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Rewards and Risks in China's PE Market

An executive summary of the Privcap series "Private Equity in China"

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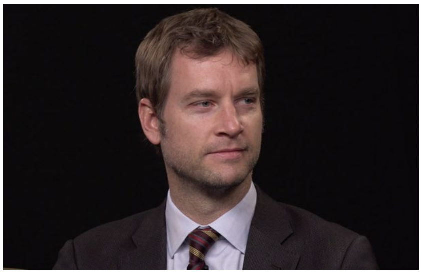
Rewards and Risks in China's PE Market

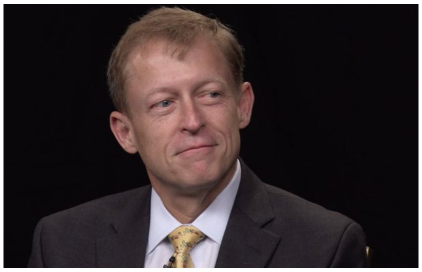
Key Findings

1. Private equity in China is picking up speed
2. Exits are difficult, and IPOs are not readily available—but there are other options
3. More seasoned players will dominate the market
4. There are multiple drivers of deal flow
5. Credit is in the toolkit of large, successful firms

The Panelists



Benjamin Fanger
Managing Director,
Co-founder
Shoreline Capital



Robert Partridge
Managing Partner
EY

Robert Petty
Managing Partner,
Co-founder
Clearwater Capital Partners

1. Private equity in China is picking up speed

Private equity in the world's second-largest economy is gaining momentum after a slow 2013. It is accelerating on the strength of investor expectations for increased deal size and volume, according to "China Private Equity Outlook, 2014," published in April 2014 by Bain & Company. The report says 80 percent of active PE investors in China expect average deal size to rise up to 25 percent in the year ahead, and 70 percent expect buyout activity to increase at a similar clip.

The Chinese government is also promoting PE investment. In June 2014 the new "Nine Regulations" released by the Chinese State Council placed "Cultivating the Private Equity Market" in its own section for the first time, while the 2014 Securities Traders Conference positioned "Private Equity Market and Innovative

Development" as its first topic of discussion.

At the same time, private equity professionals operating in China are getting better at their job. "The industry's in its second generation," says Robert Petty of Clearwater Capital Partners. "It has now got a seasoned group of experienced GPs who are on fund two and fund three, so we really have hit the maturation point in terms of the development of the industry."

2. Exits are difficult, and IPOs are not readily available—but there are other options.

Despite the rapid rise of the PE industry, it has been a trial by fire for many China investors. "The biggest topic is the difficulty around exits," Petty says. "We're excited about the fact that the market's gotten to the second stage, but we should recognize that exits and development and creating liquidity is the dominant question mark."

Many private equity firms entered the Chinese market with the expectation that exits would be available via IPO. But in recent years, the public markets have not been an easy option.

"What was planned to be the channel of exits has not been for the last few years—and that's the IPO market," says Benjamin Fanger of Shoreline Capital. "Some strategies don't rely on the IPO market as their exit. We certainly don't and have returned capital to our investors, but none of it has come from the IPO market."

However, a public offering is not the only way to achieve a return. "There are strategies within the private equity space that work in an environment where the economy is decelerating," Fanger adds. "But it requires managers who can do something other people can't do—actually add value to the investments they make."

The good news is that confidence is rebounding and

Benjamin Fanger, Shoreline Capital

Order in the Court

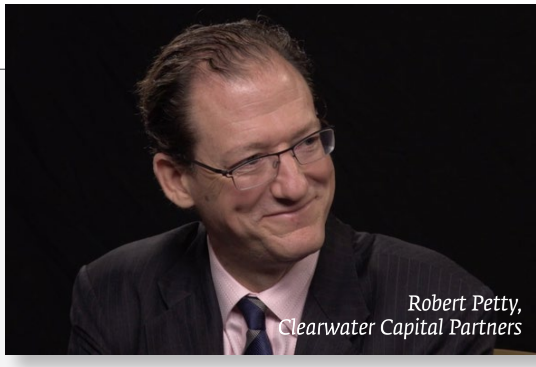
The biggest fear for foreign investors in China is the perceived lack of court protection. Fanger believes the tide is turning and that it's now possible for investors to win legal battles in China, if it comes to that.

