

Private Equity: ***PE Trends in China***

Section AB:

Zhang Di

Marc Xu

Vaibhav Toshniwal

Zachary Lee

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1. EXECUTIVE SUMMARY

Whether or not the Chinese economy is slowing down, the private equity (PE) industry in the world's most populated country is flourishing. Many established global funds are growing their presence in China and domestic funds are emerging at an incredible pace. China is arguably creating momentum for the global PE industry as a whole.

China's PE market is growing rapidly, with total AUM reaching USD 1.6 trillion in 2016, supported by inflows from institutional investors, corporations and high net worth individuals (HNWI). Capital controls and the complexity of currency conversion mean that traditional firms which in the past raised USD funds have raised RMB funds in the last few rounds. Recent capital controls have changed the behavior of PE funds, sparking moves such as immediate capital draw-downs to avoid potential capital default.

From a sector perspective, high technology, industry, real estate and consumer goods jointly represent 60% of total deals in China. While most are growth deals, the proportion of buyouts has increased recently. General Partners (GPs) tend to focus on relationship-building with their portfolio companies and on operational improvements, as opposed to chasing returns. Raising capital is relatively easy but identifying great deals is challenging.

Domestic initial public offerings (IPOs) were the preferred exit path until a sudden change in IPO strategy in 2015. Firms and companies now pursue alternative exit approaches, including IPOs on overseas stock exchanges, buyouts, and secondary transactions.

We see a growing trend in co-investment in Chinese PE, reflecting concerns about returns and regulation compliance. Most Limited Partners (LPs) are happy with a hurdle rate of 5% to 14%, even though this proportion has dropped slightly. Dry powder has reached a record high after robust fundraising in 2016.

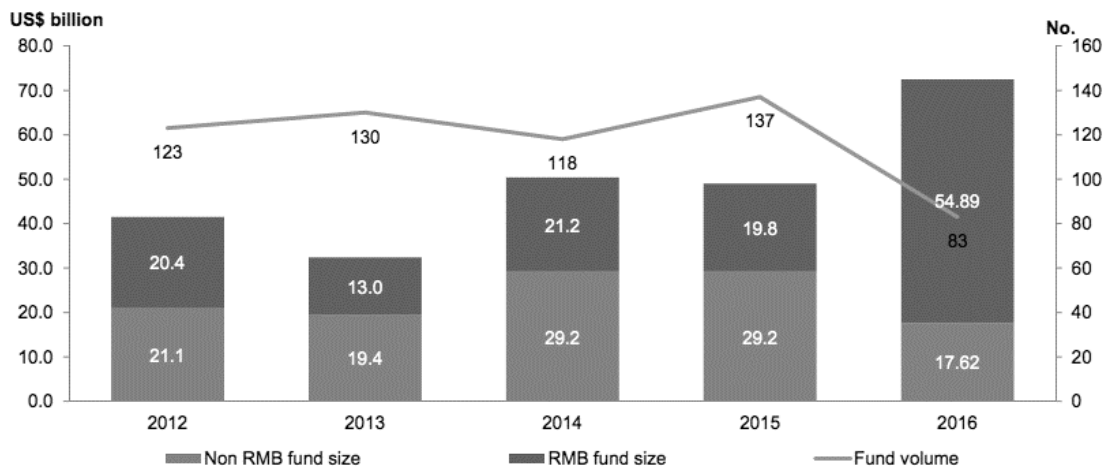
2. TRENDS IN FUNDRAISING

Skyrocketing RMB fund size

According to a PwC report, Chinese PE and Venture Capital (VC) funds raised a record USD 72.5B in 2016, a 49% growth rate over 2015. This was driven mainly by the scale of RMB funds, which grew from USD 19.8B to USD 54.9B, a rate of 177%. From another data source, pedata.cn, the total number of new funds closing in 2016 reached 1675, raising RMB 996B (~USD 144B).

A key driver of fundraising in China was the wave of exits in PE from 2013 to 2015, which provided LPs with significant capital for reinvestment. Furthermore, GPs have strong incentives to deploy capital after years of robust fundraising and low activity levels. Although the total amount raised reached a record level, the number of funds dropped from 137 in 2015 to 83 in 2016 (Figure 1).

