China's Changing Private Market Landscape and its Emerging Investment Opportunities

A workshop hosted by the Private Capital Research Institute and the PBC School of Finance, Tsinghua University

On June 21, 2019, a group of limited partners ("LPs"), academics, and general partners ("GPs") met at the PBC School of Finance at Tsinghua University in Beijing, China to share perspectives on the changing landscape of private capital in China. The days of bewilderment about private capital are long gone for the Chinese entrepreneur. Private capital investors are pouring more and more money into Chinese firms. Over the past three decades, the private capital industry in China has grown and evolved into a mature industry, now a US$1.6 trillion[1] industry with over US$94 billion[2] in private equity investment value last year alone.

The maturing of the industry has challenged both Chinese GPs and LPs to rethink their value creation strategies and their relationship with each other. The traditional C-to-C ("Copy to China") business model is disappearing as new technology is being used to disrupt traditional businesses. While a significant portion of many LP investments is direct, LPs still strive to establish strong working relationships with top GPs, either through investing in funds or co-investing. As the first generation of entrepreneurs grows older, buyouts with some leverage are becoming a larger part of investment strategies. Lastly, the academic research featured in this workshop showed how, despite challenges, the creative use of data can help answer some important questions about the evolving Chinese private capital industry.

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[1] Cheng, Evelyn, "China's Once-burgeoning Private Equity Industry Hits Growing Pains," CNBC, https://www.cnbc.com/2018/09/27/chinas-once-burgeoning-private-equity-industry-hits-growing-pains.html.

[2] Akhtar, Usman, Johanne Dessard, and Kiki Yang, *Asia-Pacific Private Equity Report 2019*, Bain Capital, March 15, 2019.

Limited Partnership Perspective

Olivia Ouyang led a panel discussion on China's evolving private capital landscape with a group of prominent limited partners. Discussants included Claire Bai, China Investment Corporation; Meng Ann Lim, Caisse de dépôt et placement du Québec; Ye Shen, Temasek; Frank Su, Canada Pension Plan Investment Board; and Yiqing Wan, China Life.

As the volume of private capital transactions in China has reached new heights, LPs have had to adapt to the evolution of new Chinese business models for private capital funds, as well as the increased availability of capital pushing valuations to higher levels. The slowing macroeconomic growth in China and aging of first-generation entrepreneurs has also presented new investment opportunities as well as challenges. Moderator Olivia Ouyang led this distinguished group of LPs to discuss their observations on how their investment strategies have evolved as the VC/PE industry in China has begun to mature over the past decade.

In today's environment, the LPs explained that they are witnessing a disruption to the traditional world in which they historically were invested. In the past, the role of the GP did not emphasize post-acquisition value-add: the operating involvement was primarily directed to taking their portfolio companies public in either the Hong Kong or US public equity markets. Moreover, many of the entrepreneurs' strategies were quite unsophisticated: a common business model was the "Copy-to-China" strategy (taking existing models from abroad and bringing them directly to China).

Today, the mixture of investments and strategies has changed sharply. Entrepreneurs are pursuing new business models not seen before, often ones that are technology and innovation driven (approximately 50-60% of all new investments funded). Moreover, there are many more types of investment strategies seen in China; start-ups, growth, cross-border, control leveraged buyouts, and buy-and-build-type approaches. LPs are no longer looking for generalist GPs, but rather ones with sector specialization and strong management skills.

The panelists agreed that PE and VC market dynamics in China are similar to those observed in the US today. With the extensive availability of funds, there is constant pressure for Chinese VC funds to raise more and more capital. This is creating a struggle for many GPs, who are faced with the temptation to get large. In most cases, the LPs find that the larger funds are earning less than satisfactory results. More disciplined GPs, who are more likely to limit the size of their funds, are better able to build a good track record.

