PitchBook

Private Equity in China

An overview and analysis of trends shaping Chinese PE activity

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Credits & Contact

Analysts
DYLAN COX Senior Analyst, PE Lead
dylan.cox@pitchbook.com
DARREN KLEES Data Analyst II

Contact PitchBook
pitchbook.com

RESEARCH
reports@pitchbook.com

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Key takeaways

- Within China, PE funds denominated in Renminbi (RMB) enjoy considerable advantages over those denominated in foreign currencies (most commonly USD). However, RMB-denominated vehicles fell to just 7% of new fundraises in 2018, due in part to the nationwide deleveraging campaign and crackdown on shadow banking.
- In a departure from its "going global" initiative of the past decade, the Chinese government recently forced divestitures from some of its biggest conglomerates, including Anbang, Dalian Wanda, and HNA. While most of these early divestitures involve overseas real estate assets, they could be a bellwether for further divestitures and carveouts (both on the mainland and elsewhere), creating buying opportunities for PE funds.
- Investing in China poses a multitude of risks for foreign GPs and acquiring companies, most notably the pervasive influence of Baidu, Alibaba, and Tencent (BAT), as well as a potential resurgence of state-owned enterprises.

Note: Throughout this note, we will use terms such as Chinese PE and China-focused funds to refer to funds based in Greater China, regardless of the parent firm's headquarter location. For the purposes of this note, Greater China includes mainland China, Hong Kong, Macau, and Taiwan. These funds may have mandates to invest outside of Greater China.

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Introduction

As part of our most recent Private Equity Outlook, we predicted that fundraising for China-focused funds would continue growing in 2019. As a rationale for this prediction, we wrote:

"Investors demand exposure to the Chinese economy—and private markets are no exception. Meanwhile, GPs recognize China and other developing economies as fruitful opportunities to launch new strategies and grow AUM. In terms of capital commitments, PE fundraising for China-focused funds more than doubled from 2017 to 2018."

We also listed a few reasons why we might be wrong:

"Ongoing geopolitical tensions may make investors hesitant to enter PE's multi-year partnerships. 2018 has proved to be a poor year for most emerging markets (including China) in terms of public equity returns and currency depreciation relative to the USD. Given the relatively small size of the Chinese PE market, many LPs may have fulfilled their allocations in last year's fundraising surge."

In this note, we'll explore some of these points further as well as give an overview of what we believe are some of the most important risks and opportunities for PE firms investing into the region.

Domestic versus foreign funds

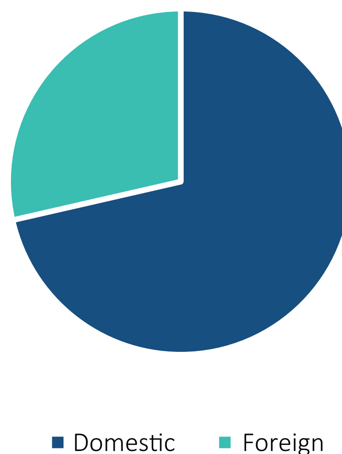
Contrary to the perception that Chinese PE is dominated by well-established firms from the US and Europe, domestic funds (i.e. by firms headquartered in Greater China) have been one of the key drivers of growth over the last decade. Domestic funds generally account for more than two-thirds of new offerings in the region, though there are more recent reports that domestic funds have been shutting down at a rapid pace due in part to the recent deleveraging campaign and crackdown on shadow banking.[1] In any case, foreign (mostly US-headquartered) investors still account for an outsized proportion of capital raised. The Carlyle Group, KKR, and TPG have each raised more than $15 billion in Asia-focused (and China-headquartered) funds since 2000, and together non-Chinese firms accounted for more than half of capital raised in 2018.

A change in the mix of foreign versus domestic PE funds, and therefore how many vehicles are denominated in RMB versus foreign currencies, could have major implications for how these funds can invest in the region. Just 7% of funds were denominated in RMB in 2018, among the lowest levels in the last decade. Much of this decrease has come from the unwinding of domestic PE firms (which tend to raise funds denominated in RMB) following the aforementioned deleveraging campaign. Going forward, however, we expect non-Chinese firms to pursue a similar mix of RMB versus USD (or other) denominated funds given that many of the benefits to raising a fund in RMB remain intact. A few of these benefits—which are mostly related to having access to domestic stock exchanges—are outlined below:

- RMB funds benefit from less regulatory oversight, greater exit options, and fewer restrictions on sectors in which they can invest.
- Two stock exchanges were launched in the last decade (ChiNext in 2009 and the National Equities Exchange and Quotations exchange in 2012) that expand exit opportunities for RMB funds.
- Currently the government does not allow firms with foreign backing (i.e. non-RMB funds) to exit via IPO on domestic exchanges.