Why does he think so? Because his firm, Shoreline Capital, went to court and won.

"We bought a portfolio of hundreds of non-performing corporate loans, and one these was a loan to a state-owned enterprise that was no longer operating and didn't have any assets that we could find," he says. "But we found evidence that they had transferred all of their assets to a subsidiary of an extremely large tobacco company in China. And when we found that out, we employed what's called fraudulent conveyance law to say that you got all the assets but now you also have to take on the liability."

Using the courts, Shoreline was able to freeze the defendant's bank accounts, as well as other equity and real estate holdings. In the end, the company was forced to settle with Shoreline.

Fanger says that China's legal system has developed to a point where firms can sue parties that they wouldn't have been able to take to court 10 years ago. "Today," he says "you can navigate the legal system in China and actually have it work."



Housing on Fire

A hot new opportunity for private equity investors in China is direct lending. And one of the best places to be a direct lender in China is in the real estate market.

"We own a particular residential building that is now in presales with two-times-collateral coverage," Petty says. "Purchasers are borrowing from us at 22 percent and paying us two points up front. That's a pretty interesting cash flow."

Why are buyers willing to pay such a high interest rate? "Because it's cheap equity," Petty explains. The average price for a residence in China is about $70,000, which is four to six times a regular family's income. That makes the housing market affordable and fast-moving.

This kind of investing in China "is not for the inexperienced," Petty warns. "But there are really interesting loans out there with good collateral and real buildings where real people are living."

exits are coming. Robert Partridge of EY notes that his firm was involved in an encouraging amount of new investments and exit planning in the first half of 2014.

"In the first four months, we've been involved in over 70 private equity deals in China," he says. "Many of those haven't closed yet, but I would say the investment appetite's very strong, and part of that is because there is the belief that exits are coming."

Partridge said that for the first time in the 15 years he's been working in China, he's seeing GPs feel confident enough to tell LPs to hold on to an investment a little longer, because they believe market conditions are improving and exit opportunities are right around the corner.

3. More seasoned players will dominate the market.

China is still far from an easy place for private equity firms to do business, particularly for those firms that don't have a lot of experience in the market. The closure of the IPO option is forcing them to exit China altogether.

"There are going to be more players who fall out," Partridge says. "We've certainly seen some challenges in fundraising efforts by unseasoned PE teams. There are a lot of PE professionals out there who might have had a good track record, raised a fund a couple years ago, and they're now challenged with the shutdown of the IPO market. We're starting to see those players not able to raise additional funds."

He says the players who survive will be those who are very focused on operational improvements and long-term growth enhancement, not short-term flips. They have the experience and knowledge to source deals even in a tough environment.

"What we're seeing is more established players getting more of a track record and getting more creative in finding deals," Partridge says. "The seasoned players are the ones we see driving an uptick in activity, as opposed to more macroeconomic conditions."

4. There are multiple drivers of deal flow.

Deals in China can be reached by a number of paths. Fanger observed that China is reaching a point in its current economic cycle where nonperforming loans are surfacing and being sold, a result of the credit boom of 2009 and 2010, when China doubled its loan book.

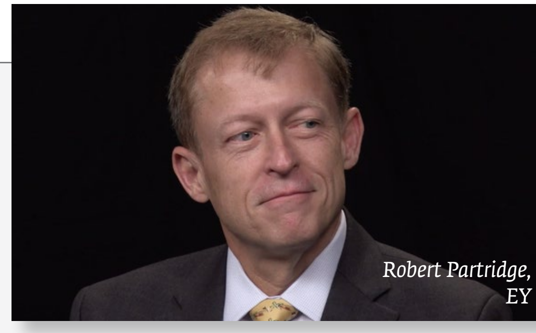
"At that point in time, I was telling investors there would be a lot of nonperforming loans coming out of this," Fanger says. "But obviously it's not an opportunity until banks recognize them. They go into default; banks recognize them and then sell them. And that's exactly what we've seen in the last 18 months or so."