Despite the attractive historical returns generated in the VC industry, the LPs explained that China is simultaneously seeing the emergence of buyouts with investor control and leverage. This change is being driven by the fact that the first generation of entrepreneurs are aging and considering exit strategies. (Unlike in many emerging markets, China does not have a strong tradition of families handing down businesses to the next generation.) In addition, the slowdown in China's macroeconomic growth and increased competition are creating more opportunities for buyout transactions. While control leveraged buyouts represented about 20% of the private capital investments in 2017, there is still much uncertainty, as witnessed by a drop to about 10% in 2018. In the short-run, the LPs explained, there is substantial unpredictability around the availability of debt financing due to regulation, the willingness of founders to embrace different corporate governance structures, and the ability to attract strong management teams. In the long-run, however, the panelists felt that leveraged buyouts will inevitably become more common in China.

Direct investing and co-investing strategies featured prominently in the LP panel discussion. A remarkably high percentage of LP investments in China is direct, as high as 90% for some LPs. While direct investing is extremely common, the LPs added that there are still tremendous benefits to creating a long-term partnership with GPs through co-investing. For the LP, co-investments are not solely about returns and lower fees, but more about knowledge transfer. They see a significant benefit in gaining experience and developing a strong internal team by investing alongside their GP relationships. While there are many advantages from co-investing for the LP, the LPs felt that GPs also gain from the practice. Co-investments allow GPs to take larger initial investment stakes and have a smoother hand-off at the time of exit. Also, GPs may derive a competitive advantage from the skills and connections of a local LP team.

Lastly, the impact of rising tensions in US-China trade relations on private capital in China was discussed. None of the LPs felt that there was a need to change their strategies in the short run in light of the tensions. The main potential short-run impact could stem from supply chain disruption. In the long-run, most felt that the tensions would not likely have a material effect because China is such an important global economic force that cannot be ignored. To be cautious, however, trade war tensions have highlighted the importance of China developing its own technological capabilities, causing LPs to intensify their due diligence focus on the innovation and R&D capabilities of managers.

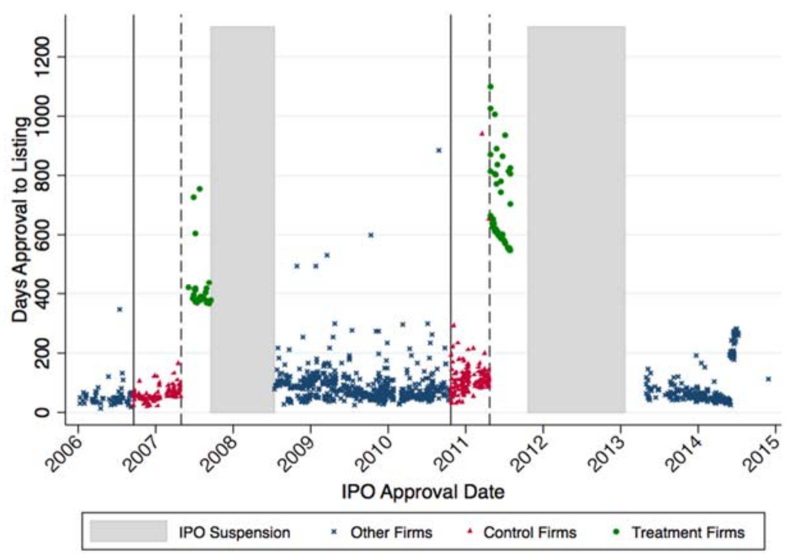
Academic Perspective

Josh Lerner from Harvard Business School led a panel discussion on the challenges of doing research on the Chinese private capital industry with a group of academics. Discussants included Sabrina Howell, New York University; Mannie Liu, Renmin University; and Xuan Tian, Tsinghua PBC School of Finance.

The lack of comprehensive and readily available data on the private capital industry worldwide poses challenges to academic researchers, who often have to rely on non-standard data to analyze the impact of this financial intermediary. These data challenges could not be more pronounced than in the study of private capital in China, where the industry — and the information sources about it — remains at a relatively young stage. In this panel discussion, a group of academics, led by Josh Lerner, presented their research on the Chinese private capital industry and their approaches to overcoming the data challenges.

