



Private Equity Insights

SIXTEENTH EDITION | Q2 2019

CURRENT QUARTER PERFORMANCE SUMMARY

The State Street Global Exchange® Private Equity Index (GXPEI) posted an overall return of 3.55% in the second quarter of 2019, a slight decrease from the 4.48% return in Q1 2019. Venture Capital funds led the group for the sixth quarter in a row with a 5.86% gain, followed by Buyout funds at 3.18% and Private Debt funds at 1.41% (see Exhibit 1).

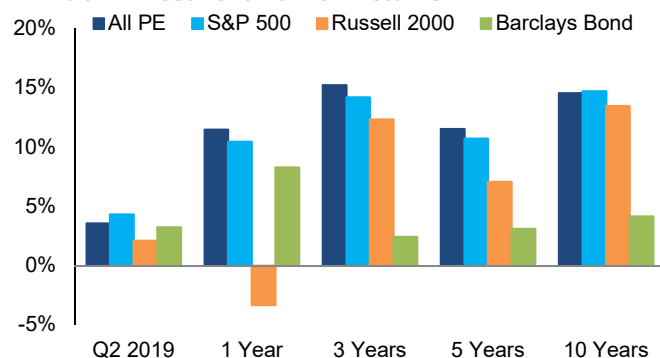
Exhibit 1. Private Equity Performance by Strategy

Column1	All PE	Buyout	VC	Private Debt
2019 Q2	3.55%	3.18%	5.86%	1.41%
2019 Q1	4.48%	4.03%	6.43%	3.57%
YTD	8.28%	7.42%	12.73%	5.15%

Source: State Street Global Exchange®, as of Q2 2019.

As shown in Exhibit 2, GXPEI outperformed the small-cap stocks (proxied by Russell 2000) and US debt market (proxied by Barclays US Aggregate Bond Index) over all horizons. Over mid term horizons (1 year – 5 years) GXPEI outperformed the US equity market public equity market (proxied by the S&P 500), but underperformed over quarterly and 10-year horizon.

Exhibit 2. Investment Horizon Returns



Source: State Street Global Exchange®, DataStream, Bloomberg Barclays US Aggregate Bond Index (total returns as of Q2 2019).

Continued on page 4.

CHINA'S CHANGING PRIVATE MARKET LANDSCAPE

Insights from Harvard University
and the Private Capital Research
Institute

By Leslie Jeng and Josh Lerner



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 trillion¹ industry with over US\$94 billion² in private equity investment value in 2019 alone (also see Preqin data in Exhibit 3). This is especially true for the venture capital industry; since 2005, the growth of assets under management in the VC industry in China has been astounding, driven by annual returns to VC investments in China reported to between 20% and 30% (Exhibit 4). But at the same time, the industry is facing unprecedented stress from both external and internal pressures.

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. This event was co-sponsored by the School and the Private Capital Research Institute, a non-profit

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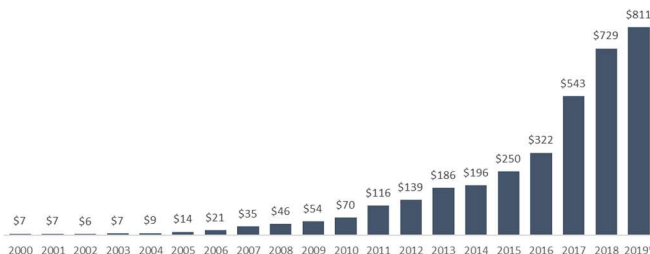
¹ Cheng, Evelyn, "China's Once-burgeoning Private Equity Industry Hits Growing Pains," CNBC, <https://www.cnbc.com/2018/09/27/chinas-once-burgeoning-private-equity-industry-hits-growing-pains.html>.

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

devoted to encouraging the development and dissemination of research about the private capital industry.

