Characteristics of

Private Equity in China

by

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Introduction

As the second largest economy in the world, China has clearly been the developing country worth paying much attention to. While previous growth was fueled by strong bank financing and sometimes the public equity market, the role of private equity (PE) capital has become ever more crucial especially for early-stage, small-to-medium, and private businesses. This thesis paper intends to improve the understanding of private equity in China and analyzes characteristics of private equity unique to the Chinese context. In terms of structure, I will first provide background information on the Chinese private equity market and then discuss characteristics of private equity in China in the following stages: fund-raising, investing, managing and exiting, with a focus on elements more unique to China. This paper aims to benefit both academia and practitioners to different extents and the assumption is that the reader is already well-versed in basic concepts in private equity and familiar with private equity practices in the developed market.

Research Method

I have drawn on primary and secondary research to arrive at my thesis. Over the course of a year, I have conducted first-hand informational interviews with over 17 professionals from a variety of organizations including international and local private equity firms, accounting firms, law firms and consulting firms. Through these interviews, I have learned insights on different aspects of private equity in China. The secondary sources come from academic publications, popular press, company filings and third-party financial databases. By incorporating everything, I will reach a conclusion in the end.

Background

Development of Private Equity in China[1]

The first private equity organization in China, called China Venture Capital Investment Company, was founded in 1986 as a venture capital (VC) firm, by government bodies including the Ministry of Science and Technology and the Ministry of Finance. The purpose was to finance and encourage the development of technology companies across China. In 1992, International Data Group established the first foreign venture capital firm in China, i.e. IDG Capital. By that time, most foreign firms had never made any investment yet due to the uncertain economic climate in China. In 1995, China's State Council approved the *Administrative Measures on the Establishment of Chinese Industrial Investment Funds Abroad*, which encouraged on-shore financial and non-financial companies to set up funds off-shore and invest in China. Most funds were invested in China from off-shore entities then because the legitimacy of domestic funds' structures was still in the grey area.

In 1990s, as the Internet developed in China, many online companies emerged and needed capital. Huge amounts of foreign venture capital flooded the Internet space and reaped handsome returns from Chinese companies that successfully went public in the US, including Sina, Sohu, NetEase, and AsiaInfo. After that, as the Internet bubble popped around 1999-2000, many foreign venture capital firms withdrew from China. In 2001, after China joined the World Trade Organization (WTO), promising to implement more changes to gradually improve the financial system, foreign PE firms like TPG, Carlyle and Warburg Pincus went into China for the first time.[2]

Private equity investments in China were limited in two ways, i.e. domestic exit channel and domestic structure. Although Shanghai Stock Exchange and Shenzhen Stock Exchange were founded in early 1990s, both were designed to benefit large state-owned enterprises (SOEs). For smaller or privately-owned companies, it was hard to raise capital via these two exchanges. That is why the first private equity investments were mostly exited overseas. Investors only saw hope of a potential exit locally in China when Shenzhen Small and Medium Enterprises Board (SME Board) was inaugurated in 2004 to allow companies of smaller sizes to IPO. In 2006, the new *Partnership Company Law* was passed to allow the limited partnership structure common in international funds to be domiciled in China. This new law initiated the true beginning of private equity practices in China. In the same year, the domestic firm Shenzhen Coship Electronics was the first PE-backed company to successfully exit locally in China. In 2009, ChiNext, the NASDAQ-like board of China, was founded to help innovative companies raise equity capital. ChiNext became a lucrative exit opportunity for many PE-backed fast-growing high-tech firms. As a result, the amount of new capital raised increased from USD13.3bn in 2009 to USD36.8bn in 2011. This enthusiasm decreased when China experienced inflation and a tight monetary policy in 2011. In 2013, due to the IPO ban for a year, trade sale became the main exit channel instead. As momentum slowed down, Chinese PE firms began to sober up and seek value in the actual investment process and portfolio management, instead of riding the previous policy tailwind. In 2013, the New Third Board (also NEEQ: National Equities Exchange and Quotation System, and the only over-the-counter exchange in China) was opened up to consider companies in all regions of China, as previously NEEQ was not an attractive exit destination due to its limitations on companies and regions. The opening up of NEEQ incentivized some PE funds to target NEEQ as an exit channel when investing. In 2014, the ban on IPOs was lifted and new policies were also issued to reform SOEs. These new changes stimulated new passion in PE players to capitalize on new opportunities.

<u>Relative Performance for Private Equity in China</u>

In order to understand the relative private equity performance in China versus elsewhere, I have gathered returns data on funds from various sources, including State Street, Cambridge Associates, Preqin, Private Capital Research Institute, Bloomberg, CVSource and Zero2IPO

Research Institute. However, it was difficult to produce a meaningful analysis due to limitations of different data sets. Firstly, most of the data sets do not include a nearly sufficient number of funds to represent China's private equity market. I could not pick out the most representative funds either because they were on a no-name basis in the set. Secondly, I was not able to distinguish among venture capital, growth equity, energy or infrastructure investments, because the data sets from different sources do not specify. Thirdly, many foreign research organizations only have data on foreign-domiciled funds, thus a lot of the RMB-denominated funds are missing from the data group. Fourthly, it was difficult to construct a public market equivalent (PME), which benchmarks private equity performance in a region against the corresponding public equity market performance, for China's private equity performance. As it is extremely difficult to distinguish funds that focus on mainland from funds that focus on Hong Kong, Macau or Taiwan, thus it is hard to determine a suitable stock market index to calculate PMEs. This was echoed during my conversation with a senior quantitative researcher at an international PE firm, where the professional commented that even inside their firm they find it hard to benchmark their private equity performance in China. To complicate the matter further, some returns data is net of fees for LPs, some returns data is gross returns, and some data sets do not tell you. Finally, after examining these limitations, I have decided not to carry out a too quantitative analysis on China's PE performance.

To have a rough idea of relative performance (as the source does not disclose how the returns are calculated), since 2004, private equity investments in China have returned a median IRR of around 20% and funds in the top quartile have returned around 30% annually, according to Zero2IPO Research.[3] By contrast, private equity in the United States has returned 13.03% for a 12-year period until 2016 (2004-2016 for same-period comparison), according to Cambridge Associates Private Equity Index.[4] This does not account for public market performance, currency risk, inflation or emerging market risks. According to the same senior quantitative researcher, it is difficult to adjust for currency risk when comparing returns and people usually just perform some degree of scenario analysis for currency fluctuations. Although the return figure seems much more attractive for China for this period, it is hard to determine how large the risk premium should be to compensate for risks in an emerging economy. Furthermore, the history of China's PE market is too short compared to the developed world, to have a comprehensive and meaningful comparison. Nevertheless, according to the same researcher, China presents an attractive market for purposes of portfolio diversification. This seems a more plausible reason for investing in China, as mainland equity markets have low correlations with the developed equity markets.[5]

Relevant Regulatory Bodies in China

The *Ministry of Commerce* (MOC) is in charge of functions like international trade and foreign direct investment.[6] It issues the catalog for restricted and prohibited sectors (the *PRC Foreign Investment Industrial Guidance Catalogue*) for foreign investors including PE investors in China.[7] That means foreign investors are limited when investing in some sectors such as traditional Chinese medicine and prohibited from investing in some other sectors such as newspaper publishing. The Ministry of Commerce also approves any foreign investment[8]. Generally foreign-denominated private equity funds are foreign investors subject to MOC approval every time an investment is made.

The *State Administration of Foreign Exchange* (SAFE) is in charge of cross-border capital flow and currency exchange. Its rules regarding currency cap and conversion heavily impact foreign investment decisions in China.[9] When money is converted for an investment, the process would go through SAFE, which can sometimes take up to months. For this reason, locally-financed RMB funds can invest money in local companies more quickly than foreign-denominated funds.

The *China Securities Regulatory Commission* (CSRC) regulates the securities industry in China, including investment banking firms. CSRC reviews potential IPO candidates and approves them, as China's IPO system is still approval-based, whereas in the US, the system is registration-based. To illustrate, the main difference between the approval-based system in China and the registration-based system in the US is the following: the U.S. Securities and Exchange Commission (SEC) vets potential IPO candidates mostly based on the truthfulness of information, whereas CSRC vets potential IPO candidates based on company performance requirements besides information truthfulness.[10] In a registration-based system, a poorly-operated and loss-making company can still file an IPO if the underwriter is willing to take the risk. However, the same company applying for an IPO will simply be rejected in China due to the low quality of business.[11] CSRC also regulates the private capital market in China, including private equity.[12] CSRC's measures to regulate the stock market have been very arbitrary. One example of the arbitrary measures was the ban on short-selling around the stock market crash in 2015 and the other example was the temporary outright ban on IPOs in earlier 2015, which caused PE exits to decrease by 95% in 2015, besides the one-year ban in 2013.[13]

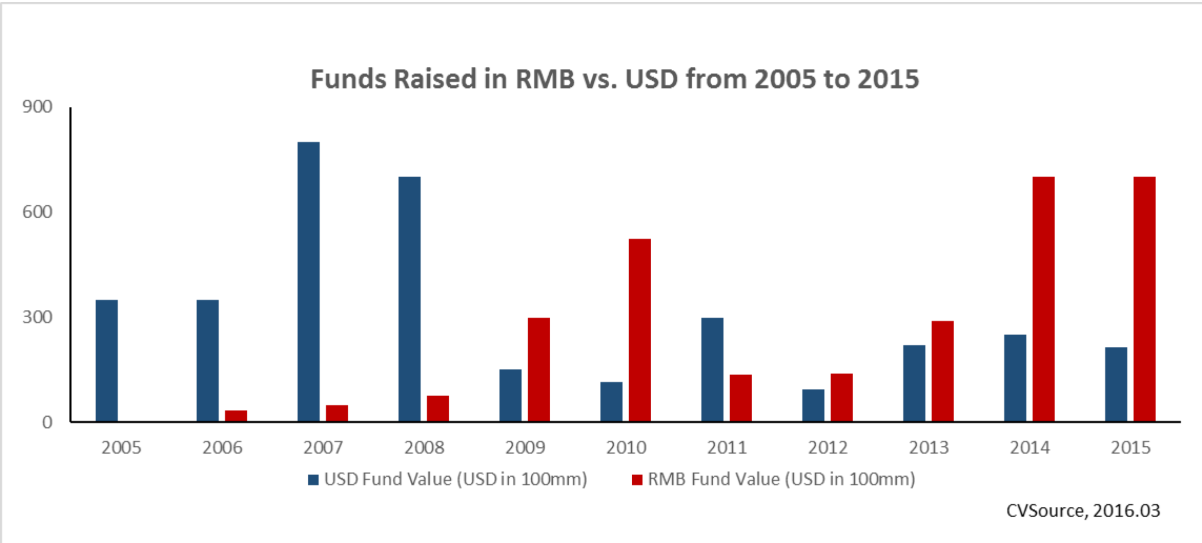
The *China Insurance Regulatory Commission* (CIRC) regulates the insurance industry in China.[14] CIRC announced in 2014/2015 that insurance companies were allowed to set up private equity funds as General Partners (GPs), subject to limitations including commitment cap as % of total fund raised and as % of last fiscal year's net assets, investment scope and team credentials.[15] More details on insurance companies participating in private equity will follow in the next sections.

