The Next Chapter for Private Equity in China

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Over the past decade, private equity (PE) in China has been one of the most attractive areas of investment for investors worldwide. The industry has grown considerably and there are now over 10,000 PE and venture capital firms in China.[1] Recently, however, the drivers of economic growth supporting this extraordinary investment opportunity have entered a period of significant transition. This shift has created a challenging environment for PE investing, placing more demands on the capabilities of General Partners (GPs) and investment savvy of Limited Partners (LPs) to generate outsized returns. In the next phase of PE in China, we believe the industry will continue to offer compelling opportunities for investment, but in different, and sometimes new, stages, sectors, and strategies.

Siguler Guff & Company, LP was one of the earliest multi-manager PE investors on the ground in China, having opened our Shanghai office in 2006. Our local team has nearly five decades of combined investment and operational experience in China, and currently maintains more than 30 local GP relationships. These relationships provide access to roughly 1,500 underlying portfolio companies at various stages of development across a variety of industries.

This paper seeks to illustrate our unique approach to identifying future investment trends and the next wave of successful PE fund managers in China, by combining a bottom-up approach to research with a top-down overlay. While success stories during the early years of China's PE lifecycle are not likely to be repeated, we believe that opportunity still exists for outsized returns. It is our view that investors can prosper in China's new PE environment as long as they adapt to the changing landscape, and the new set of risks and challenges they will face. We hope our views can enlighten the GP and LP communities during this critical period of change and uncertainty in China.

UNDERSTANDING CHINA'S GROWTH STORY

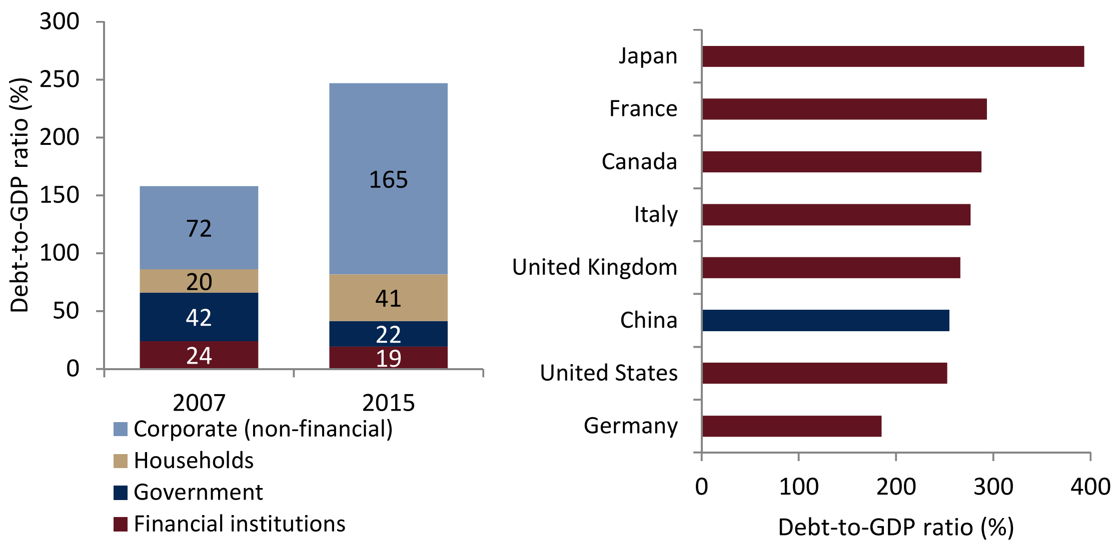
China's economy has seen extraordinary growth in the 21st century, driven by market-oriented reform, industrialization, and urbanization. On average, GDP has grown nearly 10% annually since 2000, making China the world's second largest economy. However, the growth rate has slowed to approximately 6.5% in recent years as the economy has matured.

Debt has also been a key driver of Chinese economic growth since the Global Financial Crisis (GFC). As global demand for Chinese exports collapsed and many factories shuttered, the government embarked on an ambitious stimulus program, largely fueled by debt. While in most countries a stimulus like this one would have been paid for directly by the government, in China it was primarily funded with bank loans. Chinese banks are controlled by the government and most of the loans went to state-owned-enterprises (SOEs). The SOEs used the new capital to build out the country's transportation network, power infrastructure, real estate, and other public works projects. At the same time, these SOEs were building up their own factories, contributing to the overcapacity issues widely reported in the press today. While the stimulus had the desired effect of creating jobs while the country weathered the GFC, limiting social unrest, it also dramatically increased the country's debt-to-GDP ratio.[2]

