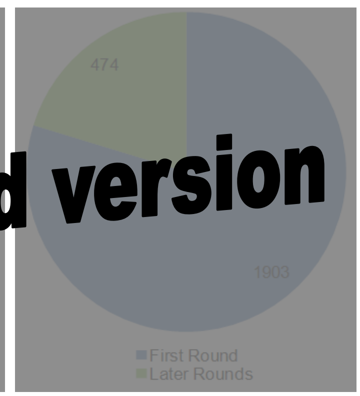


Industry $ Invested

Round # Deals



Round $ Invested



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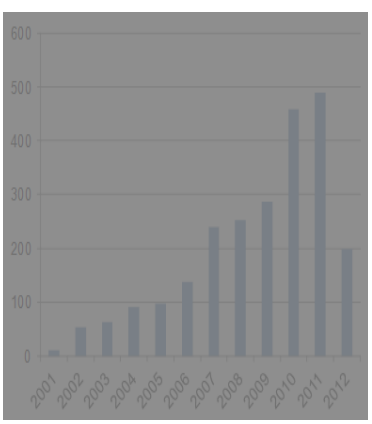
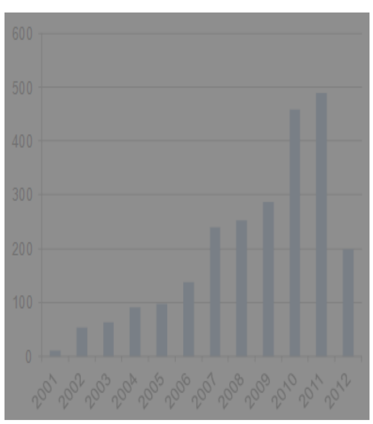
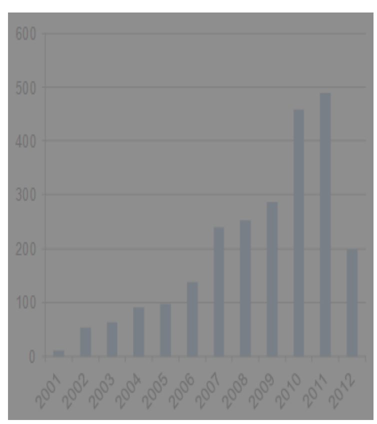
Unexited Investment # Deals



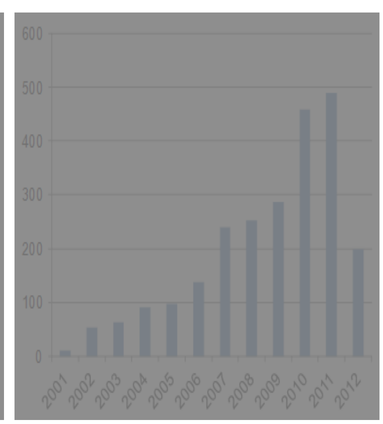
Unexited Investment $ Invested ($mn)



Exited/Unexited # Deals



Exited/Unexited $ Invested ($mn)



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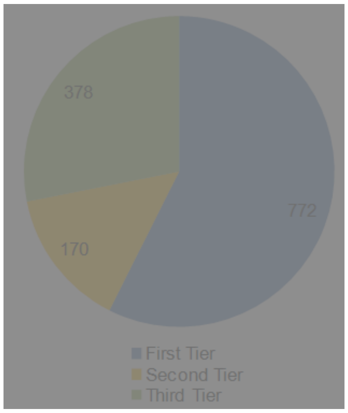
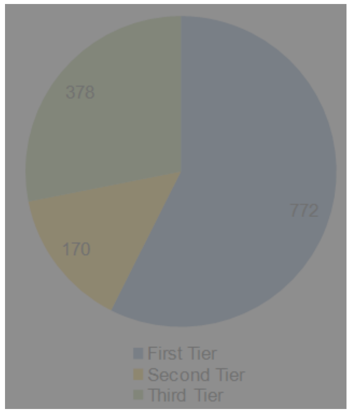
+$30 mn Original Investment Size