The Rise of Domestic Funds (RMB-Denominated)[16]

As can be seen from earlier background information, the very first private equity funds entering China were all foreign funds with overseas money (non-RMB), domiciled off-shore under foreign laws. As there was too much uncertainty in the Chinese financial system and difficulty listing on domestic exchanges, the majority of Chinese PE-backed companies especially technology companies went abroad for an exit. As covered earlier, after the beginning of the 21st century, domestic exchanges were more established (and with smaller boards opening) and commerce law was made more transparent and beneficial for the domestic PE market. As an outcome, numerous PE companies began to raise RMB-denominated funds domiciled in China.

The first attempt to raise a PE fund in RMB was by Jiangsu provincial government in 2000 to form a partnership between the local investment company Jiangsu Govtor Capital and a foreign-funded investor consortium including CDH Investments, IDGVC, and DragonTech Ventures. At the time, RMB funds were not successful for similar reasons that off-shore funds were not successful. Besides the lack of limited partnership law and exit limitations, the added obstacle for foreign-sponsored RMB funds was stringent capital control. In 2003, the *Administration of Foreign-Invested Venture Investment Enterprises Provisions* created a legal structure for foreign venture capital to invest in RMB projects. In 2006, the same revision of *Partnership Company Law* mentioned earlier benefited RMB funds as well. As new laws and policies were issued to address these impediments, RMB funds raised increased from USD1bn in 2006 to ~USD55bn in 2010. In terms of exit channels and stock exchanges, the same developments described in the first section also apply here to RMB funds.

Currently, China is still going through an experimental stage with policies and regulations on private equity and government's intention has been to expand and mature local private equity market. To capitalize on the rising RMB funds, many international firms have planned to, if not already, set up RMB funds and sourced capital from local Limited Partners (LPs) base.



As shown in the graph here, the changes over time of funds raised in RMB vs. USD in China match the previous discussion on PE development in China. Newly-established laws facilitated the development of private equity partnership structures in early 2000s, and the financial crisis drained out foreign capital after 2007. In the meantime, RMB funds steadily grew due to improvement in smaller stock exchanges and overall regulatory environment. However, as described earlier, fund-raising slowed as economy slowed down from 2011, entering a rebalancing stage. More recently in 2014, fund-raising increased again, this time with total RMB funds raised almost matching the peak of total USD funds raised back in 2007/2008. Reasons included lifted ban on IPO and further policy tailwinds in China, for this period.

The rise of RMB funds over time in China could be explained by the following factors. First, it has become easier for companies to be listed on domestic exchanges as the tiers of the capital markets have been expanded to serve various financing needs. Also, higher valuations in domestic markets as opposed to Hong Kong or the US appear more appealing to portfolio companies. Second, there has been an increasing amount of local capital ready to be allocated, both at an individual level and at an institutional level. Third, demand for RMB capital has been increasing due to much fewer constraints associated with RMB funds compared to USD funds.

The main salient characteristic of private equity in China is the existence of local RMB funds vs. foreign investors, which is something not present in the United States. Firstly, the US is at a stage where the free flow of capital and trade does not impose any practical hindrance for foreign-currency-denominated funds. For example, if a US-based fund is raised in Canadian dollars from pension funds in Canada, it will not face any similar regulatory constraint as present in China when investing, say, in the US (converted to US dollars) or in the UK (converted to pounds). Moreover, the legal structure and commerce law in these developed markets are so established and complete that they are more similar than being different. These similarities facilitate all stages of the private equity process, whereas in China, the institutional environment makes a huge difference.

Structures of RMB-Denominated Funds in China[17]

1. Wholly-Foreign-Sponsored

International private equity companies, upon approval from SAFE and MOC, can set up RMB funds in China and directly invest in local companies. One example is IDG Capital, who has already gotten approval from MOC and has raised multiple RMB funds. As GPs often times manage RMB funds and USD funds at the same time, this structure serves LPs the best because there would not be any potential conflict of interest as the LP base is the same for RMB and USD funds under the same GP. In other words, LPs of the GP-managed USD funds also invest in the same GP's RMB funds. There will be no conflict when it comes to which fund to invest from for the same project, because the LPs are the same people for both types of funds.

Recently, it has become more difficult to have this wholly-foreign-sponsored structure approved as the government started to control capital inflow and encourage local fund-raising.

2. Foreign-Domestic-Sponsored

Foreign fund managers can involve local LPs (besides existing foreign LPs) in China to finance and raise RMB funds together. SAIF Partners and DT Capital Partners are amongst the foreign investors that have set up RMB funds this way. Unlike the first structure, there will be some potential conflict of interest between two groups of LPs. When a deal comes up, the GP has to decide whether to draw capital from the RMB fund financed by both local and foreign LPs or the USD fund financed by solely foreign LPs. This conflict can be easily eliminated as the standard practice is to invest from two types of funds pro rata.

Moreover, there arises another point peculiar to this structure. As foreign institutional LPs have much longer fund durations and local Chinese LPs have much shorter fund durations, for the second structure to work, the GP would need to find projects that accommodate both LP bases. In other words, the investment horizon of a project needs to be short enough to accommodate local Chinese LPs, while long enough to suit foreign LPs' investment needs. Moreover, as RMB LPs become more institutionalized and patient with the rise of government-led funds, pension funds and insurance companies, this duration mismatch problem will be less relevant.

Due to the inclusion of foreign capital, the above two structures are considered "foreign investors," subject to SAFE (currency conversion) and MOC approval (sector limitations and investment approval). However, the one advantage is that foreign-sponsored RMB funds (the first two structures) do not require approval from MOC for every single portfolio investment, which was the case previously. Nowadays foreign-sponsored RMB funds get approved by MOC once at the outset and can invest in companies afterwards without as much red tape.

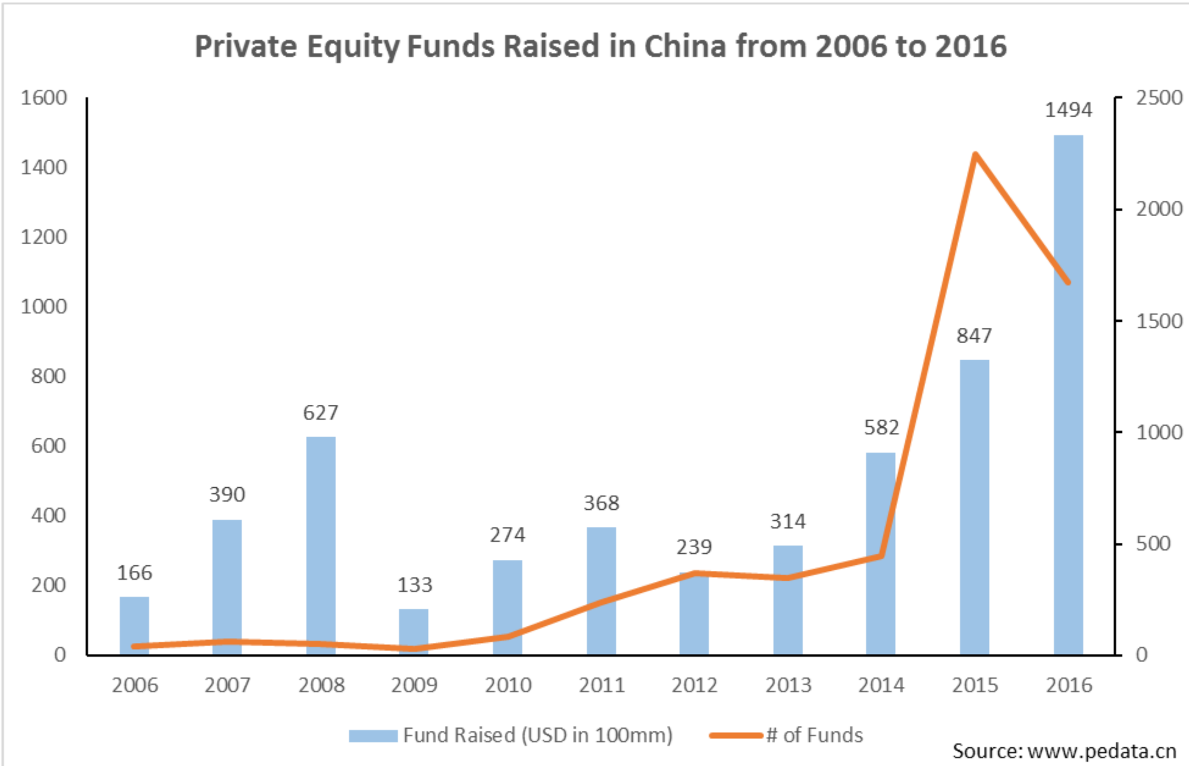
3. Wholly-Domestic-Sponsored

GPs source 100% of the capital from only local LPs in China to set up purely locally-financed RMB funds. This structure can do away with approval from MOC because it is an on-shore entity, just like any other domestic company in China. The downside, however, resides in the conflict of interest amongst LPs if the GP also manages funds financed by foreign LPs, as in the case of the second structure. If the GP manages a RMB fund and a USD fund both investing in China, the question becomes which fund to draw from for the same project. Again, as mentioned earlier, when this conflict of interest happens, the capital allocation is usually decided pro rata, or on previously-agreed upon terms when the fund is set up.