[1] Zero2IPO China VC/PE Market Revuew 1H 2016, July 2016
[2] Rothman, Andy, Matthews Asia, "Cleaning up China's debt," September 2016

As shown in Exhibit 1, China's debt-to-GDP ratio was approximately 160% in 2007. By the end of 2015, it had increased to roughly 250%. While higher than other emerging market economies, China's debt-to-GDP ratio is lower than many of the G-7 nations, and is consistent with that of the U.S., also demonstrated in Exhibit 1. It is important to note the composition of China's debt. The Chinese household debt-to-GDP ratio is low relative to most other developed countries. At approximately 40%, Chinese households are much less levered than U.S. households (80% of GDP) and U.K. households (90% of GDP).[2] The financial products that drove the U.S. financial crisis in 2008 to 2009 do not exist in China; namely, there are no subprime mortgages and very few mortgage-backed securities. In China, homebuyers are required to make a down payment of at least 20% for first homes and at least 30% for second homes.[3] In the U.S., the median first-time homebuyer made a down payment of between 3% and 10% in the lead-up to the financial crisis (2001 to 2008).[4]

Exhibit 1: China's Debt-to-GDP Ratio[5,6,7]



Profit growth and valuation arbitrage, two of the most important sources of returns for PE managers in China over the past decade, have been propelled by strong GDP growth, rapid capital markets expansion, and the high trading multiples of the domestic A-share market (especially the ChiNext stock exchange). However, years of overexpansion have caused corporate debt levels to more than double, and Chinese companies can no longer rely on expanding production capacity to grow revenues. In recent quarters, GDP growth has slowed to less than 7%, reflecting a decreasing rate of population growth and slowing fixed asset investment. It is against this backdrop that operational efficiencies, rather than indiscriminate capacity expansion, will become a top priority for Chinese companies and their investors.

Across Siguler Guff's underlying portfolio companies in China, we have observed that multiple expansion was the key driver of returns from 2005 to 2010. Since then, faced with slowing GDP growth, we have observed many GPs turning their focus towards making operational improvements to drive profits.

We believe that a slowdown in China's economic growth will contribute to a healthier and more balanced economy going forward. Tremendous opportunities exist to invest in industries benefiting from China's "consumption upgrade," such as the consumer, mobile-internet,

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[3] Bloomberg, "China Eases Mortgage Down Payment to 20% for First Homes," February 2016
[4] Federal Housing Finance Agency, A Study of First-Time Homebuyers, October 2013
[5] McKinsey & Company, "Debt and (not much) deleveraging," February 2015
[6] Bloomberg, "China's growing debt problem isn't quite what it seems," August 2016
[7] Bank for International Settlements, September 2016

tourism, leisure, education, and healthcare spaces.

We believe that a more focused economy will help transform traditional manufacturing to a value-added, advanced form of manufacturing, characterized by high barriers to entry and technological expertise. Additionally, technology businesses will also take their cues from the astounding success of internet-based companies, such as Alibaba and Tencent, which have become $100+ billion enterprises in just a few years' time.

INEFFICIENCIES IN PUBLIC MARKETS CREATE AN OPPORTUNITY FOR PRIVATE EQUITY

The underdeveloped financial market has been a factor in the advancement of China's PE industry. Despite more than two decades of progress in the capital markets, bank loans continue to act as the major source of financing for companies in China. The majority of Chinese banks are state-owned and, therefore, most loans are made to state-dominated sectors such as transportation, telecom and energy. As a result, small and medium-sized private companies — the key growth drivers of the country's future economy – have suffered from a significant funding gap. As depicted in Exhibit 2 below, the market capitalization of China's stock market, as a percentage of GDP, is much lower than similarly-sized economies.

Exhibit 2: Stock Market Capitalizations Relative to GDP in 2016

Country	Market Cap (USD Billion)	GDP (USD Billion)	Market Cap as a Percentage of GDP
U.S.[8]	26,497	18,562	143%
United Kingdom[9]	3,732	2,650	141%
Japan[10]	5,011	4,730	106%
India[11]	1,663	2,250	74%
China[12]	3,985	11,392	35%

The volatility of China's stock market over the past ten years illustrates the fact that the country's capital markets have been unbalanced and underdeveloped. The public markets generated strong returns and traded at high P/E multiples when China was enjoying strong, double-digit GDP growth, and companies were aggressively seeking capital for business expansion. The Shanghai Composite Index traded at an all-time high of more than 6,000 in October 2007. However, as the public markets soared, their shortcomings became more glaring. A rigid, approval-based IPO process not only created a limited supply of new listings on the exchanges, but helped to inflate a stock market bubble.

