AUGUST 2016
www.bdo.com

AN ALERT FROM THE BDO PRIVATE EQUITY PRACTICE

BDO KNOWS:
INTERNATIONAL PRIVATE EQUITY

INTRODUCTION TO PRIVATE EQUITY TRENDS IN MAINLAND CHINA

In recent years, China has emerged as a top player in the global market, with considerable growth in the private equity (PE) sector.

According to the BDO Horizons Q2 2016 Report, China accounted for nearly 23 percent of all global mid-market M&A deals in Q1 2016. In the first half of 2016, sovereign funds participated in at least $16.4 billion cross-border deals, according to Asian Venture Capital Journal. This figure already far exceeds the previous annual record of $11 billion in 2012.

In a historic move in June 2016, the China Securities Regulatory Commission lifted the ban on foreign investment. As a result, there has never been a better time for private equity funds to get acquainted with the Chinese market. In collaboration with BDO China, we compiled an overview of private equity in China that details recent trends, outlines new regulations and provides insights on the growing sector and its changing regulatory landscape.

INDUSTRY OVERVIEW

2015 marked a period of tremendous growth for private equity in China, boasting record-high deal values and volumes. At year-end, the total number of private equity funds operating in the country reached 1,314, with a fund-raised value of USD $117.7 billion. This marked a 141 percent increase in volume and 46 percent increase in value from the previous year.

PE funds in China are structured similarly to U.S. funds, with the main fund structure being the PE investment fund under partnership. Fund managers, or general partners with unlimited liability, usually contribute a small percentage of total committed capital, but earn an annual management fee at a certain percentage. They have the legal power to act on behalf of the investment fund. Passive investors, or limited partners (LPs), normally contribute the majority of the total committed capital with limited liability.

Typical limited partners in China include:

- Sovereign wealth funds, funds-of-funds (FOFs), Social Security funds, banks, insurance and other financial institution-based funds. These are the targeted investors for PE funds.
- The idle funds of state-owned, private and listed companies.
- The idle funds of high-net-worth individuals.

Despite media reports of overvaluation, the average return for PE firms in China was still 33 times more than the initial investment in

HOW DO I GET MORE INFORMATION?

Interested in learning more about PE investment and trends in China? Please contact:

LEE DURAN
Partner & Co-Leader of the Private Equity Practice, BDO USA
858-431-3410
lduran@bdo.com

SCOTT HENDON
Co-Leader, Private Equity Practice, BDO USA
214-665-0750
shendon@bdo.com

BILL LIAO
Partner & China Services Desk Head
310-557-8537
bliao@bdo.com

LARRY MIAO
Senior Director, China Services Desk
212-885-7450
smiao@bdo.com

Read more ▶

2015. This increased return rate is indicative of continued growth and a successful wave of exits in the years following China's "National PE Period" in 2011, when there was a nationwide explosion of new Renminbi (RMB) private equity funds.

2015 featured a decrease in IPO activity and steady M&A activity, with many private equity and venture capital firms engaged in major transactions throughout the year. PE firms exited a total of 360 deals valued at $5.372 billion through M&A transactions, with the average ROI for M&A reaching 5.44. However, IPO activity was decidedly more anemic—ROI for IPO exits reached just 2.18—the lowest rate in five years. In fact, new offerings came to a standstill in 2015 as the total value of IPOs dropped from $95.7 billion in 2014 to $4.5 billion in 2015—a 95 percent decrease. This caused PE firms to withdraw from the public markets.

NEW REGULATIONS

At the end of this successful year for the PE industry, the China Securities Regulatory Commission launched a series of self-regulation policies designed to tighten supervision of PE firms and managers. Instituted in February 2016, the "Internal Control Guidelines for Private Equity Fund Managers" are designed to minimize overall risk and require private equity funds to strengthen internal risk controls and standard operational capacities. They also require private equity fund managers to establish an effective human resources management system with senior management in charge of risk control compliance.