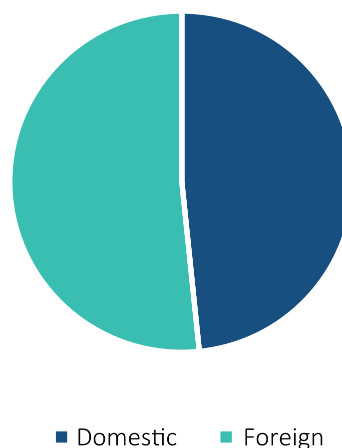
1: "China private equity funds suffer wave of closures," Financial Times, Gabriel Wildau & Yizhen Jia, August 5, 2018

2018 Chinese PE funds by GP HQ (#)



Source: PitchBook

2018 Chinese PE funds by GP HQ (capital-weighted)



Source: PitchBook

Select list of open and upcoming funds

Investor name	Fund name	Fund type	Target fund size ($M)
CVC Capital Partners	CVC Capital Partners Asia Pacific V	Buyout	$4,000
Centurium Capital	Centurium Capital Partners 2018	Buyout	$1,900
Ping An Insurance (Group) Company of China	The Ping An Global Voyager Fund	Buyout	$1,000
C-Bridge Capital	C-Bridge Healthcare Fund IV	Buyout	$800v
Hopu Investment Management	Hou An Innovation Fund	Buyout	$800
Longreach Group	Longreach Capital Partners 3	Buyout	$650
PAG	PAG China Growth Fund	PE growth/expansion	$500
Yao Capital	Yao Capital Fund	Buyout	$250
Loyal Valley Capital	LVC USD Fund II	Buyout	--
Morgan Creek Capital Management	Morgan Creek New China Fund	PE growth/expansion	--
U.S.-China Green Fund	U.S.-China Green Fund II	Buyout	--

Source: PitchBook

Note: In instances where the fund has stated a target range, the upper end of the range is given here.

A quick glance of open and upcoming funds in the region reveals investors—both domestic and foreign—are continuing to target larger sums. CVC, a British firm with its headquarters in Luxembourg, is aiming for $4 billion for its fifth Asia-focused fund, above the 3.5 billion it raised for the same strategy in 2014 (though still below the $4.1 billion it raised just prior to the financial crisis). On the domestic side, Centurium Capital, based in China and led by former Warburg Pincus China head David Li, is targeting $1.9 billion for its debut fund, focusing on consumer and healthcare investments in China.

Regardless of a GP's headquarter location, there are a few key developments—leading to both opportunities and risks—that we believe all investors should keep in mind.

Top North America- and Europe-headquartered investors by capital raised for China-focused funds*

Investor name	Capital raised ($B)
The Carlyle Group	$21.2
Kohlberg Kravis Roberts	$19.8
TPG Capital	$16.5
Bain Capital	$11.1
CVC Capital Partners	$10.3
The Blackstone Group	$2.9
Goldman Sachs Merchant Banking Division	$2.5
Warburg Pincus	$2.0
EQT	$1.7
Intermediate Capital Group	$1.4