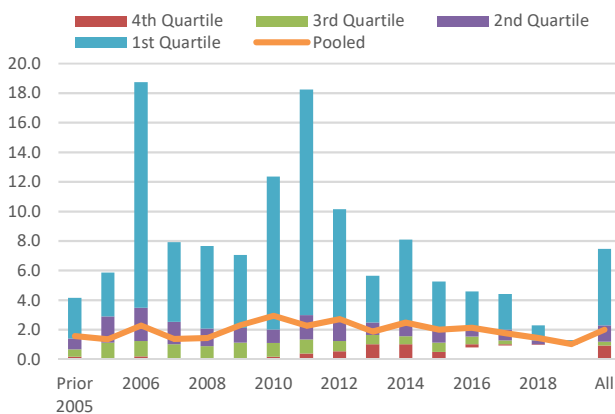
Exhibit 3. Total Private Equity Asset Under Management (\$B) of China-based Managers

Total PE AUM (\$B) of China-based managers, 2000-2019*



Source: Preqin as of 10/28/2019.

Exhibit 4. China Venture Capital deals - Total Value to Paid-In Ratio Quartile Chart



Source: State Street Global Markets as of 2019Q2.

In early 2000, much of China's economic growth was driven by state-owned enterprises. The shift to VC-backed entrepreneurs becoming an important driver of growth in China in the late 2000s was enabled 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. This income growth created 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 traditionally had not focused heavily on basic research, it became very good at the application of new technologies at scale, helping to disrupt—or leapfrog entirely—traditional business models.
- Lastly, shifts in government public policy presented and amplified new investment opportunities. For example, public policy to boost health care has been a tremendous impetus to innovation and entrepreneurship in the healthcare industry, and many funds benefit from public investments or co-investments.

Reflecting on this growth, the Chinese private capital market is rapidly changing. In the past, the role of the GP did not emphasize post-acquisition value-added services. 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 funded 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).

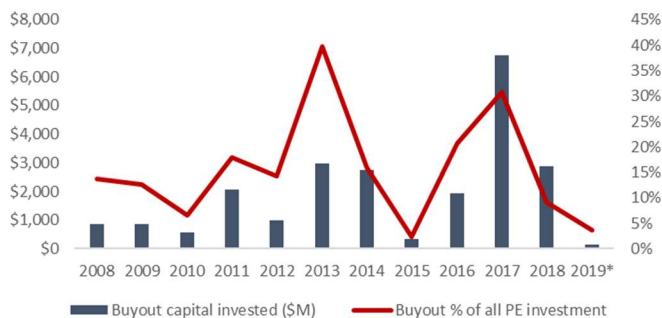
Today, the mixture of investments and strategies is changing sharply. Rather than simply copying western business models, entrepreneurs are pursuing new business models not seen before, often ones that are technology and innovation driven (approximately 50-60% of all new investments funded). Moreover, there are many more types of investment strategies seen in China, including start-ups, growth, control leveraged buyouts, and buy-and-build approaches. The spotlight is no longer only on local Chinese markets, as investors are looking abroad for opportunities – often in businesses that help Chinese companies tap international markets or foreign real estate.

Despite the growth in these new industry investment opportunities, the participants thought that there were still tremendous investment opportunities outside of the core area that venture capitalists have focused on, which have been characterized by very high valuations. Many of these focused on traditional industries in China that were increasingly using modern technology as part of their business models. Examples included 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.

Despite the attractive historical returns generated in the VC industry, China is simultaneously seeing the emergence of buyouts with investor control and leverage (Exhibit 5). 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 volatility, as witnessed by a drop to about 10% in 2018. In the short-run, 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 believe that leveraged buyouts will inevitably become more common in China.

Exhibit 5. Chinese Buyout Investment Trends



Source: Emerging Markets Private Equity Association.

Lastly, the panelists shared their thoughts on the potential impact of the recent US-China trade wars on private capital investing in China. From an investment strategy perspective, the panelists believed there could be short-run implications on both fundraising and exits. Currently, 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%. Much of this is driven by the fact

that Chinese LPs are less patient and more worried more about exit strategies, which for a Chinese company is typically limited to an IPO. The greater uncertainty of the trade wars could hurt companies seeking to IPO in the US, but could also bring more opportunities for Chinese companies seeking to IPO on the Chinese stock market. In the long run, the panelist felt that the tensions would not likely have a material effect because China is such an important global economic force that cannot be ignored.

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 groups that will be able to excel in the newly competitive and challenging 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.