While China has strengthened internal regulations, it has also eased up on restrictions to foreign investments, taking steps to open its traditionally closed markets to international investors. In June 2016, the China Securities Regulatory Commission passed regulations that allow foreign private equity funds to invest in domestic stocks and establish asset management services within China.

PE INVESTMENT TRENDS IN 2015 AND 2016 TO DATE

Overall, private equity funds in China have favored enterprises with simple commercial business models, competitive management teams and unique value propositions. Industries that attracted significant PE investment in recent years include technology, media and telecommunications (TMT); new services (professional services, modern logistics, TV shopping and film); chain industries (catering, educational training, healthcare, supermarkets, pharmacy, chain retailers, etc.); and clean energy.

PE investment strategy diversified significantly in 2015. For the first time in the history of PE in China, startup companies received more funding than developed projects. With increased funding from private equity, there was also significant growth in the number of FOFs, which offer less risk, lower capital requirements and more stable returns.

Technology has been a particularly hot area of investment. TMT investment increased by 330 percent in 2015 due to the mergers of large enterprises and the return of variable interest equities. We've also seen increased interest in emerging sectors like mobile medical care and online education.

WHAT LIES AHEAD IN 2016?

The private equity industry has shown promising signs of continued growth throughout 2016, and we expect this trend to continue through the end of the year. According to a ChinaVenture report, only 4 percent of Chinese limited partners plan to reduce private equity allocations—a significant decrease from 22 percent last year. Instead, 57 percent of LPs said they plan to maintain allocations to PE this year, up from 34 percent last year. With private equity in China continuing to flourish, we predict a few key trends will emerge in the coming months:

1. **The Online-to-Offline (O2O) market will continue to boom, but attention will gradually return to traditional core businesses.**

   We expect the O2O market to reach maturity as mergers take place, and as "Big Data" and "Internet Plus" continue to grow as the next frontier of technological innovation. Investors who remain interested in O2O businesses will look for companies to achieve a steady rate of development. Smaller startups looking to attract PE dollars should seek to streamline their businesses, enhance efficiency, integrate their supply chain, establish a compelling brand and improve the quality of their business models.

Read more ▶

2. **Sovereign wealth funds (SWFs) will play an important role.**

   China's sovereign wealth funds, which operate under government control and have their own advantages and shortcomings, will likely take on a dominant role in private equity. Through direct or indirect participation, SWFs function to standardize the investment behavior of capital markets and overcome market failures. To implement national macro-control and industrial policies, SWFs usually focus on innovative small- and medium-sized enterprises (SMEs), as well as fields with long-term growth potential, such as biopharmaceutical and environmental protection. To some extent, investments made by SWFs represent the government's forecast for future development. Foreign LPs may want to closely observe SWFs' investment strategies for insights into emerging opportunities.

3. **M&A activity will reach its peak.**

   Many startups are poised to begin scaling through mergers and acquisitions. These enterprises are eyeing targets that will allow them to acquire core technology, expand users, seek new profit growth points and integrate resources. We expect PE and venture capital firms in China will look to take advantage of this appetite by pursuing strategic buyers as a key exit strategy through the end of the year and possibly into 2017.

4. **Interest in the National Equities Exchange and Quotations (NEEQ) market will persist.**

   NEEQ has changed the pattern of the national capital market. Since its launch in August 2014, transaction volume has skyrocketed and, with IPOs stalling, the number of companies listed on NEEQ increased by 175 percent in the past year.

   The listing threshold for the NEEQ is low, which leads many investors to view a public listing as a viable exit strategy and stokes competition among corporate financiers and PE firms alike.

NEXT STEPS

For PE firms interested in exploring investment opportunities in China, the first step is establishing a solid understanding of the regulatory landscape and educating partners accordingly. Once firms cultivate a foundational knowledge base, they can then begin to flesh out an investment strategy and, crucially, a compliance strategy.

People who know Private Equity, know BDO.