These elements, along with the GFC, contributed to the crash of China's stock market in 2008. The equity market crash only made things worse for companies seeking financing from traditional channels. As the GFC dampened expectations, private companies seeking equity financing in the public markets faced the reality of valuation declines. By November 2016, the price of the Shanghai Composite Index was nearly 50% below its historical high and trading at a P/E ratio of less than half of its record high in 2007, as shown in Exhibit 3.

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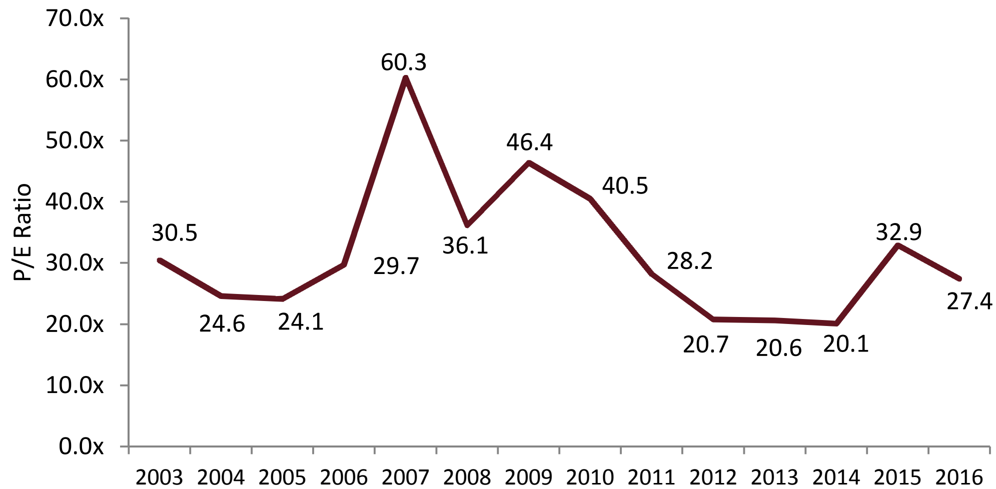
[8] Comprises NYSE and Nasdaq
[9] Comprises London Stock Exchange and Borsa Italiana
[10] Comprises Tokyo Stock Exchange and Osaka Securities Exchange
[11] Bombay Stock Exchange
[12] Comprises A-share Stock Market

Exhibit 3: Shanghai Composite Index Average Annual P/E Ratios



Source: Capital IQ. 2016 data through October 31, 2016

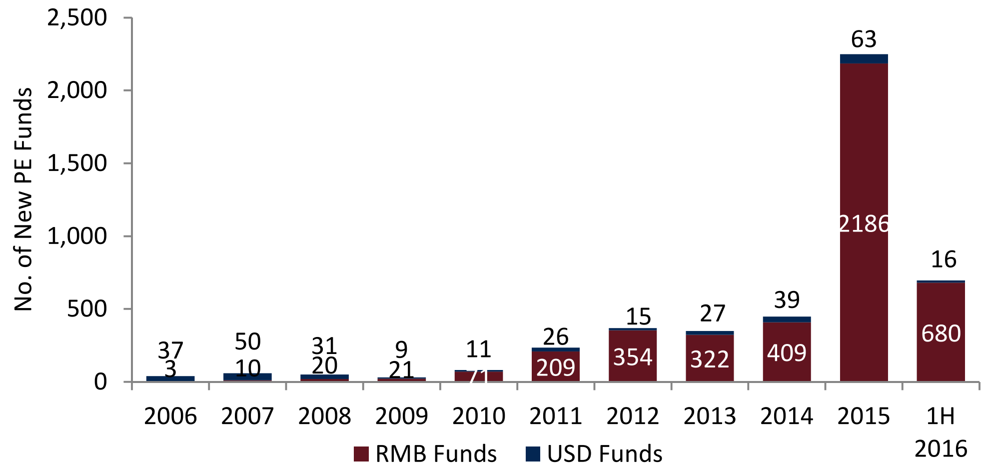
China's rigid IPO policy, in combination with the narrow M&A market and the suspension of A-share IPOs between October 2012 and January 2014, further limited access to capital for companies and also burdened the exit environment for PE managers. Today, despite the reopening of the IPO market, there is a long list of companies still waiting to go public, as well as a great deal of capital "stuck" in the PE ecosystem. The exit environment should improve in the future as the China Securities Regulatory Commission (CSRC) carefully executes market reforms and switches its approval-based IPO listing requirements to a registration-based model. Though volatile historically, as shown in Exhibit 3, valuation multiples of listed companies have generally normalized in recent years.