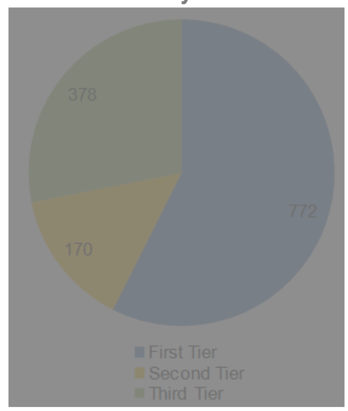
PE Tier # Deals



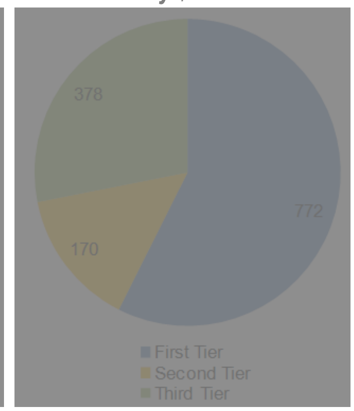
PE Tier $ Invested



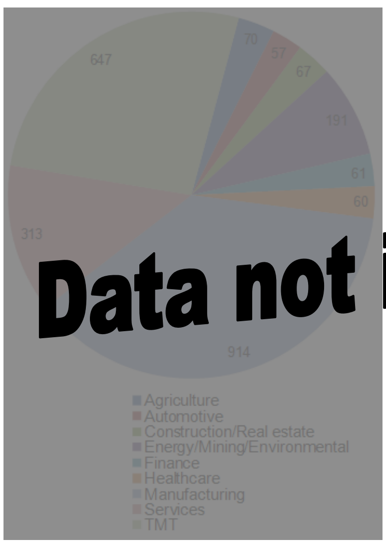
Currency # Deals



Currency $ Invested

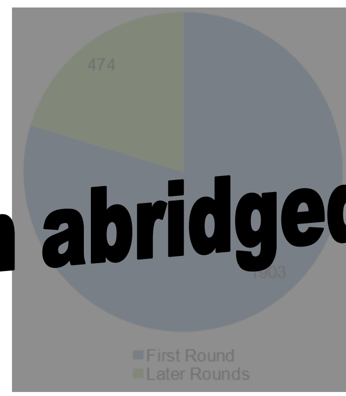


Industry # Deals

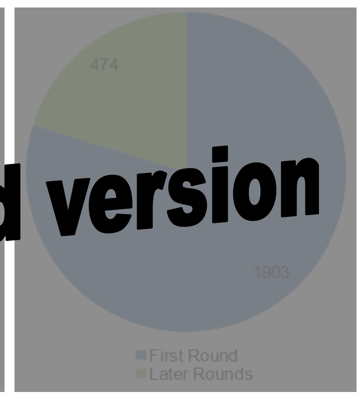


Industry $ Invested

Round # Deals



Round $ Invested



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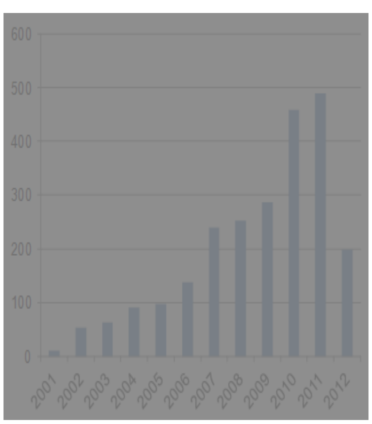
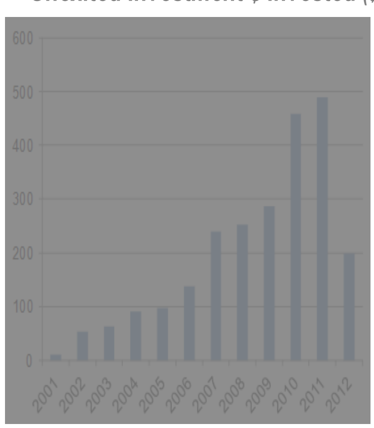
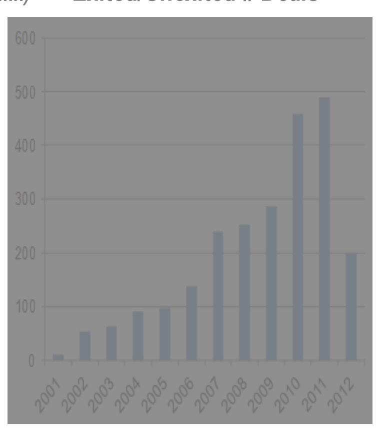
Unexited Investment # Deals



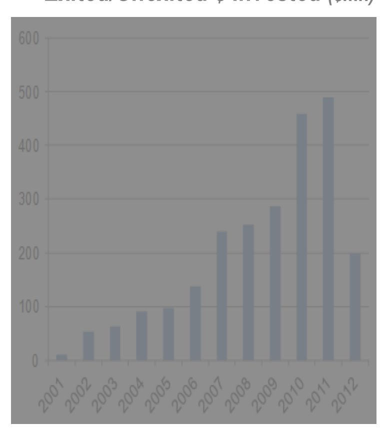
Unexited Investment $ Invested ($mn)



Exited/Unexited # Deals



Exited/Unexited $ Invested ($mn)



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China First Capital *is a leading China-focused international investment bank and advisory firm for private capital markets and M&A transactions in China. We have a disciplined focus on -- and strive for a leadership position in -- four distinct business areas. These are:*

- *Private placement and equity financing for China's high-growth entrepreneur-led companies;*
- *Private equity Secondaries, buy-side and sell-side representation for acquisitions and early liquidity events;*
- *Strategic M&A transactions, domestic and cross-border acquisitions for Chinese clients;*
- *Restructuring, financings and advisory for China's SOE*

China First Capital's geographical reach and client mandates are across all regions of China, with exceptional proprietary deal flow. We have significant domain expertise in most major industries in China's private and public sector, structuring transactions for a diversified group of companies and financial sponsors to help them grow and globalize. We execute transactions across the capital spectrum to minimize dilution and optimize our clients' capital structure and returns. We are a knowledge-driven company, committed to the long-term economic prosperity of Chinese business and society, backed by proprietary research (in both Chinese and English), that is unmatched by other boutique investment banks or advisory firms active in China.