A major disadvantage with the third structure is that currently there hasn't been a strong LP base in China for private equity. The institutional LP base like one in the western world such as pension funds, endowment funds, and sovereign wealth funds (SWFs) is not as robust in China in terms of experience as well as capital sizes.

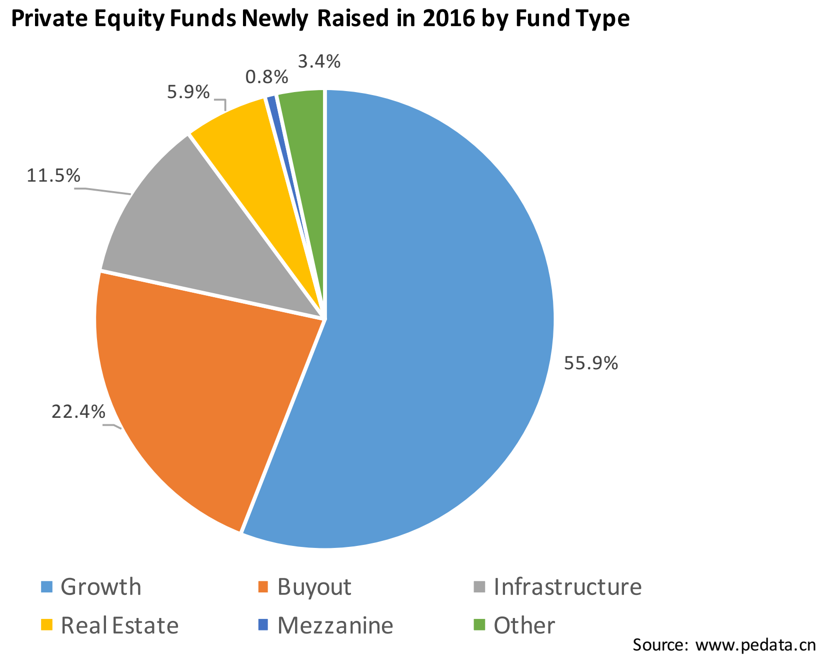
Fund-Raising

The growth of private equity capital raised in China has accelerated over the years. As shown in the chart here, the number of new funds raised increased from 40 in 2006 to 1675 in 2016, and the amount raised increased from USD16.6bn in 2006 to USD149.4bn in 2016. Notably, the amount raised increased from USD84.7bn in 2015 to USD149.4bn in 2016, by 76%. This hyper growth is explained by the stage of private equity development in China. New policies are still opening up to serve the private equity market better going forward and China's PE market has just gone through its infancy stage and begun to enter a growth spurt.



It is important to note that there is a discrepancy between total funds raised in this chart by www.pedata.cn and the total funds raised in the USD vs. RMB chart by CVSource, as presented earlier. It is uncertain why the discrepancy exists. One possible explanation is that one source accounts for venture capital, infrastructure and mezzanine as part of private equity, whereas the other source does not. Overall, the message conveyed by these two charts (the www.pedata.cn chart here and the chart on USD vs. RMB funds raised in an earlier section) are not affected, where one compares USD funds raised with RMB funds raised and the other shows the general rising trend of total PE funds raised in China.

In terms of the types of funds raised, growth funds dominate the scene, according to the pie chart below. With 55.9% of total capital raised, growth funds are followed by buyout funds, which take up 22.4% of total capital raised in 2016.



RMB-Denominated Funds vs. Foreign-Denominated Funds (especially USD) in China[18]

When it comes to fund-raising for a GP in China, the first consideration that comes to mind is clearly what type of fund to raise in what type of currency, considering the dynamics of more prominent RMB funds in China. According to a fund diligence professional at a major private equity consulting firm, USD funds in China generally follow international practices, thus they highly resemble what we see in the US, whereas the RMB funds have the more unique Chinese characteristics. Combining my findings from informational interviews and secondary sources, here I will present a brief summary of differences between RMB funds and USD funds and provide details on relevant areas afterwards.

1. USD funds come from USD investors. RMB funds can come from domestic investors or USD investors.

2. RMB funds comply with Chinese laws, including *Company Law*, *Securities Law*, and *Partnership Company Law*, whereas USD funds follow laws in their domiciles, e.g. United States, Cayman Islands, and British Virgin Islands.[19]

3. USD funds *and* foreign-sponsored RMB funds are subject to investment limitations listed out in the *PRC Foreign Investment Industrial Guidance Catalogue* by MOC.[20] It is important to note that wholly-domestic-sponsored RMB funds are free of this constraint.

4. Usually USD funds attempt to exit their portfolio companies through an off-shore structure via an overseas IPO or trade sale, whereas RMB funds exit on-shore. The reason is that one requirement to go public in mainland China is a mainland domicile, whereas the requirement to list abroad is an off-shore domicile.

The history of RMB funds is too short for us to draw a conclusion on if an RMB fund setup benefits the GP/LP more than a USD fund setup. Most of newly-raised RMB funds still have yet to exit.

Fund Life and Size

In terms of fund life, while USD funds, as under international practices, have a life of mostly 10 years, RMB funds are much shorter in fund life, ranging from 2-3 years to 5-7 years. This shorter time span is mainly due to the inexperience and impatience of LPs for RMB funds. RMB funds tend to be in smaller sizes than USD funds due to RMB funds' smaller capital base.

Considerations for LPs when Investing in Funds of Different Currencies

The first priority is what currency the LP has, according to a major fund of funds firm I spoke to. A lot of domestic investors only have money in RMB and if they focus on China today, there is no reason to consider USD funds at all, unless they prefer a potential exit overseas.

The second factor is the power dynamics between a GP and an LP. Major USD funds like KKR might not want to take money from a local Chinese LP, such as an asset management company, because local LPs are not as professional or patient as the usual institutional investors KKR would work with. The impatient nature of some local Chinese LPs is not accepted by many international funds who are used to a longer-term investment strategy. Also, demand for investment in a well-known GP like KKR is much higher, so the more established international LPs, compared to local Chinese ones, would have more bargaining power. Conversely, major domestic RMB funds may not want a foreign pension fund's USD because of the restrictions for a foreign-sponsored RMB fund.

Other factors are similar to the ones that fund diligence professionals are familiar with in the developed market, including fund strategy, investment size, track record, and potential exit channel. I will skip them here as they are not unique to China.

Funds Managing Both Currencies

A lot of USD funds, due to the constraint on USD, have been raising RMB funds on the side from local LPs. This way the GP will have fewer limitations in what it can invest in. For major USD-funded GPs to raise RMB funds, these RMB funds serve a more complementary role, because USD funds would still account for a majority portion of assets under management for these overseas GPs.

Another motive for raising funds in both currencies is to cater to different needs of potential portfolio companies. Depending on areas of operations and strategies, some target companies would desire a certain currency over another, RMB or USD. Therefore, managing both currencies provides more flexibility for GPs and an edge over other GPs who manage a single currency, ceteris paribus. Firms like TPG, Blackstone and CDH Investment have all raised their RMB funds.

The same flexibility applies to LPs that hold capital in both currencies. One FOF company I spoke with is one of the few FOFs in China that manage assets in both currencies.

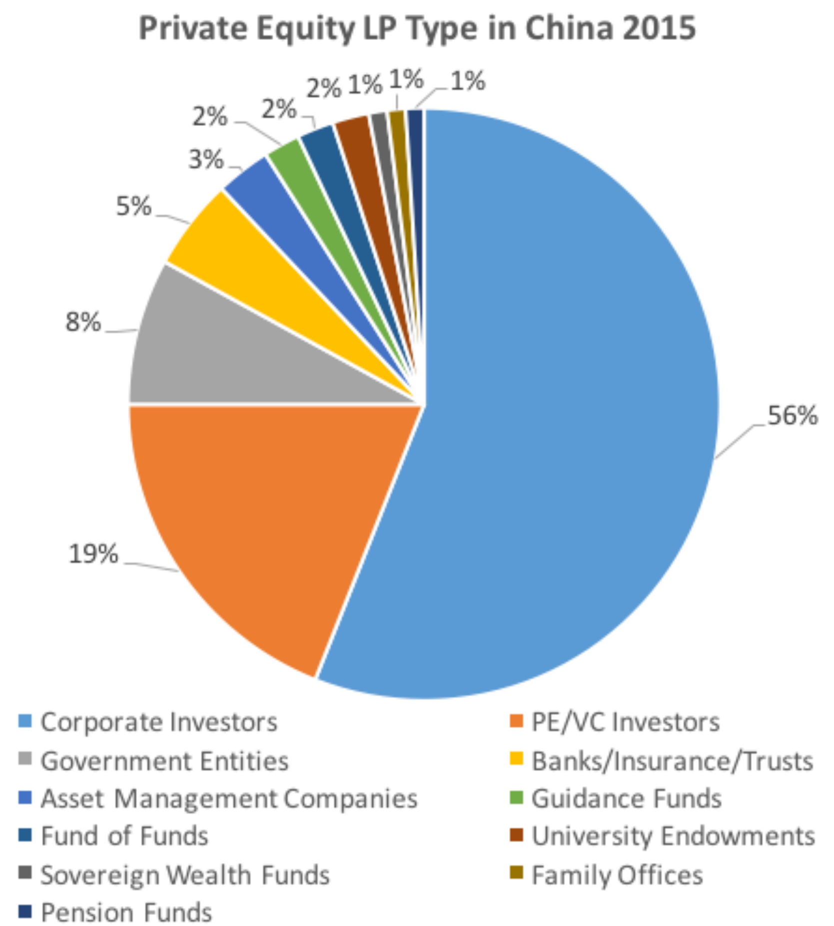
They confirmed that the flexibility does provide them with an advantage when investing in funds, because being able to put money into both USD funds and RMB funds helps the FOF diversify their investments better.