Professor Sabrina Howell began by describing her research with co-author Will Cong at Cornell University[3], which looks at the importance of having reliable access to IPO markets on the development of corporate innovation. To examine this, the researchers isolate two periods in China's history in which the Chinese IPO markets were suspended (2008-09 and 2012-14). The researchers then look at two groups of firms that filed for an IPO within the year before each suspension. One group was able to successfully IPO before the shutdown (these control firms typically filed to go public a number of months before the suspensions) versus another group whose IPO was delayed due to the suspension (the treatment firms whose IPOs were delayed in many cases for a year or more). See Figure 1 below.

Figure 1 – IPO Delay (by Approval Date)



Source: Cong and Howell, Slide presentation of "IPO Intervention and Innovation: Evidence from China," Tsinghua University and PCRI Roundtable discussion, June 21, 2019

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[3] Cong, Lin William and Sabrina Howell (2019), "IPO Intervention and Innovation: Evidence from China," NBER Working Paper No. w24657.

The researchers find that losing access to the IPO market had a deleterious long-term effect on the innovation created by the firms. The treatment firms saw an immediate 28% drop in patent activity in the year following the suspension. What is most striking is that even four years after the suspension, after having gone public, this same group had 18% lower patent activity versus the control firms. The researchers conclude that these firms fall behind permanently. The findings suggest that innovation has a cumulative component and that the uncertainty and financial constraints caused by the IPO suspension disrupted the fundamental development of the firms. The researchers further conclude that having a well-functioning public equity market is critically important for funding innovation. Professor Howell added that these results have important implications, particularly for emerging markets, where there is more uncertainty due to regulation, as well as fewer alternative sources of capital.

Professor Mannie Liu described her research on revenue-based financing ("RBF"), which is a type of financing (equity or loan) in which capital is repaid based on a percentage of ongoing revenue, typically up to some stipulated amount. RBF is typically used by smaller companies who are profitable but not growing fast enough to be of interest to venture or angel investors. The small size and uncertain finances of these firms deter the interest of banks as well.

These deals have the potential to offer many advantages. For the entrepreneur, RBF is an attractive source of capital. It is often quicker and easier to obtain over alternative sources, as there is no need for an exit or a personal guarantee. Furthermore, there is little to no loss of ownership. For investors, there is a substantial pool of qualifying firms. Again, these investments are easier to set up, and are generally less risky than traditional equity. With RBF transactions, the return of capital to investors begins within the first year and full liquidation is expected within seven years.

Data on RBF transactions are still difficult to find because, most often, terms of agreements are not published. Thus, to study RBFs, Professor Liu examines several case studies of RBF transactions. Whatever the specifics of the structure, the return to the investor will depend on the percentage of the revenue received by the investor, the cap on investment returns (which is frequently a multiple of the initial investment amount), and the company's revenue growth rate. By studying RBFs, Professor Liu hopes to get a better understanding of this fast-growing and promising financial market that is offering opportunities to meet the funding needs of underserved companies through financial innovation.

Professor Xuan Tian highlighted his research with graduate student Jiajie Xu[4] at Boston College on whether place-based policies in China have a role in the promotion of local innovation and entrepreneurial finance. The researchers specifically focus on targeted geographic areas called National High-Tech Zones ("NHZs"). As of 2016, there were 146 NHZs established in China, which have become a major economic engine in China, representing 12% of China's GDP, 44% of R&D expenditures, and 20% of total granted invention patents in 2015.

