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Research on the Exit Routes of Chinese Private Equity Funds

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Abstract

Up to the present, private equity (PE) is a relatively new financial instrument in China. Due to the rapid growth of Chinese economy, a great number of domestic and overseas capitals had participated in PE business in recent years. PE usually claims back the funds from the investment after earning satisfactory profits. The primary exit routes for PE include IPO, write-offs, Management Buyout (MBO), repayment of shares or loans and sold to other venture capitals or financial institutions. Among these strategies, IPO has always been the dominant exit routes for PE. Nonetheless, PE faced a few obstacles withdraw the funds from investment through IPO in China lately, such as the bad performance of domestic stock market and the tight monetary policy. Accordingly, PE should consider further the effectiveness of these routes when reclaiming the funds from the investee companies.

Keywords: Research, Exit, PE, IPO, M&A, MBO, Transfer

1. Circumstance of current Chinese Private Equity

Private equity (PE) is an asset class consisting of equity securities in operating companies which are not publicly traded on a stock exchange. PE is a fairly new financial instrument in China and developing extremely rapidly recently. Numerous domestic and overseas capitals have been rushing into the industry in recent years. However, the industry is lack of a systematic legal environment and formal regulations, especially in the aspect of exiting. After the new Partnership Business Law (PBL) was promulgated on 1st June 2007, a number of new limited partnership PE have emerged in Chinese financial market. These limited partnership PE which had existed and been operated effectively in western countries for long are fairly fresh and popular in China presently. Compared with other sorts of privately offered funds (POF) in Chinese financial market, limited partnership PE performed much more actively and flexibly. Most of privately offered funds in China not only invest in secondary market, but also are involved in private placement, strategic allotment, private equity investment, etc. However, nearly all the limited partnership privately equity funds in western countries has a promissory duration of operation. These POF would exit the market on the date of maturity to pay back the limited partners as investment returns. Moreover, as an important form of privately offered funds, PE usually reclaims the funds from the investment after gaining satisfactory profits. Thus, the exit routes of Chinese limited partnership privately offered funds, and especially PE should be researched in advance to prevent a chaotic phenomenon in future.

Chinese POF used to operate primarily in two different models which are account management model and trust plan model before the promulgation of the new Chinese Partnership Business Law. In the account management model, investors usually open an account with a stock broker in the name of themselves firstly. Then the funds managers will act on behalf of the investors to manage their accounts. If the net value of investment has lost more than a certain percentage, say 10%, investors is permitted to end the clientage unilaterally. Oppositely, the profit exceeding 10% will be distributed at a promissory ratio. Most of petty POF are operating in this model, and main investors are from funds custodians' relative or friends. Because such type of POF is short of legal safeguard, both investors and custodians could not appeal to court if their benefits had been infringed. On the contrary, a great number of POF with huge amount of capital may raise funds and invest collectively in the way of trust plan (Yang Jingjing, 2008). Hence, it is a fairly regular POF model at present. Compared with the circumstance in China, limited partnership PE is the dominant form of PE in developed countries, especially US. A majority of PE in China are running in this way before the new PBL was enacted on 1st June 2007.

Nowadays, PE is crucial to the capital markets overseas. For instance, according to the statistics of KPMG, the gross monetary amount of M&A is 1300 billion US dollars from Jan 2006 to November 2006 in US. 35% of them were supported by PE (Ba Shusong, 2007). As a prosperous financial industry, PE also plays a more and more significant role in current Chinese capital market. 12 domestic PE had established in 2007 compared to the only 6 new PE appeared in 2006. These 12 funds had risen 3.73 billion US dollars which had gone up by 145.9 percent in 2007. Additionally, in all 12.818 billion US dollars had been invested in Chinese mainland by PE in the past year. In terms of industrial distribution, the Broad IT industry continued to lose weight in the total equity investment. Oppositely, the Traditional and Services industries became hot investment sectors in the year 2007.

In 2007, Chinese PE industry had changed quite a lot, especially in the aspect of investment strategy. On the one hand, more and more PE became interested in investing their funds on bridge finance and PIPE (private investment in public equity). In 2007, 22 investments had been taken place in the form of Pre-IPO capital compared with only 11 in 2006. For instance, the investment of 100 million US dollars made by Carlyle Group in New Century international hotel management limited company was accomplished through the way of bridge financing in 2007. Besides that, Merrill Lynch, Deutsche Bank and Temasek Holdings also had invested 400 million US dollars in Heng Da real estate group while Heng Da planed to list in Hong Kong Stock Exchange. In addition, 22 PE had invested their funds in the form of PIPE in 2007 in contrast with only 19 in 2006. On the other hand, few PE had made their investments in the form of Mezzanine Capital and turnaround in 2007. 9 investments of 843 million US dollars which are 6.6% of total amount of the year occurred in 2007.