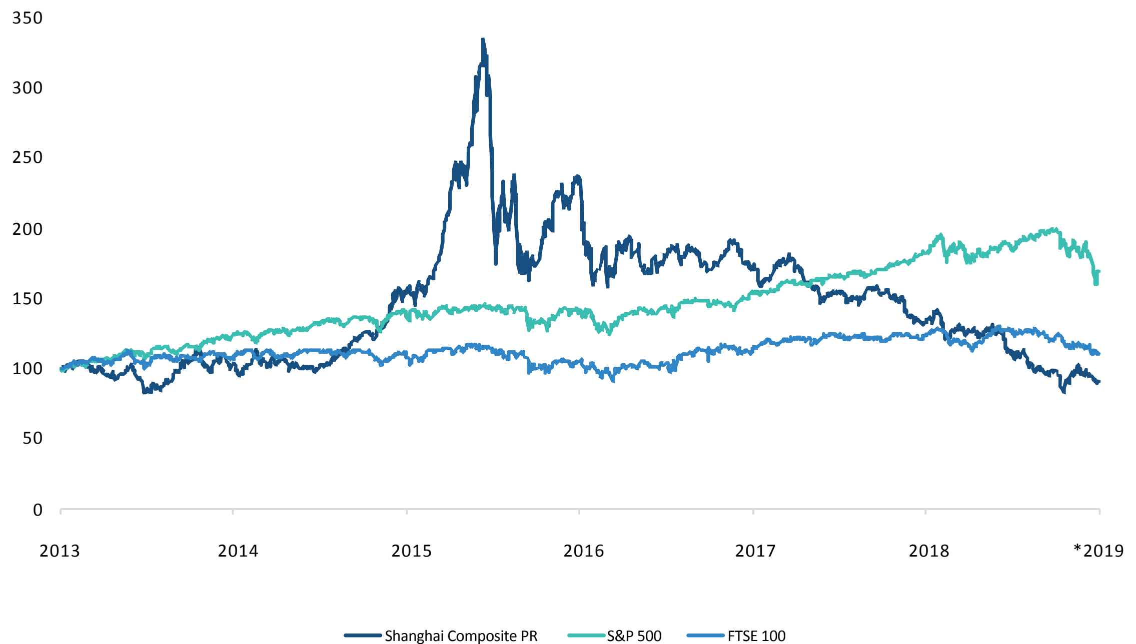
Source: PitchBook
*From 2000 to March 6, 2019

Opportunities

Recent slide in public equities

The Chinese stock markets had a terrible year in 2018; the Shanghai Composite Index fell by more than 46.3%. And while they have recovered somewhat in the first two months of 2019, equities remain well below their level this time last year. The tumultuous period was not new for Chinese equities, as the market has historically been highly volatile and has seen several substantial drops in recent years. We pointed to a slide in developing-market equities last year as a reason that LPs might think twice about allocating to those regions, but lower valuations will also create opportunities for PE firms to take stakes in publicly held firms or to take them private altogether. Similarly, lower public equity valuations are likely to depress private market valuations for comparable firms.

Performance of Shanghai Composite Index versus other major indices (re-based to 100)



Source: Morningstar
*As of December 31, 2018

Breakup of conglomerates and deleveraging campaign

In a departure from its "going global" initiative of the past decade, the Chinese government recently forced divestitures from some of China's biggest conglomerates, including Anbang, Dalian Wanda, and HNA. While most of these early divestitures involve overseas real estate assets, they could be a bellwether for further divestitures and carveouts (both on the mainland and elsewhere), creating buying opportunities for PE funds. Along the same lines, the much-publicized deleveraging campaign taking place across China has the potential to create mispricings either through forced divestitures or at companies in need of equity financing to help recapitalize their newly scrutinized balance sheets. Carveouts and divestitures have become prime targets for deal sourcing in North America and Europe, accounting for nearly 12.1% of buyouts last year.

Approval of foreign investment law

Shortly before this report went to press, the Chinese government approved a new law concerning foreign investment in the country. While details are still scant, it reportedly allows other countries to participate in its Belt and Road Initiative, as well as repeals the requirement that foreign entities share intellectual property with domestic partners (aka "forced technology transfers"), among other considerations. Implementation is likely contingent upon resolving ongoing trade disputes with the US, but this will almost certainly be a consideration for foreign PE firms going forward.

Note: The remainder of this section appeared first in Venture Capital in China, written by PitchBook VC analyst Alex Frederick.

Growth of China's economy

China's GDP was $12.2 trillion in 2017, closing in on the size of the US. The Chinese government has invested heavily to prioritize the development of the domestic economy. GDP growth was in the double digits in the last decade and has continued to grow at 6%-8% annually over the past six years (6.9% in 2017), with a slow decline in growth projected by the IMF through the next five years.[2] Investment is one way the government encourages economic growth through avenues such as government guidance funds. We expect continued government investment as well as increasingly investment-friendly policies to be enacted as the government pulls levers to continue GDP growth.