For these reasons, PE has played a significant role in China by providing equity financing to companies unable to access traditional funding channels. Most of the well-known, fast-growing companies in the private sector (e.g., Mengniu, Focus Media, Alibaba, and Belle) have benefited from capital infusions from PE funds. The ability of PE to close the funding gap has generated outsized returns for investors in the country since the early 2000s.

CAPITAL OVERHANG? YES FOR RMB, NO FOR USD FUNDS

With the influx of PE capital in China, the issue of capital overhang (i.e. too much capital chasing too few deals) emerged in 2009. From 2010 to 2014, over 1,000 new RMB-denominated funds entered the market, as shown in Exhibit 4. Then in 2015, more than 2,000 new RMB funds were set up. RMB fund managers were attracted to the significant valuation gap between public and private companies. Initially, many of these managers were opportunists with little PE experience chasing pre-IPO deals. This phenomenon inevitably drove up valuations, especially in high-growth sectors, as RMB funds had no problem paying high multiples for private companies as long as there was still some room for multiple expansion once those companies went public. As valuation multiples for ChiNext-traded companies started to decrease, and operating performance for many portfolio companies was sluggish due to the macroeconomic slowdown, performance of RMB funds suffered.

Exhibit 4: New PE Funds in China by Denomination



Source: Zero2IPO China VC/PE Market Revuew 1H 2016, July 2016

More recently, the Chinese government has started to play a particularly active role in the PE market. Local, provincial, and national governments have both committed money to and established PE and VC funds. While the GPs of U.S. dollar funds have a fiduciary duty to their investors, investing capital is the end-unto-itself for many of these RMB funds. The primary goal of investing is to support the growth of the country's private sector rather than to generate attractive returns for investors.[13] For example, in early 2016, a group of Shanghai government departments announced that they will begin to partially compensate investors for financial losses on investments made in the city in an attempt to stimulate the local VC environment.[14]

The dramatic increase in the number of RMB funds in recent years has not had a noticeable impact on the performance of U.S. dollar funds. Rather, the performance of U.S. dollar funds has been consistent and strong over the last ten vintage years for which meaningful return data is available. Between 2005 and 2014, Chinese PE & VC funds generated pooled net IRRs greater than 15% for every vintage with the exception of 2009. To put this performance in context, Cambridge Associates' Chinese PE & VC benchmark, which is comprised of U.S. dollar-denominated funds, has outperformed the U.S. PE benchmark by an average of nearly 900 basis points over the last ten vintage years, as demonstrated in Exhibit 5 below.

Exhibit 5: Performance of China PE & VC Funds

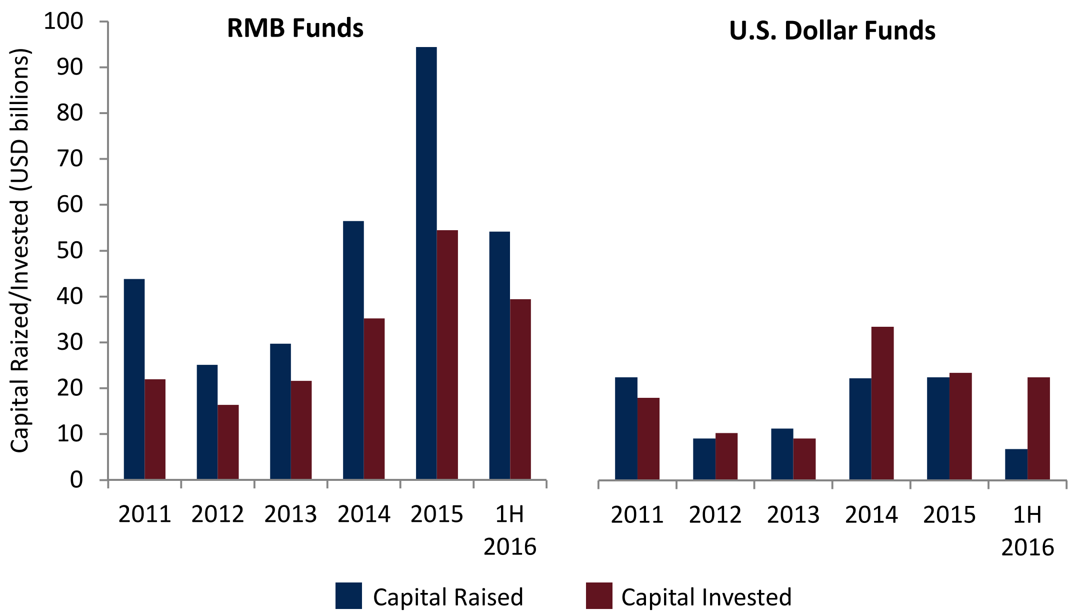
	Pooled Returns From Inception to June 30, 2016		
Vintage Year	China: PE & VC Funds	U.S. PE Funds	China PE & VC Outperformance
2005	20.9%	8.7%	1,218
2006	17.2%	8.2%	893
2007	15.7%	12.0%	376
2008	19.2%	10.4%	878
2009	13.8%	16.8%	(299)
2010	19.6%	13.7%	587
2011	26.7%	13.8%	1,286
2012	15.9%	11.9%	401
2013	20.3%	4.7%	1,558
2014	20.9%	3.1%	1,776