Case Study: RMB Funds by TPG Capital

In 2010, TPG Capital raised a RMB-denominated fund of RMB5bn (USD736mn) with the Shanghai Municipal Government and the Pudong New Area Government. The fund was said to focus on "consumer, retail, financial and healthcare industries." This government partnership was part of Shanghai's efforts to become a more international financial center.[21] In 2012, TPG was raising another RMB-denominated fund targeting RMB4bn (USD635mn).[22] As observed by TPG founding partner James Coulter: "The market is becoming broader and institutional … The key players are pension funds ... and then, there're insurance companies, which we hope would over time form the core institutional base for private equity funds in China."[23] These institutional forces provide strong potential for RMB-denominated funds raised for PE firms. In the meantime, Sing Wang, co-chairman of TPG Greater China, commented that setting up RMB funds could mean fewer limitations on TPG's investments in the financial service industry in China.[24]

Private Equity LP Type in China[25]

As USD funds in China are like those in the US, their LP base tends to be the ones we see in the developed market. For example, the California State Teachers' Retirement System (CalSTRS) has invested in many international PE funds focused on China including Bain Capital Asia and Hony Capital, according to their online filing.[26]



Source: CVSource, Noah Research

By contrast, RMB funds' LP base is less institutional, although becoming more institutionalized over time. As shown in the pie chart above, the largest private equity LP in China was corporate investors in 2015, and other LP entities included financial institutions (insurance companies, banks and asset managers), government funds (social security funds and government guidance funds), high-net-worth individuals (often times via asset/wealth management products or trust products), and fund of funds. I will go through each type of LP individually and relate its significance to China's PE market.

Trust Products and Asset/Wealth Management Products

A trust product is like a wealth management product. What it means is that individual investors would put committed money into a pool and that pool is managed by a trustee from a trust company or a wealth management firm. The trustee or the appointed wealth management firm would then invest the pool of money and return the capital to the individual clients after a period of time. The type of asset class invested in, the investment horizon and return promised, the minimum investment amount, or what sector it is in all vary. A good number of wealth management firms provide products in private equity. One example is Noah Holdings, a NYSE-listed Chinese wealth management company, that has seen an increasing portion of private equity fund products in its business segments.[27]

Previously, the majority of LPs for RMB funds were individual investors via these pooled products and most of the individuals did not understand private equity very well. Many would put money into a private equity product created by banks, trust companies, fund of funds, or asset/wealth management companies. The private equity capital was conceived as “fast money,” because there was little patience in the investment process due to the speculative nature of individual unknowing investors. Hence, the duration of the products marketed to these individual wealthy investors tends to be short, e.g. 1-3 years. In order to match the long-term nature of private equity investments, the Chinese government implemented policies to allow institutions like the insurance firms and pension funds to participate more in private equity.

<u>The National Social Security Fund</u>

The National Social Security Fund (NSSF) is a state-controlled investment fund established to provide for China’s social security system, and according to the Sovereign Wealth Fund Institute, the fund has approximately $146.5 billion in assets.[28] NSSF could be compared to the Canada Pension Plan Investment Board for Canada, but at a much less developed stage. The Chinese government instituted policies around 2007 to allow NSSF to invest in private equity. Since then, a series of major funds have raised money from NSSF. According to the table below, among them are Hony Capital, Lenovo Investments and IDF Capital.

GPs that Social Security Funds Invested In

Time	PE Firm
2008	Hony Capital
2008	CDH Investments
2009	CITIC Private Equity
2010	Legend Capital
2010	IDG Capital
2010	Hony Capital
2011	CDH Investments
2011	CBC Capital
2011	CITIC Capital
2012	New Horizon Capital
2012	SAIF Partners
2012	CITIC Private Equity
2013	Fosun Capital
2013	CICC Capital

Source: Social Security Website, Noah Research

Case Study: CITIC Capital[29]

CITIC Capital launched an RMB-denominated fund with NSSF in 2008, where NSSF put up RMB1bn and CITIC Group put up another billion RMB, among other unnamed SOEs. This was a mutually beneficial partnership, as CITIC was able to set up its own RMB fund to benefit from the rising RMB trend and NSSF was able to start diversifying into private equity. Moreover, this was in line with the government's plan to encourage private equity investments and reduce reliance on bank financing.

Insurance Companies

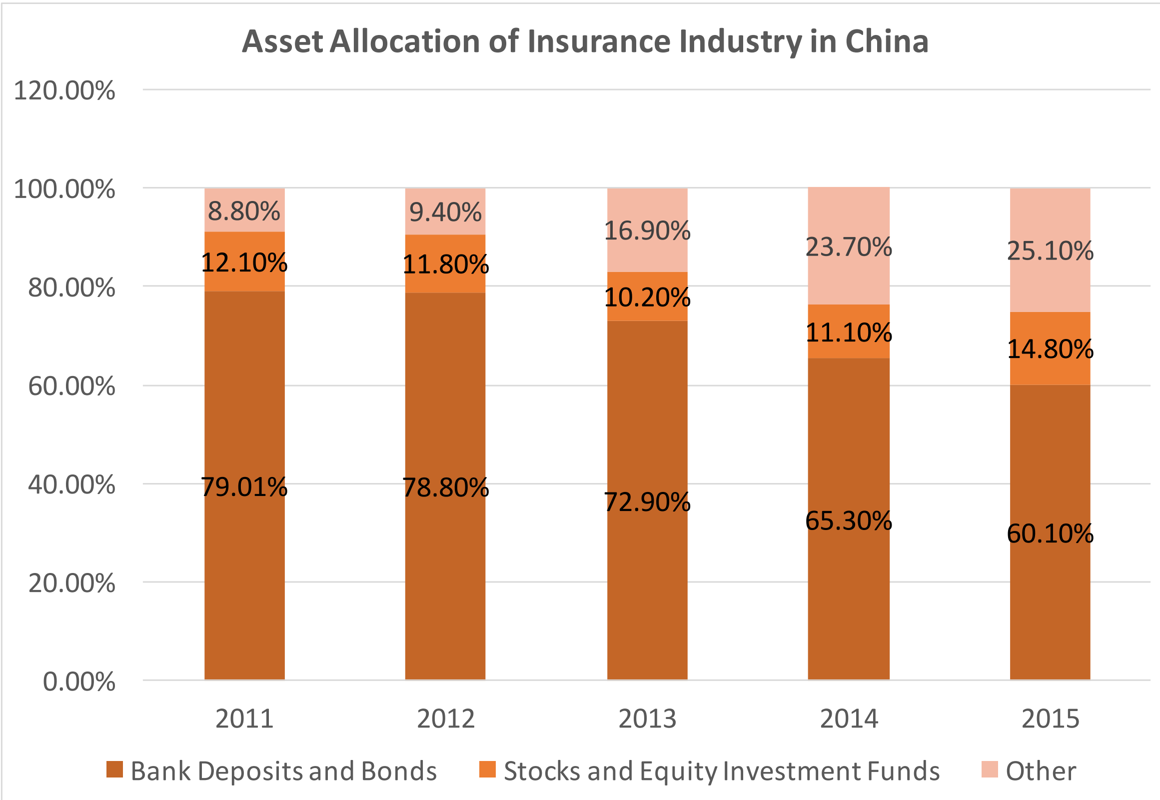
Below is a list of policies that have gradually "liberated" insurance companies so they could more freely invest in private equity. Insurance companies were permitted to invest in GP funds first in 2010 and since 2014 insurance companies have been permitted to set up GP funds with other insurance companies/financial investors as well, which I will go into in the Investing section.

Regulations Related to Insurance PE Investment

Time	Government Body	Policy	Key Points
2010.9	CIRC	Interim Measures for Equity Investment with Insurance Funds	Allowed insurance companies to invest in GP funds for the first time
2012.7	CIRC	Notice of Issues On Equity and Real Estate Investment with Insurance Funds	Clarified that insurance investment in private equity, including growth, buyout, or FOFs, cannot exceed 10% of total assets from last fiscal season
2014.8	State Council	Several Opinions of the State Council on Accelerating the Development of the Modern Insurance Service Industry	Allowed professional insurance asset managers to set up mezzanine, buyout, real estate and other private funds
2014.12	CIRC	Notice of the China Insurance Regulatory Commission on Matters concerning the Investment of Insurance Funds in Venture Capital Funds	Allowed insurance funds to be invested in venture capital funds
2015.9	CIRC	Notice of the China Insurance Regulatory Commission on Matters concerning the Formation of Insurance Private Funds	Supported insurance funds to set up growth, buyout, mezzanine, real estate, venture capital funds and other FOFs

Source: Noah Research

Overall, the amount of insurance capital allocated to stocks and equity funds has increased from 12% in 2011 to 14.8% in 2015, signifying government's effort to encourage more allocations to alternative investments rather than bonds/cash for insurance companies, as seen below.



Source: CVSource, Noah Research

<u>Corporations</u>

Although individuals tended to the funding source for RMB funds at the start, corporations have been the major force investing in private equity. As mentioned earlier, corporations were the largest LP in China with 56% of the total market.

<u>Government Guidance Funds[30]</u>

Efforts of government to set up funds to support the private equity market started in the 1990s, as discussed in the first section. But the most recent wave of government guidance funds being set up began only after newer measures by the State Council in 2014 and 2015.

General characteristics of government guidance funds include the following:

1. Funds come from tax revenue or state-backed loans, and are non-profit in nature. However, government guidance funds split gains with managers they invest in. The purpose of guidance funds is to encourage certain sectors in certain areas, with a focus on early-stage companies.

Government guidance funds were established to "overcome the failure of pure market-oriented allocation of venture capital."[31]

2. Government guidance funds do not make any direct investment.

3. Government guidance funds operate without any unfair advantage from the government, such as subsidies or better loan terms.

Case Study: Hubei Yangtze River Economic Belt Industry Fund (Yangtze Fund)[32]

Yangtze Fund was founded by Hubei provincial government and funded by RMB40bn (USD5.8bn) of government budget in 2015. The fund is intended to benefit a variety of industries and attract capital into Hubei Province. Yangtze Fund aims to attract major venture capital firms like Sequoia Capital and Hony Capital to settle in Hubei. With government ties to help bring deal sources, Yangtze River has already locked in 23 funding projects in numerous emerging industries around mid-2016.[33] Besides the RMB40bn put up by the Hubei government, Yangtze Fund also intends to set up fund of funds with other partners including major state-owned banks and private equity investment firms. Yangtze Fund targets RMB200bn (USD29bn) raised for this fund of fund effort.[34]

Bank Participation in Private Equity

Besides insurance companies and trust companies investing in PE, banks themselves also do. In search for higher returns on capital, some banks have begun to either invest in GPs or set up direct investment divisions. However, when banks give money to GPs, they don't have to use the standard LP-GP agreement. Because the banks don't wish to take on that much risk, they have designed a structure where banks put up capital for GPs to invest and in return recoup a fixed return on that capital over a period of time. This arrangement is more contractual in nature and is more like a fixed-income investment. This phenomenon has been common as banks seek higher returns. This practice, due to the leverage put on GPs, is still in the grey area in China, and it is more common amongst smaller banks.