New wealth spawns wave of consumers and investors

Economic development in China has led to a sharp growth in the size of China's middle class, rising from roughly 3 million in the 1990s to over 500 million today, just 20 years later. This puts China's middle class roughly on par with that of the US, with more growth on the horizon. Rising wealth continues to change spending habits, with consumers earning more disposable income. As Shaunak Mazumder of Morningstar notes, "Growing nations that have seen their GDP per capita grow rapidly over time from $5,000 to over $10,000 experience a similar change in population spending, from basic needs such as food, clothing and housing, towards insurance, education, healthcare, travel, banking and other services."[3] The group above the middle class is beginning to swell too. According to a report by consulting firm Capgemini, China's high-net-worth-individual population increased 11.2% in 2017, reaching 1.3 million people with investible assets over $1 million.[4] Chinese investors have limited attractive investment options. Domestic stock markets have high volatility, and the government limits foreign currency exchange (thus all foreign investment) to $50,000 per person annually. This makes investing in domestic (or foreign-owned, RMB-denominated) private markets an especially attractive vehicle to diversify and grow assets.

2: "China: Growth Rate of Real Gross Domestic Product (GDP) from 2011 to 2023," Statista, January 2019
3: "Profiting from China's Growing Middle Class," Morningstar, Shaunak Mazumder, June 15, 2018
4: "Capgemini's Asia-Pacific Wealth Report 2018," Capgemini, Sam Connatty, November 28, 2018

Risks

Baidu, Alibaba, Tencent (BAT)

A note on Chinese PE would not be complete without at least acknowledging Chinese internet giants Baidu, Alibaba, and Tencent (collectively known as BAT). Together, BAT has a market cap of $956.4 billion (Baidu with $56.4 billion, Alibaba with $476.4 billion, Tencent with $415.6 billion as of February 28, 2019). They have expanded into nearly every part of Chinese tech (ecommerce, AI, gaming, healthcare, payments, etc.) and have made countless investments into other subsidiaries (the Financial Times estimates this figure to be over 1,000 companies).[5] The trio has close ties to the Chinese government and can even affect industry incumbents in non-tech sectors. In a recent report on China, KKR noted that "by being part of the BAT network and infrastructure, several companies ... are quickly emerging as almost preordained winners, often at the expense of incumbent companies in the more traditional consumer categories (many of which are multinational players)."[6] Being part of this network can be crucial—no matter which sector a company competes in—given the unprecedented reach these platforms have with consumers.

Potential for resurgence of SOEs

After decades of growth fueled largely by private enterprise and the creation of special economic zones, Chinese leadership recently changed its tone regarding the role of private enterprise in its economy (notwithstanding the recently announced foreign investment law profiled in the opportunities section of this report). At least 46 private companies agreed to sell shares to SOEs in 2018, which is significant given that the prevailing trend had been for SOEs to sell stakes to private investors.[7] It is quite difficult to tell just how resurgent these SOEs will be, and investors should be especially prudent when evaluating companies that may be competing with an SOE (see "lack of regulatory transparency" below). The Chinese government has implemented or announced various pro-domestic policies, such as Made in China 2025, exemplifying the party's emphasis on state- or China-owned businesses.[8] This, in turn, could lead to future regulation, which makes it more difficult for foreign entities, including PE firms, to remain active in the region.

5: "China is winning the global tech race," Financial Times, Michael Moritz, June 17, 2018
6: "China: A Visit to the Epicenter," KKR, Henry H. McVey, August 7, 2018
7: "Private Businesses Built Modern China. Now the Government Is Pushing Back," The New York Times, Li Yuan, October 3, 2018
8: "What is Made in China 2025 and Why Has it Made the World So Nervous?," China Briefing, Melissa Cyrill, December 28, 2018

Note: The remainder of this section appeared first in Venture Capital in China, written by PitchBook VC analyst Alex Frederick.

Regulations and government oversight

Government oversight is a major factor that affects all stages of private capital investments in China. Regulation of VC and PE is primarily handled by the China Securities Regulatory Commission (CSRC) and the China Asset Management Association (CAMA). Local governments administer their own regulations as well. While central government regulations limit investment and exit options, opaque and selectively enforced local policies present the largest risks to investors.