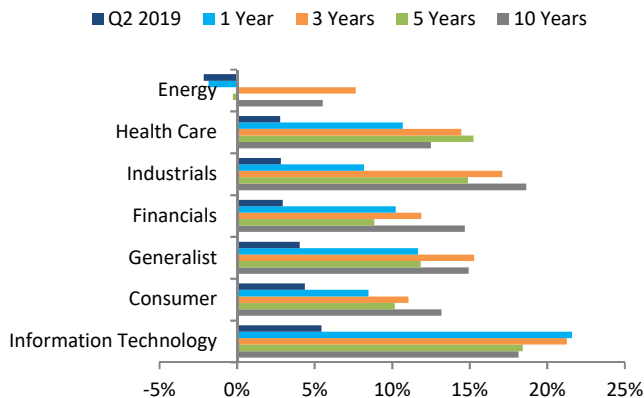
Josh Lerner is Director of the Private Capital Research Institute and Jacob H. Schiff Professor of Investment Banking and Head of the Entrepreneurial Management Unit at Harvard Business School. **Leslie Jeng** is Director of Research of the Private Capital Research Institute.

The Private Capital Research Institute is a not-for-profit 501(c)(3) corporation formed to further the understanding of private capital and its global economic impact through a commitment to the ongoing development of a comprehensive database of private capital fund and transaction-level activity supplied by industry participants. The PCRI, which grew out of a multi-year research initiative with the World Economic Forum, also sponsors policy forums.

CURRENT QUARTER PERFORMANCE SUMMARY – CONTINUED FROM PAGE 1

Among sectors, Information Technology funds led for the sixth straight quarter with a 5.45% quarterly return, slightly down from 6.72% in Q1. These were followed by Consumer funds with a 4.37% quarterly return, up from 2.32% in Q1. Energy funds – the only sector experiencing a negative return in Q2 – saw returns fall to -2.15% from 2.42% in Q1 (Exhibit 6).

Exhibit 6. Returns of Sector Focused Private Equity Funds



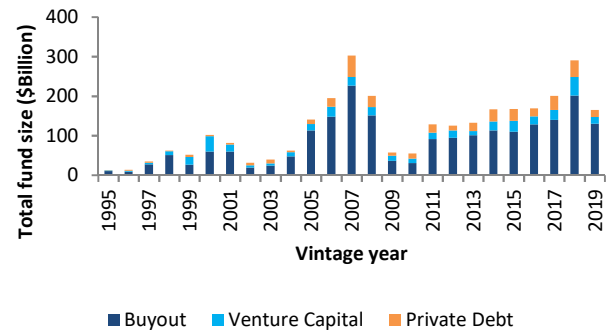
Source: State Street Global Exchange®, as of Q2 2019.

Fund Raising

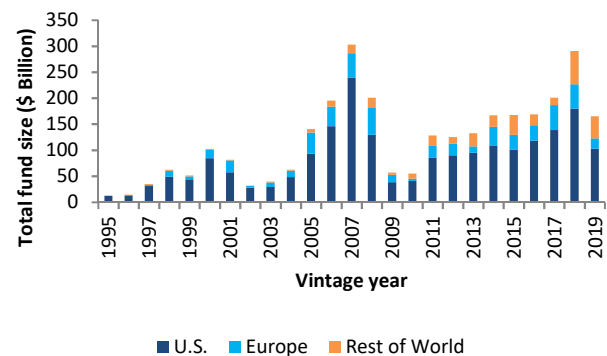
In the first half of 2019, Buyout funds followed a steady pace in fund raising activities with more than \$160 billion raised, nearly 65% of the funds raised in 2018. However, Venture Capital and Debt Related funds continued seeing a slowdown since the first quarter of 2019. Both strategies raised \$17 billion in the first two quarters, which was only 37% and 41% relative to their fundraising throughout last year (see Exhibit 7(A)). Across regions, U.S. and Rest of World collected \$103 billion and \$42 billion respectively thus far, more than half of the amounts raised in 2018. Europe fundraising fell behind with \$20 billion, counting only 42% of the total amount from last year (see Exhibit 7(B)).