2. Obstacles of claim back the funds through IPO

From the late 2007, Chinese stock market has been performing much more like a bear market. Shanghai Security Index has felt from the top 6124.04 in 16 October 2007 to 3271.29 in 2 April 2008. Consequently, investing on stock market has not been the merely leading investment strategy of domestic POF at present. Thus, Private equity has become the principal investment channel for domestic POF lately. 94 PE had withdrawn funds from the companies invested in 2007. 84% of these, which are 79 cases had reclaim the funds through IPO. In addition, some of investors of other 9 PE decreased their shares to exit. Investors of 5 PE sold their shares to other investors to claim back the funds. Besides, only 1 PE quit the market by M&A in 2007. Take United States for example, American PE usually exits from the market within 5 years at present. The primary exit forms include IPO, management buyout (MBO), write-offs, repayment of shares or loans and sold to other venture capitals or financial institutions. IPO is an extremely popular way for these funds to exit the market. Similarly, IPO is also the most ideal route for PE to claim the money for the moment. On the one hand, one of the best news for PE to exit the investment in domestic enterprises is that the Second Board Market which is also called Growth Enterprises Market in China will open within 2008. According to the current listing requirements of Medium and Small Size Board, to be listed on Shanghai and Shenzhen Stock Exchange, a company is expected to demonstrate earning power of aggregate profit for the last three fiscal years of 300 million Chinese Yuan together with a minimum in the most recent fiscal year of 50 million Chinese Yuan. Additionally, all three years must be profitable. Compared with the main board, the requirement of profitability and other financial factor will certainly be much lower. Based on current media report, the requirement of aggregate profit for enterprises listed on Second Board would be minimum 10 million Chinese Yuan for the last three fiscal years. Besides that, the requirement for stock volume would be not less than 15 million shares before listing. Obviously, the emergence of Second Board would be highly advantageous to PE.

On the other hand, according to the agreement of cooperation on financial service sector concluded after the third China-U.S strategic economic dialogue on December 2007, China Security Regulatory Commission (CSRC) will evaluate the influence of foreign capital holding shares in domestic security companies (Gao Qin, 2008). After the evaluation, CSRC will offer a policy proposal for adjusting the authorized proportion of foreign capital share participation in domestic security companies. Furthermore, qualified foreign investment companies and banks are permitted to issue shares in Chinese Yuan on Shenzhen and Shanghai stock exchange.

Nevertheless, there are still a few barriers for PE to reclaim the funds from the investee companies through IPO. First of all, the exact number of companies permitted to list on Second Board every year is still unknown. Consequently, what is certain is that numerous domestic small and medium size companies with shares held by PE may not make their dream come true in the near future. Additionally, the performances of both Shanghai and Shenzhen stock market will be doubtable under the pressure from the issuing of restricted shares. Based on current data, in all 412 listed companies announced the reduce stake from 2006 to 1st April, 2007. Furthermore, among all these listed companies, 83 companies declared having sold initial offering more than 30% of total share capital.

Moreover, the reduce stake of restricted shares commence to reach a climax in 2008. As estimated, 118.127 billion, 663.742 billion and 121.321 billion restricted shares will come into the market in year 2008; 2009 and 2010. The market value of Shanghai and Shenzhen stock exchange was approximately 7556.574 billion Chinese Yuan. In term of current price level, the market value of two stock exchanges will be 9314.981 billion Chinese Yuan at the end of 2008.

In addition, the market value will increase by 66.10% to 6157.79 billion Chinese Yuan in the end of 2009. In the end of 2010, the market value of two stock exchanges will increase by 43.27% to 22285.494 billion Chinese Yuan. It is almost 3 times than current market value (Chang Yan, 2008).

To make matter worse, tight monetary policy is adopted by Chinese government to attain a soft-landing of domestic economy. Hence, these PE would face the problem of insufficient capital when exiting the investment market by IPO. Furthermore, the whole procedure of IPO usually takes probably 18 months in China. The condition of domestic stock market after 18 months is too unclear to be forecasted. Moreover, it has been more and more difficult for domestic companies to be listed overseas since the Ministry of Commerce had been endowed with the authority of permission for domestic companies offering shares overseas through the documentation of the regulation on merger and acquisition for foreign investors in China issued on 8th September 2006. Numerous early VC (Venture Capital) and PE active in China had oversea background, so that IPO overseas used to be the most ideal way to exit. The first-day return of IPO in Hong Kong is 6.37 which is the highest among all IPO overseas in 2007 (China Venture, 2008). Nevertheless, more and more PE in China would choose to list the investee companies on domestic stock exchange instead of oversea stock markets.

3. Advises for PE withdrawing the funds

Two suggestive arrangements could help PE claim back the funds through IPO more fluently under current circumstance. Firstly, PE should add a few defensive clauses in the investment contract signed with the target companies. For instance, the stock repurchase agreement could be executed to force the company buy back the shares when the performance of the company is not as ideal as predicted. Secondly, domestic PE should hold enough shares to control the target company sufficiently when made the investment decisions. Accordingly, the resolution of listing could be passed by management board more easily. Besides that, PE also could switch to another exit route much conveniently when facing obstacles in IPO.