Factors for GPs Raising Funds

When GPs raise funds focused on China, they would consider a few factors.

The first factor is needs of potential target companies. Especially for early-stage companies, RMB financing might be preferred because it takes a shorter time for RMB to be raised compared to USD. Also, generally RMB financing comes in smaller sums than USD financing, and thus it would be adequate for early-stage companies that may not need as much capital. Later-stage companies that require large sums of financing may prefer USD funds simply because some USD funds can afford bigger ticket sizes.[35] For example, Hillhouse Capital invested USD265mm in JD.com in 2010, which was not a sum many RMB funds could afford at the time.

Second, as RMB LPs are more impatient, they tend to invest in GPs that have shorter-term strategies. In China, private investment in public equities (PIPE) and pre-IPO investment are especially popular among RMB investors for this reason. Thus the GP could consider RMB LPs if it has a shorter-term investment strategy.

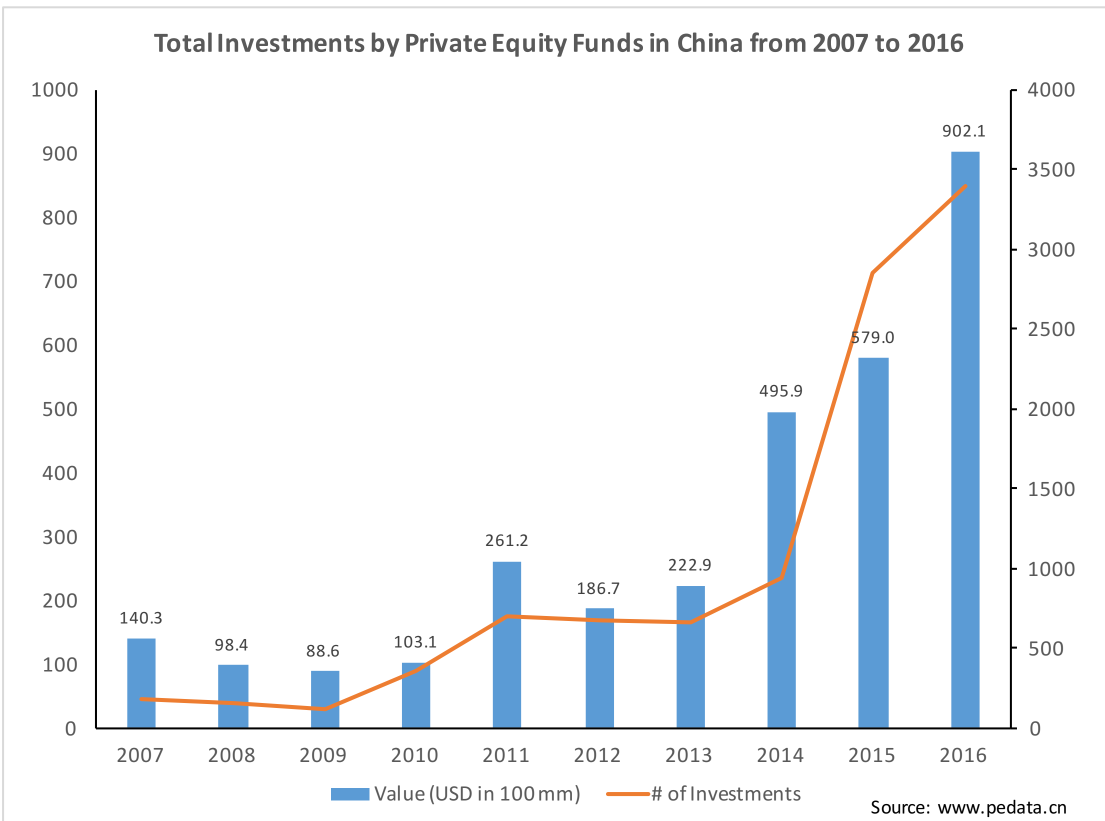
Third, because there is a lot more RMB capital in the system, more money is chasing the same number of deals. As a result, valuations tend to be higher and RMB funds are willing to pay a higher price. RMB financing becomes relatively cheaper for target companies in this regard. If that is a concern, the GP might want to raise the fund in USD instead, because often times USD funds and RMB funds invest in different deals in terms of regulated sector and investment sizes. Nonetheless, it is important to observe that this negative effect of a high entry point for RMB funds may be mitigated by a high domestic exit multiple.

Also, exit valuation variances amongst different stock exchanges will impact GPs' fund-raising decisions.

Finally, the sector focus of the GP matters too. As mentioned earlier, companies in sectors promoted by the government will be favored by general policy as well as certain exchanges like ChiNext for a technology firm.

Investing

The chart here shows the change of total private equity capital invested in China over the years, and a similar trend to the one for fund-raising is present.



Private Equity Direct Investors in China

Besides the conventional financial GPs, there are other parties that directly invest as well. I will go through the common ones here.

Corporations

As the largest LP in China, corporations are also major direct investors in private equity. When they invest directly, they could either invest for purely strategic reasons, or for both strategic and financial reasons. Some of the high-profile corporate investors in private equity include BAT (Baidu, Alibaba and Tencent), Fosun, Hainan Airlines, Haier and Lenovo. Some other corporations also partner with financial GPs to set up funds together, among those Eastern Gold Jade and High Hope International Group. These corporate players present increasing competition against pure financial investors because the corporations have in-depth industry expertise as well as adequate capital.

Case Study: HNA Group (Owner of Hainan Airlines)

HNA was founded in 1993 by Hainan Government as a pure-play airline company. Recently it has begun to diversify and aggressively invest in a variety of businesses. In 2010, Hainan Airlines launched the first private equity fund (RMB5bn/USD747mn) in China focused on the aircraft leasing industry. This was set up with Tianjin Yanshan Investment Management Co and intended to improve Hainan Airlines' revenue structure and business in aircraft leasing.[36]

HNA invested an undisclosed amount in Uber in early 2016.[37] In the same year, HNA also acquired electronics distributor Ingram Micro Inc IM.N for about $6 billion.[38] Later in 2016, HNA Group bought 25% of the hotel chain Hilton from Blackstone for $6.5bn.[39] HNA has emerged as a global hospitality and tourism player via its investments in these different businesses. Looking at the sheer sizes of these deals, it is not surprising that many of these corporations have been some of the most active private equity investors.

Insurance Companies

Besides serving as LPs, insurance companies also invest directly in private equity.[40] Ever since the opening up of insurance companies to private equity, insurance companies in China have contributed a substantial amount of capital to this market. These insurance firms have deep balance sheets and long-term asset-liability needs, which are suitable for private equity investments.[41]

Case Study: China Life Insurance

According to Preqin, China Life became the largest insurance-backed PE investor in the world in 2017.[42] According to limitations by the CIRC, the amount of capital available to China Life is several hundreds of billions RMB.[43] China Life decided to raise this amount from 2% of total assets to 15% in August 2016 and planned to partner with unnamed international private equity funds.[44] In 2015, China Life and Ping An Insurance co-invested in Tishman Speyer's Pier 4 Boston Waterfront Project, marking the first ever insurance PE investment in US real estate.[45]

Banks and Securities Firms

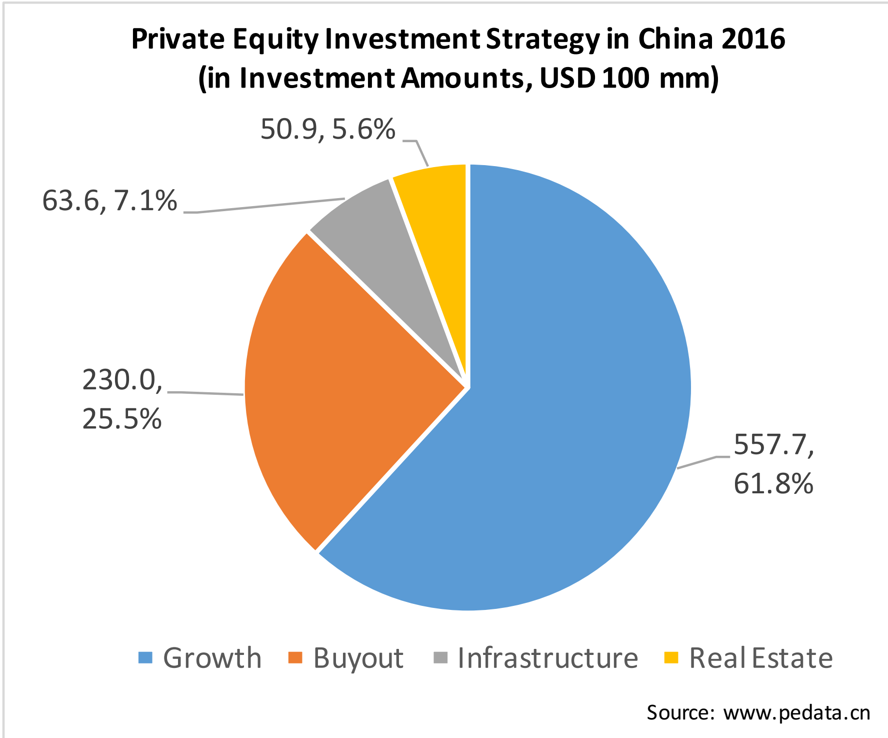
Banks and securities firms are setting up their own direct investment divisions also.[46] Currently in accordance with China Securities Regulatory Commission, securities companies' direct investment activity is limited only to pre-IPO investment, and the investment horizon is capped at 3 years.[47] Also, securities firms can invest its own cash, with the maximum amount capped at 15% of total net assets, or the securities firms can raise a fund to invest.[48]

Investment Horizon

In China, RMB funds investment horizon is necessarily much shorter because the fund life is much shorter. The investment horizon could be as short as 1-2 years or as long as 3-5 years. Nevertheless, the investment horizon is expected to lengthen as more long-term institutions become RMB LPs, such as insurance companies and pension funds.

Investment Strategy

In terms of investment strategy, growth strategy dominates in China. The chart shows that growth strategy takes up 61.8% of total in 2016, followed by PIPE (25.5%) and buyout (7%).