Among sectors, Information Technology funds drew growing attention from investors over the past five years. Given the relative poor performance from the energy sector since 2014, the fundraising proportion of Energy-focused funds was trending down in recent five vintage years compared to 2009 – 2013 vintage years. Consumer, Financials, Industrials and Health Care sectors stayed small (see Exhibit 8).

Exhibit 7. Total Fund Size (USD Billion) (A) By Strategy

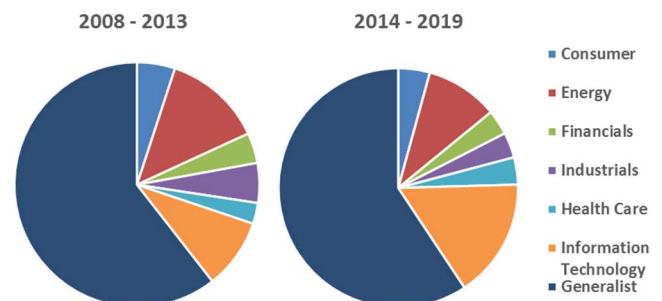


(B) By Region



Source: State Street Global Exchange®, as of Q2 2019.

Exhibit 8. Total Fund Size by Sector Focus (Vintage Year 2008 – 2013 VS. Vintage Year 2014– 2019)

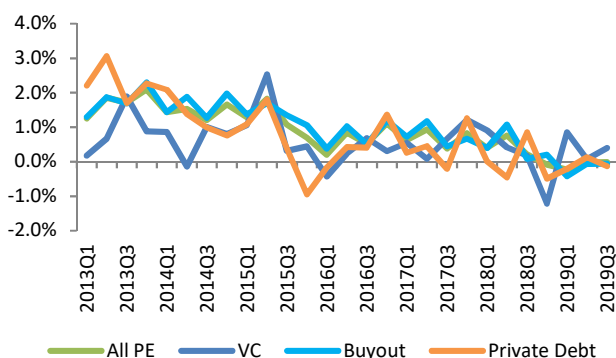


Source: State Street Global Exchange®, as of Q2 2019.

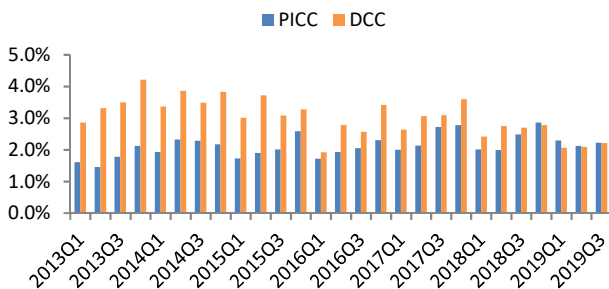
Cash Flow Activity

Exhibit 9(A) shows a general trend of diminishing net cash flow since Q1 2013. The overall net cash flow was still floating around zero in Q3 2019, driven by the fact that the quarterly cash flow distributed to investors stayed at a cautious low point of 2.2%, normalized by commitment (see Exhibit 9(B)). Net cash flow of Venture Capital marginally increased to 0.4%.

Exhibit 9. Quarterly Cash Flow Ratios Normalized by Commitment (2013Q1 – 2019Q3)
(A) Net Cash Flow



(B) Contribution and Distribution of All PE



Source: State Street Global Exchange®, as of Q2 2019.

Valuations

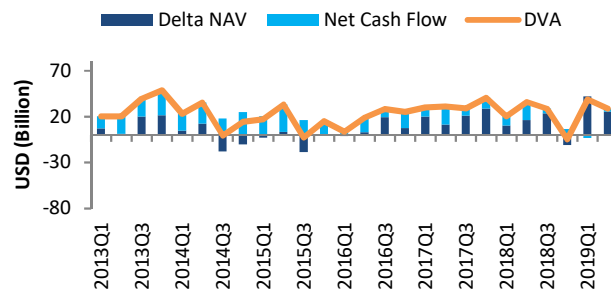
The Dollar Value Added (DVA) is the sum of NAV changes and net cash flows. It measures the realized and unrealized gain and loss in dollar amounts.

$$\text{DVA} = \text{Ending NAV} - \text{Beginning NAV} + \text{Distribution} - \text{Contribution}$$