For more information and to learn more about our strengths and capabilities in direct secondaries, please click here, or contact directly our firm's senior management below.

Chairman & CEO
Peter Fuhrman
Tel: 0755 86590540
ceo@chinafirstcapital.com

Managing Director
Dr. Yansong Wang
Tel: 0755 86590540
wangyansong@chinafirstcapital.com

Press Reports about China Private Equity Secondaries and the China First Capital research report

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End Notes:

Data: *Our report's data is drawn from China First Capital's analysis of over 9,000 PE-invested deals in China, including both publicly-disclosed deals, as well as entries from our deal log. This data set, like any that attempt to capture private equity and venture capital deal flows, is by its nature incomplete. In every market, a percentage -- often a meaningful percentage -- of PE and VC deals are executed confidentially and remain undisclosed. Our experience over five years in China is that a great number of deals are undisclosed.*

We identify and parse 7,500 unexited PE-invested deals in China. The total number of unexited deals, and so the scale of the overhang, is certainly larger. We have also developed a separate database of so-called "Quality Secondaries", the unexited deals that should be of greatest interest to acquirers in direct secondary transactions. That list of Quality Secondaries is not included in this report.

In addition, publicly-disclosed deals often suffer from a number of deficiencies, including imprecision about valuation, date of close, investment instrument, investment size. This explains why the sample size for some deal metrics in the report (price/earnings ratio, invested currency) is sometimes smaller than the total set of PE investments.

Report's Purpose: *China First Capital has produced this report to measure and illuminate the approximate dimensions of the unexited overhang of private equity deals in China. In our view, the consequences of this overhang could be especially far-reaching. None concerns us more than the fact that new private equity investment deals in China since mid-2012 have basically come to a halt. Despite sitting on billions of dollars of "dry powder" capital raised to invest in private sector companies in China, and despite ongoing fundraising activities by GPs to raise an additional $50 billion in new Limited Partner commitments to China-focused private equity, PE investors, in most cases, have withdrawn from the market and stopped deploying capital.*

PE capital is now a main source of expansion capital for China's private sector companies. Bank loans remain difficult and costly. So, when, as now, PE firms stop putting money in, private companies are deprived of capital, impacting not only their expansion, but ultimately China's GDP growth as well.

PE capital in China has an especially high multiplier. In thirty years, China's private sector has gone from non-existent, to producing well over half of the country's entire GDP. PE money has in the last decade played an increasingly vital role in this, providing over $150 billion in capital as well as expertise and encouragement to entrepreneurs. Today's China would be unrecognizable had no private equity industry emerged. More so than in any other country, it is true to say that virtually all of the country's largest, most competitive, most famous and dynamic private businesses were financed by private equity or venture capital.

IPOs have also played an important, if little recognized, part of China's remarkable growth story over the last decade. They fueled the boom in private equity as well providing the mechanism through which stock markets in New York, London, Hong Kong and China could allocate far larger sums into China's private sector companies. Total IPO proceeds for Chinese companies over the last decade exceed $300 billion. IPOs and PE money have together turbocharged China's private sector, increasing competition, consumer choice and economic dynamism in China.

Now that gusher of PE and IPO money has turned to a trickle. When IPO markets will again welcome Chinese companies in large numbers is uncertain. But, the need to increase liquidity in PE investment is more urgent and more critical. The current imbalance, where exits for most China PE deals hinge on IPO transactions, needs to be redressed. The three other exit routes for private capital markets deals -- M&A or trade sale, secondaries, buyback/recapitalization -- need also to become fully operative and actionable for PE investors in China. Going forward, recaps/buybacks need to be better structured. A more active and competent buy-side for M&A exit needs to arise in China. Both will take time.

Secondaries offer the most immediate viable remedy to the intertwined challenge of the large unexited overhang and expiring PE fund life. Liquidity through direct secondaries, for at least a percentage of unexited deals, will benefit the three core constituencies in China private equity: GPs, LPs and investee companies. It will also perhaps help unleash the "animal spirits" of PE investors who are now unwilling, because of blocked exits, to commit to new investments in China.

Our firm shares the view that investing in China's entrepreneurial companies is among the world's best risk-adjusted investment opportunities. Within this asset class, direct secondaries should offer investors especially attractive values. More, not less, capital should be committed to Chinese private companies, not so much because China's economy requires it, but because the investments continue to produce outstanding outcomes, measured by robust growth in corporate profits and enterprise value.