This composition is due to a combination of factors in the Chinese context. First, there are not as many mature buyout targets in China for its stage of economic development. Second, not many funds have adequate capital sums to conduct buyouts. Third, the debt capital market is not as deep to support any real leverage in a buyout situation. Further, Chinese financial institutions have not yet fully recognized the value of a buyout. In other words, a lot of the banks are extremely risk-averse in backing buyout deals. Nevertheless, one RMB funds manager informed that it is common to lever up an investment in a short-term pre-IPO or PIPE situation. Since the market crash in 2015, the limit for leverage has become more strict. Whereas investments were levered up to 8 to 10 times debt to equity, now most investments can only be leveraged up to 5 times. Specific rules on leverage vary in practice, depending on the bank, the investor and the investment.

Growth strategy makes much sense considering the high-growth nature of many portfolio companies. When funds do have the money to carry out buyouts, they would opt not to for two reasons. First, in China, the management of companies is usually also owners and buying out the company means replacing the major shareholders. As these owners are often unwilling to give up their controlling ownership, it is very difficult to concert them into professional managers with only a minority equity stake. Second, it is important to have powerful local partners who are vital for the firm, thus fully buying out owners would be counterproductive. That is to say, investing a minority position and retaining the current management and owners are in the best interests of private equity investors.

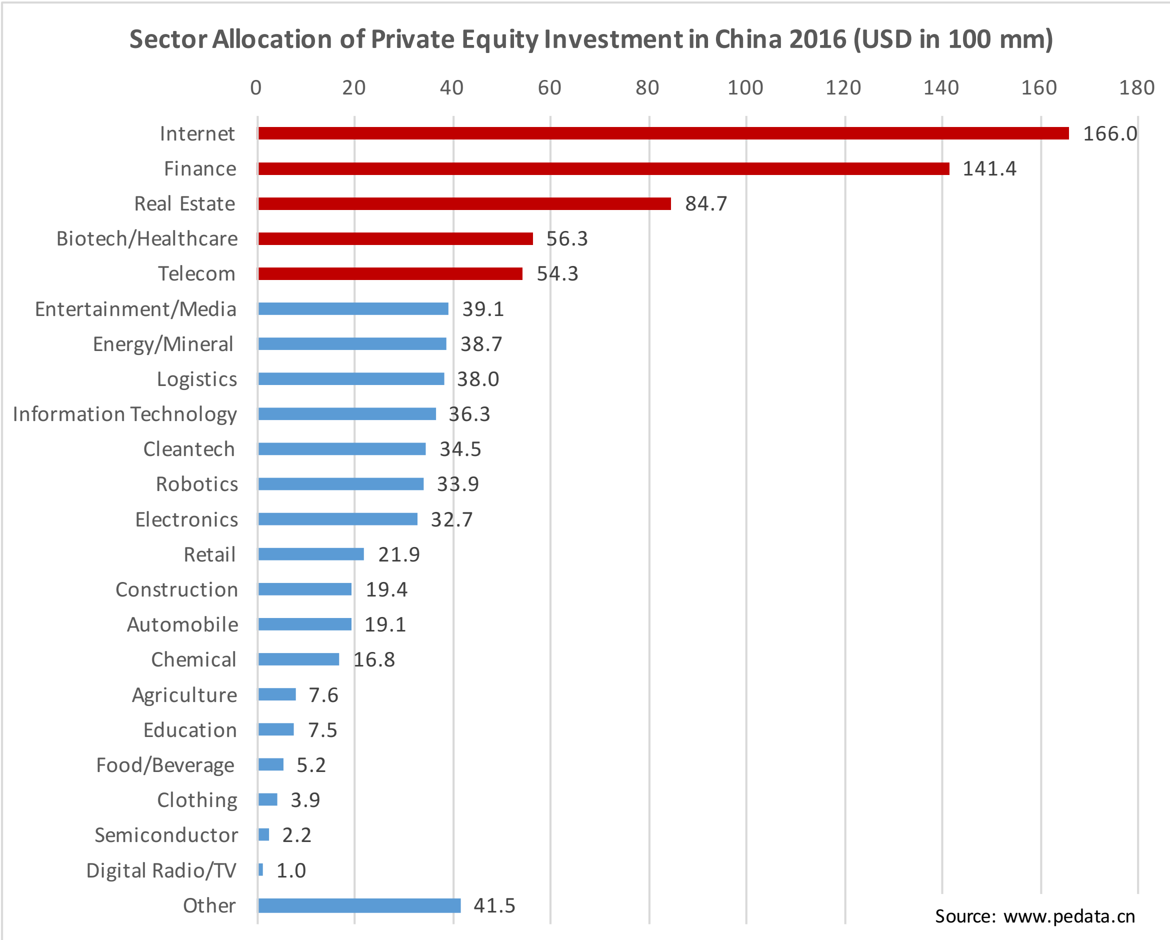
Moreover, GP-LP co-investment and consortiums are also common. It makes sense as large sums can be invested with combined expertise from multi-parties, while the risks are shared. It is also a way to build on existing relationships for future partnerships.

Due Diligence

There is extreme information asymmetry conducting business in China, especially if you are a foreign investor. One professional brought up the issue of accounting fraud and book cooking for some of the Chinese companies. Another professional told me about how conducting due diligence on target companies in China is much more strenuous than in the US.

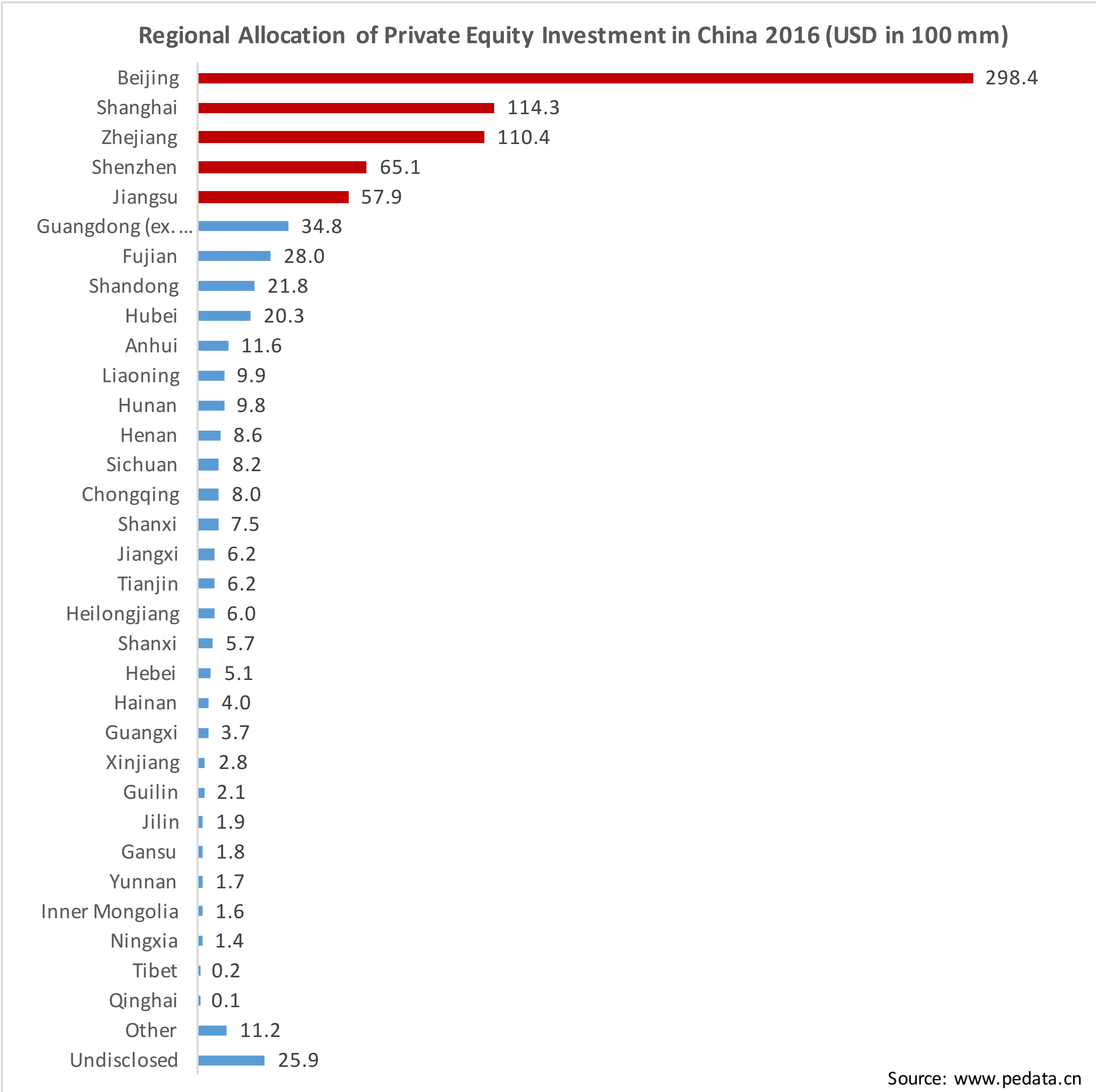
Sector Allocation

In China, Internet, IT, media, healthcare and finance are amongst the most popular sectors in private equity market. These sectors are popular as targets because of their high-growth nature. Also, these sectors tend to be ones that do not have as adequate access to more traditional financing means, such as loans. The chart below shows the most popular sectors PE firms invest in.



<u>Regions</u>

The majority of PE investments are concentrated in the first-tier areas in China, notably Beijing and Shanghai, according to the diagram below. This is similar to the financial hubs in the US like New York. PE is noticeably more centered in Beijing than elsewhere, because PE is highly policy-driven in China and most policy bodies reside in Beijing.



Contract Enforcement

Contract enforcement can be an issue for less developed markets such as one like China. From my conversations with the professionals, I believe that this is always work under progress. Due to the immaturity of the legal system, not least one that applies to alternative investments, local businesses definitely have an advantage in local courts. Over time, as government bodies work to fill the cracks in the system, and as business practices become more professional, contract enforcement will improve. This is, however, not much of a problem for off-shore transactions, as they are subject to laws that are more established and more familiar to everyone in the western world.