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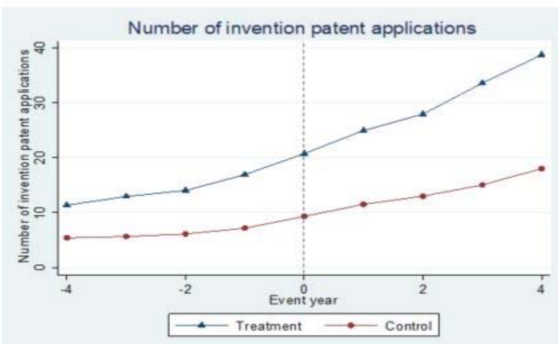
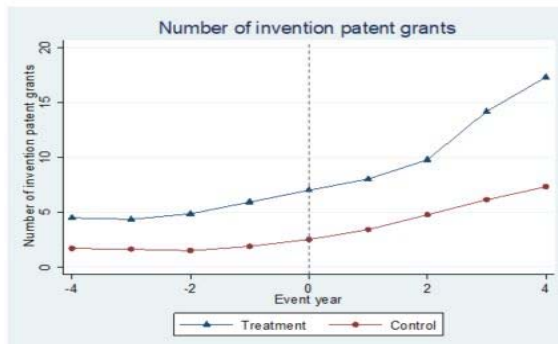
[4] Tian, Xuan and Jiajie Xu (2019), "Do Place-Based Programs Affect Local Innovation and Entrepreneurship," SSRN Working Paper.

The researchers conclude that NHZs seem to promote innovation, as measured by patent activity. They find that the establishment of an NHZ leads to a 34% increase in patent applications, 50% increase in patent grants, 23% increase in patent citations, and 12% increase in new firm registrations (See Figure 2 below). Professor Tian explained that the most plausible explanations for these results are that NHZs enjoy many advantages: favorable tax treatment, more early-stage VC investment from public sources, land price reductions, access to financing resources, and reduced administrative burdens. He adds that there is also more talent cultivation in NHZs, with over 4,000 more college students in each NHZ district than non-NHZ districts.

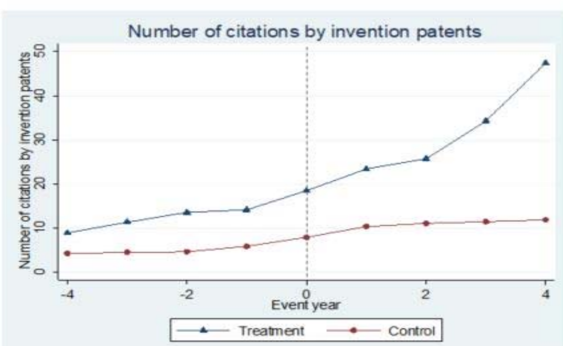
Figure 2



Panel A: Number of invention patent applications



Panel B: Number of invention patents grants



Panel C: Number of citations by invention patents

Panel D: Number of new firm registrations

Source: Tian and Xu (2019), “Patent and Firm Registration Dynamics Surrounding Establishment of Zones,” SSRN Working Paper.

Despite the inroads made by these promising empirical studies and the fascinating development of Chinese industry, there still is a lack of good data sources on Chinese private capital and the impact of government policies. This may reflect the sensitivity of the Chinese to sharing confidential data. Proprietary data is sometimes available, but often redacted. There are, however, some commercial companies, such as Alibaba, pushing the frontier on making data available to researchers.

GP Panel Perspective

Carolyn Chen from the Silicon Valley Bank led a panel discussion on the evolution of the Chinese private capital industry with a group of leading GPs. Discussants included Julian Chen, Warburg Pincus; Feng Deng, Northern Light; Erhai Liu, Joy Capital; Ray Yang, Marathon Venture Partners; and Xu Yi, CICC Capital.

Since 2005, the growth of assets under management in the VC industry in China has been astounding. The annual returns to VC investments in China have frequently been between 20% and 30%. Furthermore, there has been an increasing number of venture capital spin-off firms in China, as talented managers leave large firms to start their own firms. In this discussion, a group of veteran GPs shared their perspectives on the hyper-growth of private capital in China over the past several decades, as well as about the opportunities and challenges of private capital in China in the future.