Last year, banks sold twice as many NPLs as they did the year before, Fanger notes. And his conversations indicate there will be twice as many this year as last year. That presents a large opportunity. NPLs are estimated to stand at between $1T and $3T, and these will be recognized over the next decade.

"So that's one opportunity," Fanger says. "The other is deceleration, which is causing companies across China in various industries to be willing to pay private-equity-level returns for debt. That's a dislocation in China right now that's brought in growth-oriented private equity investors to access the opportunity."

The scale of credit in China is immense. There is about $20T total credit in the system. Petty calls that "a very interesting opportunity set to think about." The surge in credit has spurred a reaction by regulators. State banks are being reined in, and the trust banks, which have been the mid-tier lenders to small and medium-size enterprises, are being restrained with new rules.

"That leads a whole host of companies to look for alternative credit," Petty says. "So we actually just do di-



The Game of Risk

Foreign investors in China are rapidly figuring out how to manage and mitigate risk.

"The right type of operators, that focus from day one on improving risk management throughout the process, are really the ones that we see being the most successful over the short term and long term," Partridge says.

A significant factor in mitigating risk is the ability to source deals effectively. "When sourcing deals through intermediaries, you need to find counterparties that are sophisticated enough to be willing to do all of those things which are actually very important to protecting your investment in China," Partridge says. "So sourcing is something that is extremely important to be able to get those types of outcomes."

Advances are being made by foreign investors as they learn to skillfully navigate the market. "The awareness among the GPs looking for opportunities in the market is happening more frequently, such as the awareness of what's going on in the judicial-enforcement area," he says. "And to the extent that continues to progress positively, it might create even more opportunities."

rect loans. We're lending money directly to companies that are unable to get through all the different regulatory constraints. Frankly, getting money is tight, so you can charge appropriately for it, and you can also write good documents."

5. Credit is in the toolkit of large, successful firms.

Many firms that started life in China as traditional private equity firms are now interested in expanding into credit.

"The managing director at one of the largest private equity firms in China once said to me in Chinese, 'You guys make sweat money, we make the easy money over here doing pre-IPOs,'" Fanger says. "That same investor today is trying to get into our space, because the pre-IPO strategy is not a strategy but a play on a certain market and is not sustainable. Now they see this private credit opportunity and want to get into it."

Seasoned players with good track records, those who do not have difficulty in fundraising, are looking for more ways to deploy more capital, and many of them are turning to credit.

"They're seeing credit opportunities as a way to replace the traditional common-equity, private-equity investing," Petty says.

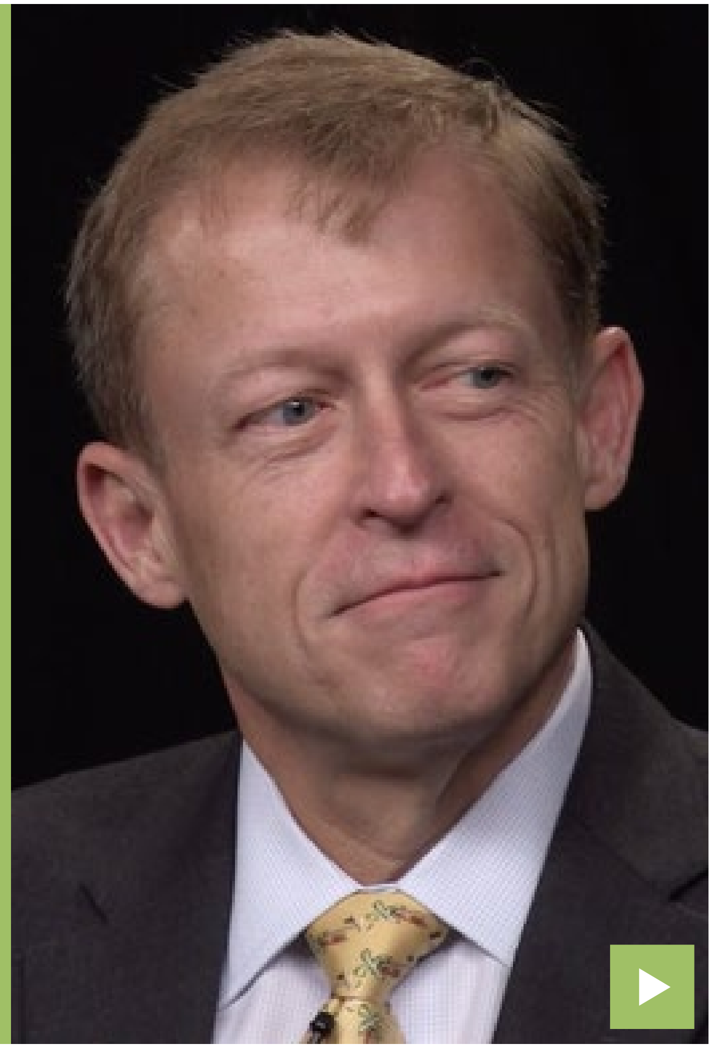
Partridge says he sees large, successful firms now thinking about credit on a pan-Asian level, with an immediate focus on China and its enormous $20T credit market. "This has people thinking that China might be the first place they practice credit strategies," he says. "The opportunity is really quite interesting. The legal system has developed, practitioners have gotten more experienced, and there's more money to think about putting credit to work as part of what you do in China or pan-Asia."