[13] Fuhrman, Peter, China First Capital, "How China's Renminbi Funds Crushed Blackstone, Carlyle, KKR, and Other Global Giants in Private Equity", April 2016
[14] Custer, C., Tech in Asia, "Shanghai Will Start Compensating VCs for Their Financial Losses," January 2016

Source: Cambridge Associates benchmarks as of June 30, 2016

According to data provider Zero2IPO, capital raising for U.S. dollar-denominated funds peaked in China in 2008 with over $44.8 billion raised. Recent fundraising totals remain well below this peak. As shown in Exhibit 6, approximately $23.3 billion was raised by U.S. dollar funds in 2015, and only $7.1 billion was raised during the first half of 2016. For U.S. dollar funds, there is virtually no dry powder (i.e. readily investible PE capital), as over the past five years more capital has been invested than has been raised. For RMB-denominated funds, if the average annual investment pace over the past five years of $30 billion continues, it would take nearly four years for all of the RMB fund dry powder to be invested. The cooling of fundraising is viewed positively, as periods of excess capital overhang can lead to inflated valuations as PE players compete to put their capital to work.

Exhibit 6: Capital Raised and Invested Since 2011



Source: Zero2IPO China VC/PE Market Review 1H 2016, July 2016

TRACKING SHIFTS IN ECONOMIC TRENDS

China's regulatory landscape and competitive PE environment have seen significant changes in recent years. Both GPs and LPs who understand and adapt to these changes have the potential to generate strong returns in the future.

Deregulation

In the past, the Chinese government exercised tight controls in nearly all aspects of the economy. Government control often resulted in high operating costs for businesses, limiting reinvestment and business upgrades. We believe that China's new leadership is committed to economic reform. A key pledge of the current government is to allow the market to play a decisive role in resource allocation. This includes loosening the government's grip on the market and relaxing controls on the financial sector. Announced reforms include reopening the domestic IPO market, interest rate liberalization, deregulation of certain sectors, encouraging mixed public/private ownership structures, greater market access to foreign investors and, perhaps most importantly, the conversion of the IPO process from approval-based to a registration-based system.

Industrial Upgrade

Historically, the Chinese government endorsed an aggressive investment strategy in the industrial sector, resulting in overcapacity and declining corporate profitability. In response, the government has introduced policies to rationalize industries such as steel, cement, coal, solar panels and shipbuilding that are suffering from overcapacity. Moreover, the Chinese government has identified industrial upgrades as a high economic priority to combat low levels of innovation, excessive competition for low-end products, and a lack of advanced manufacturing and technological expertise. This trend should encourage PE investors to continue to invest in high-growth sectors and look for consolidation potential in traditional sectors.

Reforms in IPO System

Significant changes have been proposed to the Chinese IPO market in recent years. Previously, as mentioned above, IPO candidates were subject to a rigorous approval process. Improving the IPO system will give underwriters and market participants more flexibility and move China one step closer to a registration-based system. Under the proposed new system, the CSRC will be responsible only for determining whether applicants have provided full and accurate information prior to listing. The assessment of risks and valuations will be left to the market, similar to the IPO process in most developed markets. This will result in a more consistent exit channel for PE investors, in addition to rational market valuations.

PRIVATE INVESTMENT OPPORTUNITIES IN CHINA TODAY

Historically in China, PE has favored traditional growth-stage companies due to their proven business models, cash-generating ability, measurable business demand, and clear use of proceeds. Since 2010, over 5,000 growth-stage private investments were made in China and total capital invested in growth deals was more than twice the amount invested in venture capital (VC) deals.[15]