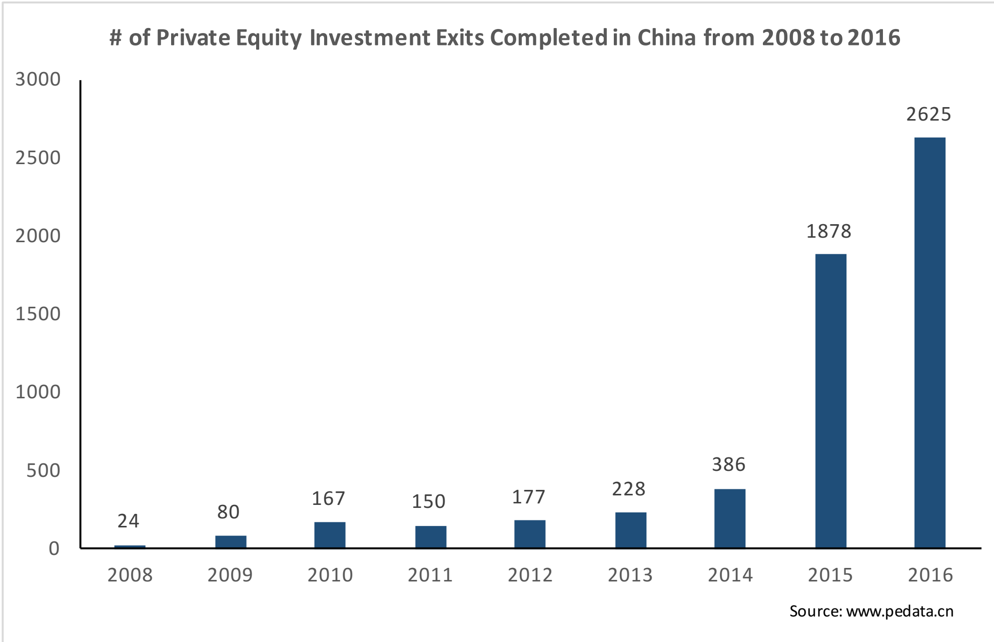
<u>Managing</u>

After successfully making the investment in portfolio companies, the following is how the portfolio management process is like in China:

Because most PE funds make minority investments in growth-stage companies, they tend to work with the portfolio companies' founding team/management and provide operational advice as minority investors. The level of intervention and board representation varies depending on the GPs. From my interviews, some funds who are more operations-focused would send a professional to work with the portfolio company daily, while some funds can be very passive, holding veto rights. Sometimes the funds would obtain board seat depending on the percentage of equity position. What the term sheet dictates also hinges on the bargaining position between investors and companies. If it is a popular deal like the recent Alibaba-affiliate Koubei financing round, the investors would be willing to give up more in order to be part of the deal, and of course vice versa.

<u>Exiting</u>

As shown here, as more and more funds have been raised and invested, the number of exits in China has skyrocketed recently. The number of exits rose from 24 in 2008 to 228 in 2013 and from 386 in 2014 to 2625 in most recent 2016.



The number of domestic exits increased as previous restrictions causing a pent-up supply were reduced. More specifically, the change in the number of domestic exits is in line with the change in fund-raising in China. Considering the short-term nature of most investments, exits would follow fund-raising much sooner than expected if it were in the US. Also, the one-year IPO ban was removed after 2014 and the long-due IPO candidates flooded the exchanges, explaining the abrupt rise from 2014 to 2016. Moreover, NEEQ was opened up in 2013, creating much more exit opportunities for companies after that.

Exit Channels

Exit channels for China are mainly trade sales or IPOs. As demonstrated earlier, the shift of policies related to IPOs heavily influences private equity activities. Here I will briefly introduce China's stock exchanges first before going into their specific characteristics.

Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE)[49]

Shanghai Stock Exchange's total market capitalization (market cap) accounted for USD5.9tn and Shenzhen Stock Exchange's market cap accounted for USD4.4tn as of 2015.[50]

Both Shanghai Stock Exchange and Shenzhen Stock Exchange were founded in the early 1990s and played crucial roles in supporting the growth of major businesses in China, especially SOEs. As explained in the first sections, it has been generally impractical for small-to-medium businesses, or fast-growing but loss-making businesses to list on the two main exchange boards due to stringent requirements regarding company size, business quality and profitability. Further, until recently when CSRC announced the intention to gradually shift the approval-based IPO system to a registration-based system in 2015 (like the one with SEC in the US), the government always had caps on the number of permitted IPOs per year and specific restrictions on the companies to be considered. For that reason, government-affiliated companies were often favored over privately-owned companies and the whole vetting process was very opaque.[51] Overall, the net result was that demand greatly exceeded supply for IPOs.

Relatively speaking, the "smaller boards" brought out by the government, most of which are essentially part of the main boards of these two major exchanges benefited private equity much more. I will provide a brief background for these "smaller boards."

Small-to-Medium Board (SME Board) of SZSE

The two exchanges I have discussed above are referred to as the main boards in mainland China, because these two boards constitute the largest market capitalizations and account for the largest corporations in China. Besides the main boards, one smaller board is the Small-to-Medium Board (SME Board) of SZSE. SME Board was first initiated in 2004 and was designed to let companies that weren't qualified to list on the main boards to IPO. In other words, requirements to list on SME Board are less strict and SME Board would provide capital to companies that would later on have a shot at going public on the main board.

Growth Enterprise Board (GEM) of SZSE (or Second-Board Market or ChiNext)

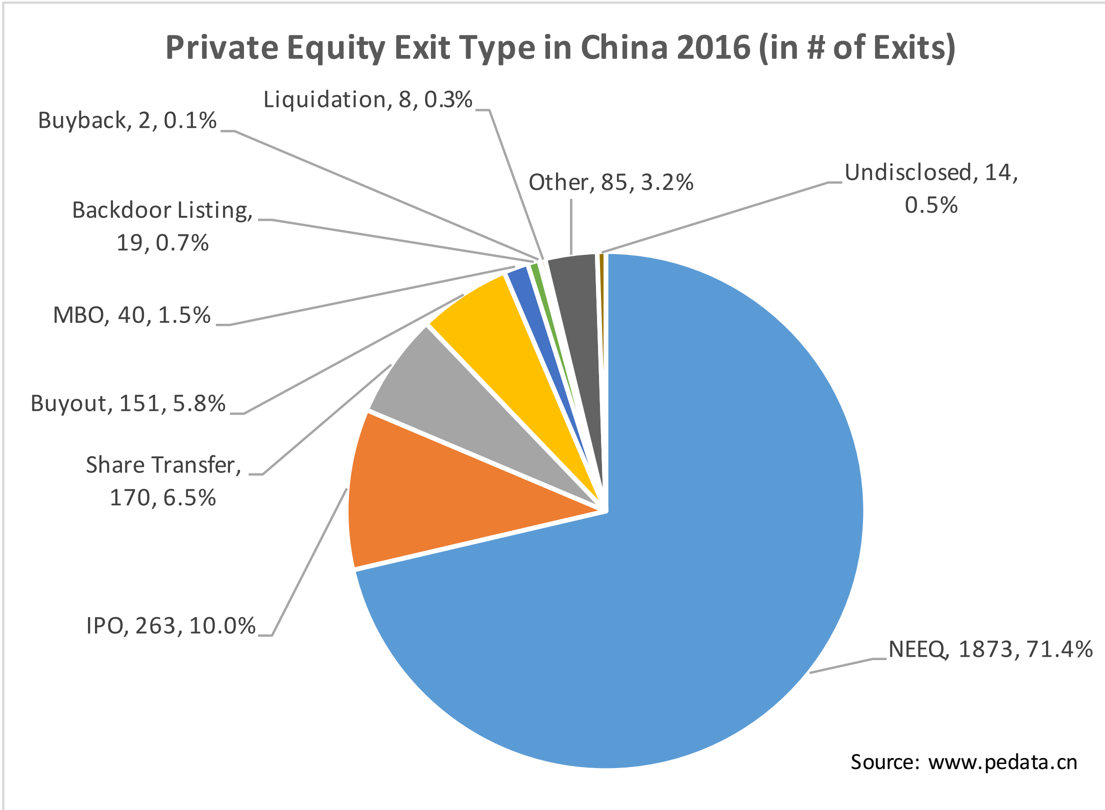
Similar to SME Board, ChiNext is also affiliated with SZSE and is designed to support small-to-medium enterprises as well. However, ChiNext is structured to prefer fast-growing innovative companies. As a result, companies looking to list on ChiNext would need to have a more appealing growth rate and a product in an area supported by the government, compared to small-to-medium enterprises going public on SME Board. For example, no matter how fast one company has been growing, if it is a grocery chain, it will not be approved to list on ChiNext, as grocery business may not be a field the government would particularly promote, compared to fields such as medical equipment or biotechnology. Furthermore, ChiNext is sometimes dubbed as the NASDAQ in China because it has an inclination for fast-growing technology companies and quite importantly, the candidate does not have to be profit-generating at the time of listing. In a way, ChiNext is a very niche exit channel.

National Equities Exchange Quotations System (NEEQ or New Third Board)

NEEQ is the only over-the-counter exchange system which caters to small-to-medium enterprises, and it is not affiliated with either of the main boards.[52] NEEQ was instituted in 2001 and was really put into widespread practice in 2013 in China, which helps explain the increase in exits after 2013. What makes NEEQ different from the smaller boards under SZSE is that NEEQ is highly illiquid and requirements are even looser for potential companies to go on NEEQ. Because the requirements are loose, many small companies with no necessarily high quality operations are able to raise some money via NEEQ. The downside, of course, is that the investors investing in this NEEQ company find it hard to sell to a buyer because the NEEQ market is too illiquid. However, financial intermediaries have figured out ways to address this issue such as via market making.