But firms must proceed with caution. Fanger notes that most pan-Asian and global firms that are adding credit as a strategy have never been to court in China and have never owned one loan, let alone thousands. He says he and Petty are the only two people he knows of who have done NPLs in China, been to court in China, and still manage a private equity fund.

"If everything goes well, you invest in a bunch of loans, none of them default, and it's fine," he says. "But if things don't go well—and particularly in a decelerating environment where you have increasing distress and asset values declining and things like that happening—there will be losers in that situation. ◆

Expert Q&A

with Robert Partridge
Managing Partner
EY



How does EY help private equity firms invest successfully in China?

With private equity in China, EY really helps deliver superior returns, whether it's helping originate deals at the front end or helping execute from a diligent structuring standpoint, to value creation once investments are made, to exit readiness, to audits of the investees, to tax and consulting advice, we're there from the front end of the landscape to exit and beyond, helping private equity deliver superior returns.

One thing about EY that differentiates us is we're very passionate about private equity in China. Certainly, others are too. But, if anything, we've overinvested in this space. Having worked on about 200 deals last year, and 70 in the first four months of this year, the ability to predict what we're going to see next and help GP's get through the execution landscape quickly, assess what kind of things they need for day-one readiness, and start to put their eyes, for those deals that are going to close, on value creation— that's what sets us apart from our competitors.

Please contact Robert Partridge at **robert.partridge@hk.ey.com**
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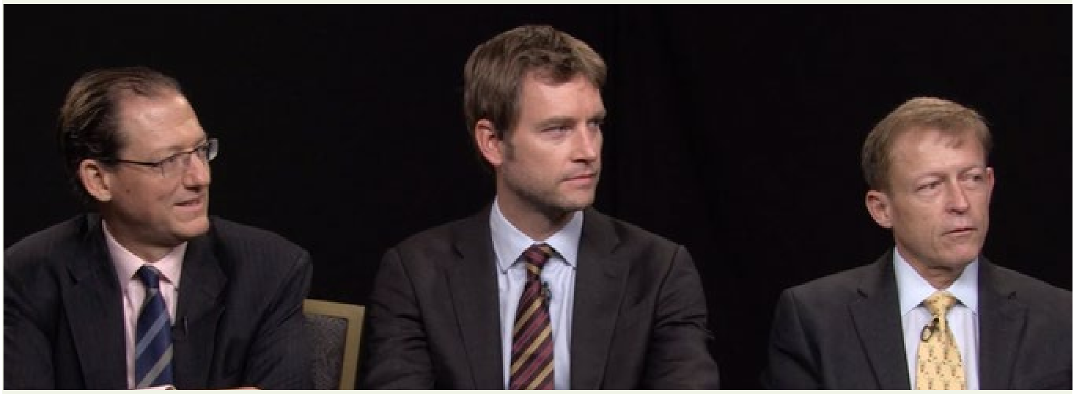

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