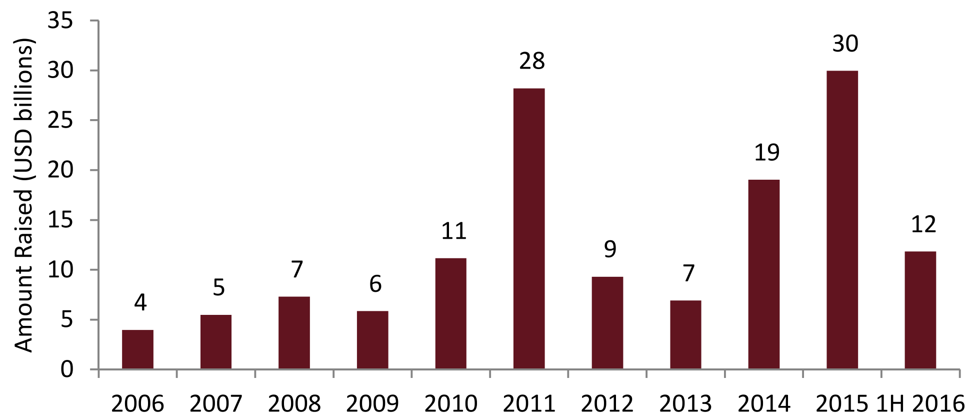
However, in recent years, many PE managers who invested in traditional growth-stage companies have struggled to achieve their target return thresholds. This has forced PE managers to adapt their strategies and to focus on opportunities in early-stage companies in high-growth sectors. For example, the emergence of a number of large internet companies in China has transformed the VC investment ecosystem, igniting competition for early-stage, technology-focused VC firms from later-stage growth investors seeking to cash in on the new wave of China's social, media consumption and consumer behavior.

In the VC space, we have observed that the healthcare and technology/media/telecommunications (TMT) industries have become increasingly popular targets for GPs. In the TMT space, our view is that the mobile-internet category is entering its next phase. Handset volume growth has stalled and smartphone penetration has become increasingly saturated. Mobile traffic growth, the key driver of China's TMT sector in recent years, has slowed. Already, China's internet giants have built comprehensive ecosystems and now control a dominant proportion of user traffic. For example, Baidu, Alibaba, and Tencent currently own nine of the top ten mobile applications in China. Clear winners have emerged in major verticals; for example, Didi in transportation, Taobao/Alibaba in e-commerce, Meituan and Dianpin in food delivery, and Ctrip in travel. Going forward, our view is that the most attractive opportunities in China's TMT space will be driven by the following factors: 1) a transition from the consumption of physical things to experiences; 2) the development of key enabling technologies like smart home, data analytics, financial technology; 3) the identification of new consumer behavior patterns and new areas of disruption by "rebels" from incumbent categories; and, 4) the consolidation of mobile traffic sources and improvement of user stickiness.

[15] Zero2IPO China VC/PE Market Review 1H 2016, July 2016

As China's VC market has matured, we have observed clear fundraising cycles. As shown in Exhibit 7, the VC space has grown dramatically during the last decade. Capital raised in 2011 reached over $28 billion. Then, the market cooled dramatically in 2012 and, since late 2013, we have again seen increasing capital flow into early-stage VC funds, which will likely lead to a new wave of early-stage TMT investments. In 2015, the amount raised totaled nearly $30 billion. It is worth noting, however, that 70% of the capital raised in both 2011 and 2015 was through RMB funds, which are categorized as VC funds but typically, invest in early growth-stage deals or in pre-IPO companies.

Exhibit 7: VC Fundraising in China



Source: Zero2IPO China VC/PE Market Review 1H 2016, July 2016
Note: Zero2IPO has a relatively broad definition of VC, which includes early-stage and early growth-stage funds. As a result, a large number of early-growth/growth capital RMB funds are categorized as VC in this sample.

Over the past five years, we have observed a clear upward trend in valuations of later VC rounds, mostly because of the increased supply of capital for early, growth-stage opportunities. However, only a handful of top-tier VC funds have produced outsized returns in China, and those returns have typically been achieved by relatively few "homerun deals". Such skewed returns make it imperative that investors select disciplined and experienced VC fund managers.

While potential returns for VC investments can be enticing, the risks associated with these investments remain high. For example, there were more than 1,000 Groupon-like companies in China in 2011 when the concept of "deal-of-the-day discounts" emerged. However, fewer than five have survived.

To successfully invest in the region, it is critical to identify GPs that recognize emerging trends, exhibit investment discipline and experience in their sector(s) of focus, and have proven execution capabilities. GPs who invest in specific stages of start-ups should have expertise within their stage of focus, as later-stage start-ups tend to be more competitive due to better performance visibility. On a more micro level, GPs should have the ability to effectively allocate resources in order to optimize portfolio company operations while uncovering the company's market potential. More than just being capital providers, GPs should serve as active advisors providing necessary guidance to their portfolio companies.