In early 2000, much of China's economic growth was driven by state-owned enterprises. The shift to VC driving growth in China in the late 2000s, the panelists explained, was marked by three notable changes. First, the tremendous growth of GDP per capita in China (growing from US$1,500 to US$8,000 in the past ten years) had a huge impact on consumption and personal wealth, creating investment opportunities in higher-end consumption market segments, such as wellness devices, consumer services (equivalent to Amazon delivery or GrubHub in the US), and healthcare. Second, while China never focused heavily on basic research, it became very good at the application of new technology, helping to disrupt traditional Chinese business models. Lastly, shifts in government public policy presented new investment opportunities. For example, public policy to boost health care has been a tremendous impetus to innovation and entrepreneurship in the healthcare industry.

Over the recent decade, the panelists noted that they are seeing many new investment opportunities. For example, there are many more investments focused on product innovation (much at the incubation stage). Also, they added that the spotlight is no longer only on local Chinese markets, as many GPs are looking abroad for opportunities – often in businesses that help Chinese companies tap international markets or foreign real estate. Yet, despite the growth in these new industry investment opportunities, there are still tremendous investment opportunities in traditional industries in China that are using modern technology as part of their business models (e.g., coffee shops like Luckin Coffee using apps for advance ordering or vehicle parts providers that use technology to improve customer service, similar to AutoZone in the US).

The GPs provided their perspectives on the dynamics and challenges of co-investing with LPs. Unlike their counterparts in the US, most Chinese LPs require co-investments. While often the GP's role in a co-investment relationship is relegated to being one of financial and strategic advisor to the LP, the panelists explained that co-investments have benefits to GPs. These investments enable them to change their investment strategies by increasing deal size, which is especially helpful when the financing requirements of portfolio companies are large. Also, larger-sized investments help enhance the impact of GPs on their portfolio companies. However, for top GPs who can raise funds easily, there is more flexibility when it comes to co-investments: they do not need co-investments in early rounds and can be more selective in their LP co-investors for later rounds. The panelist added that co-investing can sometimes be problematic, as many LPs are not quick to make decisions, especially in early-stage rounds. Thus, LPs typically co-invest at a later stage – one rarely sees an LP invest in A or B stages. Also, one other disadvantage of co-investing is that LPs require more transparency and have higher requirements for reporting, which can become a burden for GPs.

Lastly, the GP panelists shared their thoughts on the potential impact of the recent US-China trade wars on private capital investing in China. The panelists observed that there could be short-run implications on both fundraising and exits. Already, there is a negative impact on Chinese currency-denominated (renminbi) fundraising compared to US dollar fundraising: the total amount of Chinese currency fundraising roughly decreased by 35% in the last year, while US dollar fundraising increased more than 120%. According to the GPs, US LPs are more patient and understand the long-term nature of private capital investments in China. In contrast, Chinese LPs are less patient and worry about exit strategies, which for a Chinese company is typically limited to an IPO. Chinese companies, seeking to IPO in the US, may become concerned about the uncertainty of the US stock market due to the trade war. While the uncertainty may hurt companies seeking to IPO in the US, this is bringing more opportunities for Chinese companies seeking to IPO on the Chinese stock market. However, in the long-run, the GPs stated that they did not believe the trade wars would have a major impact on their activities.

Final Thoughts

With the slowing of China's GDP growth, private capital managers will have to hone new skills to drive value creation in their portfolio businesses in China. Investors evaluating fund managers will have to employ new evaluation measures to identify those firms which will be able to excel in the new competitive environment. Meanwhile, it seems likely that managers and investors alike will increasingly shift attention to new investment opportunities outside China's technology sectors, to markets that may not be so highly valued.

The workshop surfaced many important themes that suggest further exploration, both by academics and practitioners. Among the open questions are:

- To what extent will the movement of Chinese funds to tech-focused and venture investments be sustained, or shift back to later-stage transactions?
- What capabilities will be required to be successful in China's new private capital environment?
- Will the push by asset owners toward more direct and co-investments be rewarded?
- Will the Chinese government's economic policies enhance or hinder the further growth of the private equity and venture capital industries?
- How quickly will the Chinese economy adapt to trade war pressures and what will be the impact on the industries deemed attractive for private capital investment?