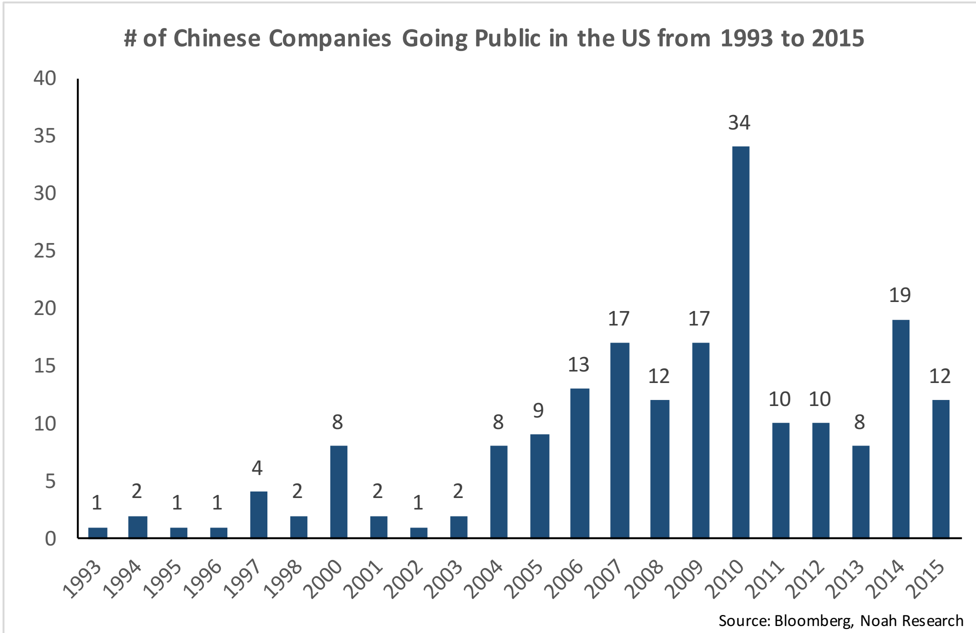
Private equity firms in China have taken advantage of these smaller boards to successfully exit their investments and earn great returns. Because these are domestic exits, the investments were mostly by RMB funds. As RMB funds have shorter investment horizons, being able to exit sooner via these smaller boards (due to lower requirements, etc.) proves to be highly advantageous. That is why new policies that encourage the development of smaller stock market boards usually excite the private equity market in China. This is also arguably the most relevant issue for PE practitioners to follow in China, especially due to the arbitrariness of stock market regulations.

As NEEQ is the easiest route to exit a company due to lowest requirements and lowest amounts of time taken, it has been a popular choice for PE firms. As shown in the pie chart below, in 2016, 71.4% of PE exits in China were via NEEQ, and 10% were via IPOs (NEEQ listings are not considered IPOs as they are OTC, which is not open to everyone). Further, the number of NEEQ exits in 2016 was 96% more than 2015. These trends really show how regulations govern PE activities. One PE firm I spoke to told me clearly that these days they would invest in companies for them to exit via NEEQ. PE in China might experience another bout of animal spirit when CSRC officially introduces a registration-based IPO system, when it will be much easier for firms to go public.



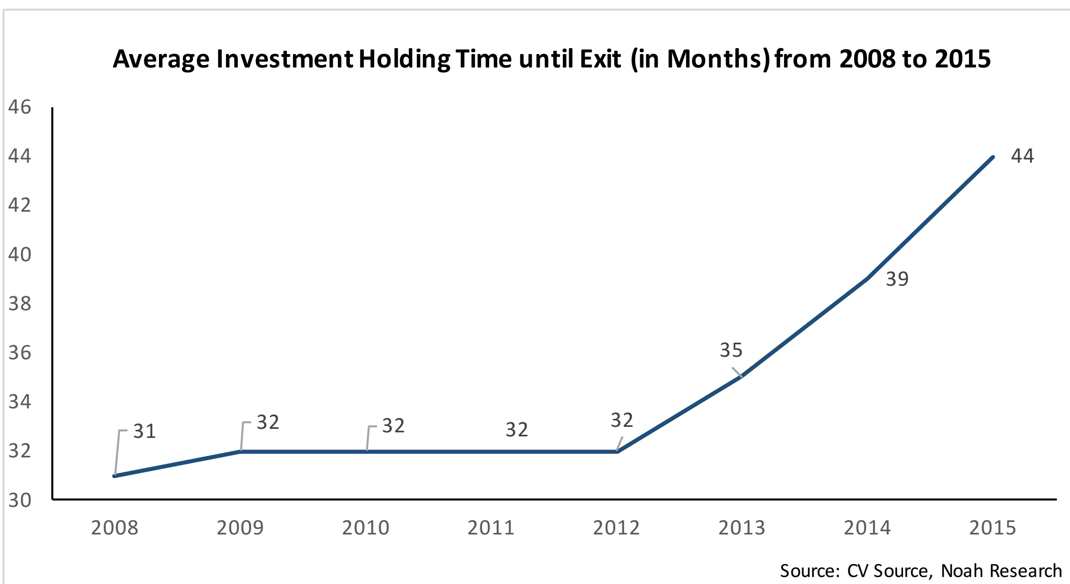
Backdoor Listing

As domestic stock markets provide a much higher valuation than foreign ones and as a lot of Chinese ADR companies are frowned upon by foreign investors, recently numerous Chinese companies have sought to privatize and relist on a Chinese stock exchange to capture the valuation arbitrage.[53] Momo and Qihu are two examples. As shown here, the number of Chinese companies seeking to go public in the US has decreased from 2010.



Time Until Exit

From the chart below, the time till exit has increased gradually, showing that Chinese PE investors are becoming more patient in their investment processes.



General Case Study: Alibaba and its Affiliates

Alibaba is one typical technology company that walked a long way from its inception in late 1990s to its IPO in 2014. This whole journey would not have been possible without the backing of venture capital/private equity, as certainly no bank was going to lend to Alibaba especially during an earlier time. One of the first investors backing Alibaba was Goldman Sachs' private equity arm. In 1999, Goldman Sachs led Alibaba's first round of financing with Fidelity's VC arm Fidelity Growth Partners Asia.[54] At the time, China was at such an infancy stage with startups that there was scant competition in the VC/PE market. Alibaba was one of the few technology startups Goldman Sachs considered. Because Goldman Sachs had much more bargaining power over Alibaba due to Alibaba's limited size, the financing terms reached were mostly in Goldman Sachs's favor. Goldman Sachs and Fidelity took up almost 50% of stakes in Alibaba with a mere ~$5mn investment in 1999.[55] However, not having much faith in Alibaba especially after the tech bubble, Goldman Sachs diluted its stakes by bringing in more investors and exited its investment as early as 2004. As later to be regretted, that exit in 2004 paid off 7 times the initial investment, but it could have been thousands of times if Goldman waited until the IPO in 2014.

Another major investor was Softbank, the Japanese diversified investor that led a round in 2000 for $20mn in Alibaba.[56] Later in 2003, Softbank, GGV Capital, Fidelity and Venture TDF invested another round in Alibaba and bought out Alibaba stakes from Goldman Sachs.[57] In 2005, Yahoo bought 40% of Alibaba for $1bn, which was worth $20bn in 2015.[58] While Goldman Sachs didn't see too much promise in Alibaba, Yahoo admitted that it took some risks too, except this time Yahoo invested in Alibaba for more strategic reasons.[59] In 2011, as earlier-stage investors cashed out, new backers including DST Global and Silver Lake joined to invest in Alibaba.[60] Later investors also included China Investment Corporation, Boyu Capital and China Development Bank PE arm when Alibaba bought back half of Yahoo's investments. Overall, Alibaba showed more and more potential as a global e-commerce giant as it gradually grew and along the way investors of different profiles and risk appetites participated in Alibaba's infancy and growth to varying degrees. When Goldman Sachs invested in Alibaba, it was certainly one of the first VC deals ever done in China and that would not have been possible without the improvement in regulations on the market. In terms of Silver Lake's investment in Alibaba, that epitomizes the ideal growth equity investment in China not long before an IPO.

Besides Alibaba itself, its affiliate companies have utilized private equity financing in China to grow as well. Alibaba's payment subsidiary, originally named Alipay, was rebranded as Ant Financial in 2014. Ant Financial closed its series A funding round in 2015 by a group of investors led by the Chinese pension fund NSSF (explained earlier) and "major Chinese insurance corporations."[61] The deal with Ant Financial was among the first that NSSF did after the opening up of social security funds into private equity. Due to the government ties through NSSF, Ant Financial would have an edge when it comes to "legal and regulatory hurdles" in the future.[62] In a series B round in 2016, Ant Financial took more capital from high-profile Chinese investors including China Investment Corporation, CCB Trust, China Life, China Post Group, China Development Bank, and Primavera Capital.[63] It is key to note the diversity of investor base here in the series B round, where China's sovereign wealth fund CIC partnered with PE arms of commercial banks (CCB and CDB), insurance companies (China Life), PE arm of an SOE (China Post) and a more "pure-play" private equity firm (Primavera). These two financing rounds of Ant Financial reflect, to some extent, the participation of different organizations in private equity in China and the private equity trends described in earlier sections.

Another Alibaba affiliate that has little trouble raising private capital is Koubei, an online-to-offline service provider for local businesses and consumers.[64] Koubei was started as a joint venture by Alibaba and Ant Financial in 2015 and raised its first outside funding round in early 2017. In January 2017, Koubei raised just over $1bn from investors including Silver Lake, Primavera, CDH Investments, and Yunfeng Capital (VC founded by Jack Ma).[65] Faced with fierce competition like Meituan-Dianping in the offline-to-online arena in China, Koubei needed more gunpowder to "execute on its aggressive growth strategy."[66]

The new private equity participants seen in more recent deals reflect government's initiatives to bring in more institutional capital. Moreover, Alibaba exemplifies the hype about the Internet sector in China's private equity market today. The example of Alibaba demonstrates the emerging power of private equity. Without that capital and support, Alibaba would not have become what it is today.

Conclusion

The private equity market in China has gone through its infancy stage in 1990s and begun its maturing stage in recent years. Realizing the importance of this capital tier, the government has designed policies to support and promote all aspects of private equity in China.

In the long run, it is expected that locally sourced RMB capital will play a substantial role in the private equity market besides foreign capital and local investment practices will gradually conform to the international standards. The government will align its policies to ensure that, as evidenced in a series of previous government announcements. It also makes sense from a country's perspective to build out this tier of capital market to support a portion of the economy that was previously underrepresented.

As RMB becomes a more internationalized currency and as regulations work to adopt a more market-driven system, the difference between RMB funds and foreign funds will be reduced. In the short run, however, due to the evolving nature of regulations and policies, both investors and issuers should be on the lookout to capitalize on emerging opportunities and avert risks.

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