ADAPTING TO CHINA'S EVOLVING PRIVATE EQUITY ENVIRONMENT

It is becoming increasingly important for investment teams at growth-oriented funds to have in-depth industry knowledge and operational expertise to support and drive the growth of their portfolio companies. At times, the knowledge and expertise needed to effectively manage portfolio companies must come from outside of the investment firm. Siguler Guff has identified three strategies that traditional growth funds in China are beginning to explore: 1) an operationally-focused strategy; 2) a sector-focused strategy; and, 3) an adaptation strategy, which may include M&A, private investment in public equity (PIPE), and buyout investments.

Operationally-Focused Funds Partnering with Industry Leaders

We have witnessed a trend where PE firms are adding experienced corporate leaders to their staffs. Many of the most successful PE firms also maintain a network of outside operating partners to better execute post-investment plans. In either case, these industry leaders offer valuable and unique operating knowledge that even the most highly experienced investment professionals can lack. Specifically, these leaders know how to accelerate growth in businesses and turn around failing ones. We have seen this strategy implemented in various ways by GPs.

Traditional PE firms tend to hire outside consultants that can aid in business expansion and improvement plans for their portfolio companies. Other GPs have built in-house teams with wide-ranging areas of expertise including human resources, corporate strategy, marketing, supply, and IT management, which portfolio companies can leverage as needed. GPs with in-house teams oftentimes also maintain networks of external operating partners across various sectors that can be tapped to help implement new strategies and add value to portfolio companies.

Specialized Sector-Focused Funds

We have observed an increase in the number of sector-focused funds in the market, especially across the TMT, healthcare, and clean technology sectors. These sectors have become increasingly popular as GPs recognize an opportunity to invest in specialized industries with high barriers to entry. In order to become more specialized, PE firms are adding seasoned professionals with non-investment, sector-specific expertise to their staffs. For example, many of the GPs focusing on the healthcare sector have medical backgrounds themselves and/or hire investment team members with extensive medical backgrounds.

Our general observations suggest that firms with sector-focused investment strategies communicate and make investment decisions more efficiently than generalist funds. On the other hand, generalist funds benefit from broader deal flow and have more flexibility to reallocate capital as the investment climate changes. Sector-focused funds may occasionally also have to tolerate higher prices given their sector focus constraints, whereas generalist funds might pass on a particular investment if the valuation reaches a critical threshold. Interestingly, we are seeing a trend where generalist funds are becoming more sector-focused, with many of these funds becoming more disciplined with regard to their target industries.

In particular, Siguler Guff finds the dynamics of the healthcare sector attractive for a PE investor. First, it is both difficult and expensive for an investor to gain exposure to the sector through listed securities. Public indices in the emerging markets are significantly underweight in their exposure to healthcare. Such a scarcity has led to fairly rich valuations among listed healthcare companies. For example, the healthcare companies listed on the Shanghai Stock Exchange traded at an average P/E multiple of more than 80x as of December 2016.[16] This compares to an average P/E multiple of approximately 30x for healthcare businesses on the New York Stock Exchange. Furthermore, even in markets where highly-priced listed companies exist, they tend to be concentrated in certain subsectors, like pharmaceuticals in China.

The healthcare sector in China is growing and is forecasted to continue to grow at a rate well above the country's GDP growth as China's aging population demands international-caliber drugs and medical services. In a 2016 report, the International Trade Administration projected that total healthcare expenditure in China will reach $1.1 trillion by 2020, up from $640 billion in 2015, representing a compound annual growth rate of 11.4%.[17] Certain subsectors are forecasted to

[16] CapitalIQ, December 2016
[17] International Trade Administration, 2016 Top Markets Report: Pharmaceuticals, 2016

experience higher growth rates. For example, the medical devices market is projected to grow 14.0% annually between 2013 and 2020.[18]

Furthermore, the chronic health issues and diseases in the emerging markets are increasingly similar to those in developed markets. There is an evident trend of lifestyle-driven disorders such as cardiac diseases, asthma, diabetes, cancer, and behavioral issues. Treatment for these disorders is often lengthy and leads to long-term patient-treatment relationships, which make the economics of treatment attractive to pharmaceutical and hospital businesses. Driven by higher disposable income and broader coverage of commercial insurance in China, there has been a gradual shift from generic drugs and traditional Chinese medicines towards Western drugs with immediate and higher efficacy.

Slow and burdensome regulatory approval in the past has shut out many of the internationally best selling drugs today. Growing public demand for safer and more effective drugs has placed great pressure on the Chinese FDA and the social insurance system for reform. Due to the fast rising healthcare spending, the government is pressured to find high-quality local products to replace expensive globally-priced innovative drugs.