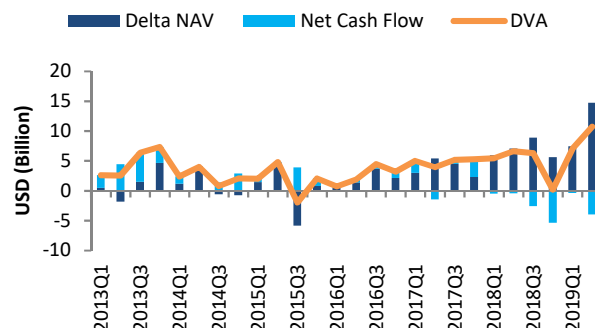
The non-growth equity funds saw a decrease in DVA from \$39 billion to \$29 billion, driven by the slowdown in delta NAV

to \$25 billion from \$42 billion in Q1. Growth equity funds, on the other hand, saw quarterly DVA trending upward since the dip in Q4 2018 and reaching all-time high at \$10 billion in Q2 2019, despite the negative quarterly net cash flow of \$4 billion. DVA of Private Debt funds dropped to \$2 billion from \$5 billion in Q1 (see Exhibit 10).

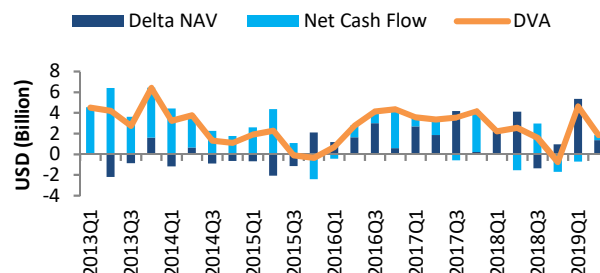
Exhibit 10. Dollar Value Added (2013Q1 – 2019Q2)
(A) Non-Growth Equity



(B) Growth Equity

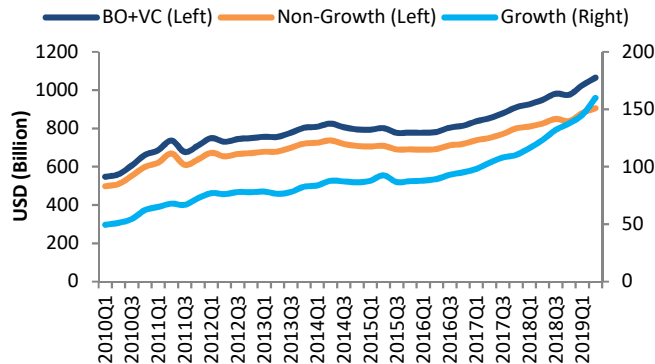


(C) Private Debt



Source: State Street Global Exchange®, as of Q2 2019.

As shown in Exhibit 11, the remaining value (NAV) of growth equity picked up steam over past four years and recorded at \$160 billion in Q2, up from \$145 billion in Q1. The non-growth equity funds, which held the majority remaining value of overall Buyout and Venture Capital funds, steadily increased the remaining value to \$905 billion in Q2 2019.

Exhibit 11. Net Asset Value (2010Q1 – 2019Q2)

Source: State Street Global Exchange®, as of Q2 2019.

ABOUT THE GX PRIVATE EQUITY INDEX

Participants in private capital markets need a reliable source of information for performance and analytics. Given the non-public nature of the private equity industry, collecting comprehensive and unbiased data for investment analysis can be difficult. The GX Private Equity Index ("GXPEI") helps address the critical need for accurate and representative insight into private equity performance.

Derived from actual cash flow data of our Limited Partner clients who make commitments to private equity funds, GXPEI is based on one of the most detailed and accurate private equity data sets in the industry today. These cash flows, received as part of our custodial and administrative service offerings, are aggregated to produce quarterly Index results. Because the GXPEI does not depend on voluntary reporting of information, it is less exposed to biases common among other industry indexes. The end result is an index that reflects reliable and consistent client data, and a product that provides analytical insight into an otherwise opaque asset class.

- Currently comprises more than 3,000 funds representing over \$3 trillion in capital commitments as of Q2 2019.
- Global daily cash-flow data back to 1980.
- The Index has generated quarterly results since Q3 2004.
- Published approximately 100 days after quarter-end.

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