Additionally, the CSRC (Chinese Securities Regulatory Commission) is working on the integration of all the regional assets and equity exchange markets to promote a multi-level domestic capital market these days. If a united state over the counter (OTC) market could be established in the near future by bring all the regional assets and equity exchange markets into the third board which is also called Particular Transfer Sector. An effective and integrated assets and equity exchange market is beneficial to PE to transfer the shares held in unlisted companies or companies failed to IPO.

Generally, people tend to think that private equity funds will obtain higher returns in exits via IPO, compared with those via trade sale and MBO. Nevertheless, when comparing those returns, they have not taken into account the duration of each deal from investment to exit. When calculating the investment returns of those exits, PE-backed investments with IPO as exiting route are mainly distributed in the late- stage enterprises, a major percentage of which are in the Pre-IPO period. Their investment term is relatively short while the term for investments adopting the other two exit routes generally last more than three years. Therefore, the average overall investment multiples for trade sale and MBO are higher than that for IPO (Leo Liu, 2007). Notwithstanding, both investors and PE are inclined to reclaim the funds within a fairly short period due to the instable global economic situations, Consequently, IPO is still an ideal form for private equity funds to exit in the investment in Chinese enterprises (Leo Liu, 2007). Besides that, the regional economic conditions of investee companies are also significant to the exit decisions. At present, a majority of companies invested by PE centralized in Beijing and southeast coastal areas in China. Because these regions are far more developed than cities in southwest and northwest of China, companies could acquire more resource and support from local government. The predominance in human resource, material resource and technology also could help PE achieve the goal of exiting much fluently after gaining enough profits from the investment.

Hypothetically speaking, the custodians of PE in China should consider other exit routes even if 84% of domestic PE had quit the market by IPO in 2007. Besides IPO, other 9 PE had exited the market by stock reduction. Another 5 PE sold their shares to other investors to exit from the fund business. Furthermore, 1 fund quit the market by M&A in 2007. In addition, these exit routes may gain more profit than PO. According to the statistics of Zero2IPO, in all 53 trades of exiting had been happened in PE business in 2006. 23 of these 53 trades had been accomplished by IPO. The analysis on 34 of these 53 trades shows that the arithmetic mean and median of investment return are 2.98 and 2.60. Both of them are lower than data of the return of share transfer and management buyout. Consequently, the adoption of other routes of exiting is duly acceptable when encountering obstacles in IPO. Moreover, a combined way of exiting had emerged in Chinese PE industry recently. For instance, some multinational investment banks had arranged a combined exit route for Taizinai group to claim back their capital before they had made the investment. Actis, Morgan Stanley and Goldman Sachs hold in all 30% shares of the joint venture company after they had invested 73 million US dollars in Taizinai group on 7th Jan 2007. Taizinai group is the largest producer of yogurt drink in China. It had constantly exceeded 100% for 11 years in terms of CAGR (Compound Annual Growth Rate). Its domestic sales value in 1997 was only 5million Chinese Yuan, but it reached nearly 3billion Chinese Yuan in 2007. Additionally, this group are running business in 8 different industries, including milk and logistic. Neither Taizinai group nor its subsidiary companies were listed when these PE participated in the group. After these multinational investment banks become the shareholders of

Taizinai, they intended to separate and restructure the company for a better valuation (Yin Xiankai, 2007). Part of the subsidiary companies can be listed in order to withdraw the funds in secondary market. Besides that, the shares of other non-listed divisions can be transfer to outside parties or repurchased by the company. The model adopted to reclaim the funds in Tainizai group combines IPO with stock transfer and stock repurchase. Such a fresh exit strategy is a greatly efficient and operative route for current Chinese PE to withdraw their funds, especially under the circumstance of poor performance of domestic stock market. Nonetheless, this may not be suitable for reclaiming funds from the investment in companies which concentrate on only one industry.

4. Conclusion

To date, IPO is still the leading exit routes for PE to reclaim the funds from the investment. Nevertheless, Chinese stock market has been performing much more like a bear market since the late 2007. Besides, the reduce stake of restricted shares commences to reach a climax in 2008 and will last in future 2 years. The whole market is not well forecasted by analysts. To make matter worse, tight monetary policy is adopted by Chinese government to avoid overheated economy. Consequently, PE in China should consider more about other exit routes to withdraw the funds when facing obstacles in IPO. Additionally, the combined way of exiting is also a practical strategy for PE. For instance, the model adopted to reclaim the funds in Tainizai group combines IPO with stock transfer and stock repurchase. To sum up, PE industry is short of a systematic legal environment and formal regulation, especially in the aspect of exit. Furthermore, there are also not adequate experience can be adopted for reference. PE in China should consider all the economic and legal factors deliberately when reclaiming the funds from the investee companies.

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