In recent years, there has been a noticeable increase in the caliber of medical innovation in China. This has been driven in part by Chinese entrepreneurs who return to China from abroad with ambitions to create new products and/or drugs in China. In 2015, there was a significant acceleration in the regulatory process for local innovative drug manufacturers that are able to demonstrate the ability to develop new drugs with similar efficacy rates to their multinational counterparts. Siguler Guff has positioned itself to benefit from the growth in the healthcare space by partnering with healthcare-focused GPs that invest across various subsectors within the industry.

New Approaches Adopted by Traditional Growth Funds

M&A

With organic growth becoming more challenging to achieve, traditional growth funds have started to use M&A and cross-border strategies to accelerate growth in portfolio companies. This practice is relatively new and is still largely unproven for Chinese companies. The risks associated with M&A in China lie in the integration process after the merger. Data on Western PE funds show that only 30% of acquisitions are ultimately successful. In China, we know the challenges are even greater as a result of the potential for opaque financial reporting and embellishment of selling stakeholders during negotiations.

Cross-border transactions entail additional risk, as they attract extra regulatory scrutiny, and can provoke cultural conflicts and operating team issues. Encouragingly, traditional growth funds have started to strengthen their internal expertise and operating teams to execute such M&A deals.

PIPEs

In certain traditional sectors, public companies can present lower valuation multiples and better established operations, making them attractive targets for private investment. The most astute GPs have been able to benefit from this strategy. In order to succeed, GPs must maintain discipline, structure deals directly with corporations, and insist on favorable terms. These terms may include higher structured returns, more current pay, equity-debt hybrid securities, influential governance within the company, and more flexible exit opportunities.

Buyouts

Buyouts are beginning to present a unique investment opportunity in China. In the past, few "true" buyout opportunities existed, and the ones that did not attract much attention. The lack of buyout opportunities was driven, in part, by entrepreneurs unwilling to sell a controlling stake in

[18] BCG Analysis, Winning in China's Changing Medtech Market, July 2014

their businesses while valuations were increasing. GPs did not often pursue these transactions given the abundance of other compelling investment opportunities available, namely high-growth companies that were in need of expansion capital. Buyout transactions are typically more complicated and require more resources to complete.

Further, PE firms risked being rejected as energetic entrepreneurs saw the potential for higher profits by remaining independent. For PE firms with the appetite to acquire these companies, the investments could backfire without a team of experienced professionals to manage the businesses. Combining all of these factors, the risk-reward ratio did not justify such ventures on a large scale.

Moreover, there have been few success stories across buyout deals in China. One issue was that that PE funds usually adopted the traditional buyout model, which often entailed overwhelming operational demands that PE managers did not have the expertise to handle. Frequently observed issues included hiring “parachuted” professional managers with little local experience, misaligned economic interests, and ill-defined roles for the owner/founder of a buyout deal.

However, as the market environment has evolved, buyout transactions in China (at varying degrees of debt and in various forms) have experienced steady growth over the past few years. According to Zero2IPO, capital invested in buyout transactions in China increased from $582.0 million in 2012 to $2.8 billion during the first half of 2016.

We believe the following factors make buyouts attractive in the next chapter of PE in China:

- Former growth companies entering a stage with bottlenecks or constraints for further growth
- Succession issues with first generation entrepreneurs
- Increasing availability of professional managers
- Multiple arbitrage between different capital markets creating opportunities for take-private deals
- Government push for industry consolidation, especially in traditional manufacturing sectors
- The need to deploy more capital per deal for large PE funds
- Increasing access to leverage (though still limited)

Consequently, we believe the buyout market in China will soon become a viable standalone investment category. There are certain growth funds in China starting to emphasize the need to make at least one buyout investment during their fund’s life. Those managers that understand this trend and seize the opportunities accordingly could replicate the success of growth funds in the early 2000s.

CONCLUSION

As the PE industry in China adopts a new development model amid a slowing economy, we believe that both challenges and opportunities lie ahead for investors.

Certainly, the low-hanging fruit is gone, and GPs cannot rely on the macroeconomic tailwinds that enabled them to invest and generate returns across the board in the past. Nevertheless, we believe that GPs with adaptive investment strategies, strong operational skillsets, and sector-focused resources will be able to achieve risk-adjusted returns in China’s transforming economy.

Likewise, it has never been more challenging for institutional LPs to allocate capital to PE opportunities. We believe that the key to success for LPs is to have historical perspective, in-depth knowledge of and experience within the local market, a deep-rooted local presence, and a fresh outlook when evaluating both established and emerging GPs. LPs who are able to successfully navigate the changing landscape will continue to be successful PE investors in China.

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