Lack of regulatory transparency

One significant challenge to investing in China is the lack of predictability and transparency in the Chinese business environment.[9] For investors and operators, an inconsistent interpretation and application of laws and regulations presents a substantial risk. Regulations may see stricter enforcement due to recent political or economic events or might be selectively enforced given the presence of a competitor firm with stronger ties to government officials. One reason many parties choose to partner with SOEs and other government entities is to better navigate opaque regulations.

Evolving contracts

Unlike in western countries, contracts in China are not set in stone and are treated as evolving documents. Continued negotiations and changes to these documents are expected as the business evolves. This will likely come as a surprise to foreign investors who expect consistency and stability in the agreement.[10] It may come into play when reviewing the client contracts held by portfolio companies or investment opportunities. Investors will be best served by expecting and preparing for these revision requests.

9: "Outbound Investment from China and Private Equity Investing in China," Simon Luk, March 7, 2013
10: "Venture Capital in China: High Technology Investing in an Emerging Economy," David Ahlstrom, Kuang S. Yeh & Garry D. Bruton, 2007

Overestimating market size

Contrary to the popular conception that China is a single market opportunity of nearly 1.4 billion consumers, the country is in fact composed of 34 (including Taiwan) distinct provinces, each with unique consumer behavior and economic considerations. Based on the regionalism concerns addressed previously (see: Regulations and government oversight), market sizing is more challenging than at first glance. It's true that a 1.4 billion population with a rapidly growing middle class presents an immense market opportunity, but domestic trade barriers and localized regulations add frictions that likely shrink most opportunity sizes.

Investment sector limitations

Foreign investors are limited in the sectors in which they can invest. Recently, regulations have begun to loosen up in some sectors that are less sensitive to government oversight. Sectors of high sensitivity and regulation include media and content, culture, financial services, and social networking. Big Data and IT infrastructure are also highly regulated. The financial sector is one area that is loosening up, fueled by the government's eagerness to attract more capital and boost the economy. Local banks were recently permitted to accept foreign investment.[11]

Exit market considerations

Worth mentioning on its own, exit paths for Chinese portfolio companies are limited, depend on investor fund structure, and involve intense government oversight and onerous restrictions. Most founders prefer to go public in the Hong Kong stock market because it is well regulated, international, and close to home markets. The Hong Kong stock market (HKEX) recently added dual-class shares.[12] This is attractive to technology companies that have shares with different voting rights that were previously barred from the exchange. Unfortunately, HKEX has not been performing well over the past year. Most companies on the exchange have dropped in value from their IPO price. The Hong Kong market is known to be volatile, although less so than China's domestic stock markets (SSE & SZSE).

11: "China Pledges to Allow More Foreign Investment in Financial Sector by Year-End," Reuters, Kevin Yao, April 10, 2018
12: "Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans," Bloomberg, Benjamin Robertson, April 24, 2018

Aside from volatility, the Chinese stock markets are heavily regulated, and the IPO approval process is long and unpredictable. Qualification requirements can be subject to short-term policy concerns, adding to the unpredictability. Many companies wait two to three years for CSRC approval. IPO registrants are required to meet collateral requirements, which can be a challenge for asset-light software firms. Due to these restrictions, foreign exchanges are often considered as a backup option. To that end, the second-most desirable markets are the major US stock markets. When listing on foreign exchanges, some companies conduct a full overseas listing, and others opt for reverse mergers. Historically, the frequency of reverse mergers has been closely tied to the changing IPO policies of the CSRC.[13] Reverse mergers are less ideal because they add excessive costs and uncertainty for investors.

One last area worth addressing is Hong Kong's and China's Stock Connect program allowing foreign investors to purchase equities on domestic exchanges through "A-shares." Launched in 2014, A-shares have become an exciting path for retail investors to invest in mainland companies. This program does not appear to have had an impact on exit options because most companies continue to list on Hong Kong or foreign exchanges. China has attempted to lure large Chinese tech firms (e.g. Baidu, Alibaba, JD.com) back to the domestic markets through the creation of Chinese Depositary Receipts (CDRs). These bank-issues certificates allow foreign-listed stocks to be listed on China's domestic markets. Thus far, the major tech firms have reportedly resisted listing via CDRs.[14]

13: "The Cost of China's IPO Regulations on the Functional Efficiency of Its Financial System," VoxChina, Charles M. C. Lee, Yuanyu Qu & Tao Shen, November 1, 2017
14: "Alibaba postpones its CDR offering," TechNode, Emma Lee, July 3, 2018