Figure 1: RMB vs Non-RMB Fund Count



AVCJ and PwC Analysis

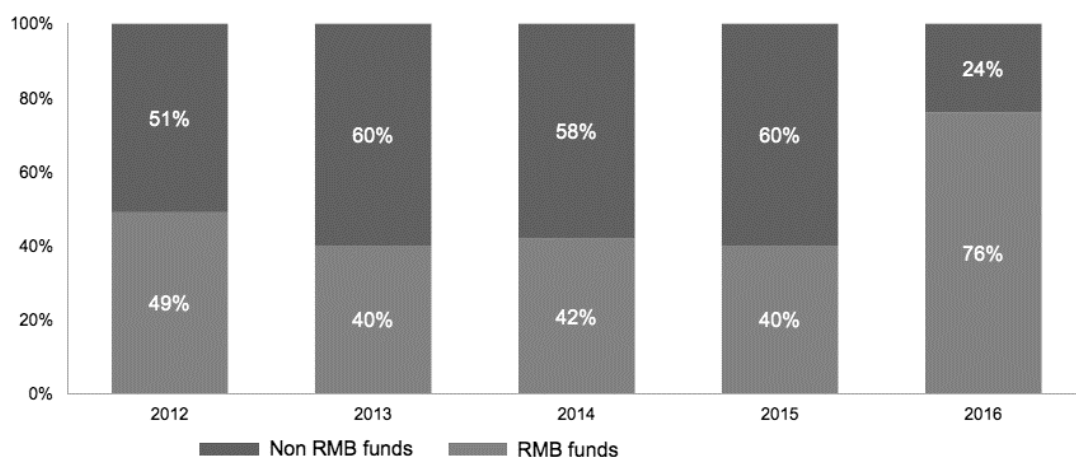
This signifies an increase in the average size of funds raised and an inclination among investors to commit to funds from larger more established PE/VC firms. At the same time, the non-RMB fund size shrank by USD 11.6B, falling from USD 29.2B in 2015 to USD 17.6B in 2016. These factors together resulted in a 76% proportion of RMB funds in the total PE/VC capital raised in

the year. As a relatively young market for PE/VC investment, China faced—for the first time—a RMB-dominant PE/VC market.

The RMB PE/VC market didn't exist ten years ago, and only took off from 2010. Until then, China's PE industry was the exclusive preserve of international names such as Blackstone, KKR, Carlyle and Sequoia, together with other pan-Asian firms based in Hong Kong and Singapore. These firms did well until the Chinese government began taking notice of all the money made in China by offshore dollar-investing entities. As a result, state-owned banks founded their own PE subsidiaries raising RMB funds, to get into the game.

The switch from non-RMB funds to RMB funds (Figure 2) was mainly due to the complexity of investing USD in China. As the actual investment is made in RMB—with at least two rounds of currency conversions and a lengthy government approval process for USD funds—domestic investors prefer RMB-denominated funds. Once the IPO wave released a huge amount of capital, especially held by SOEs, the RMB funds' money pool flooded.

Figure 2: Proportion of RMB vs Non-RMB Fund Size



Source: AVCJ and PwC analysis

As the local PE market matures, traditional foreign PE firms are likely to come under pressure from the top (government), the side (competitors) and the bottom (portfolio companies). A majority are likely to exit (or already have exited) the Chinese market and pursue a minority partnership with a local PE firm.

Pressure from the top – The Chinese government is changing the regulations to increase taxes on investors abroad, as well as intensifying scrutiny of local companies that receive foreign investment. There are reports that the tax authorities may draft regulations that seek to tax unrealized gains from Chinese partnerships, in which case the net return for the foreign investor would be reduced. Additional scrutiny and layers of investment approval for local Chinese companies discourages joint investments with foreign firms.¹

Pressure from the side – Many Chinese PE firms have sprung up over the last 10 years, gaining incremental know-how on how to raise funds, make investments and manage exits. In addition, they have greater advantages (than their international peers) as they have a stronger local network with the target firms and greater appeal to the Chinese government.

Pressure from the bottom – Most companies like to work with local PE firms because it is easier to build trust, so a local firm is more likely to get exposure to a deal than an international firm like TPG Capital. However, local PE firms generally hire a lot of people (at least 100), are less structured, and offer lower compensation than international firms.²

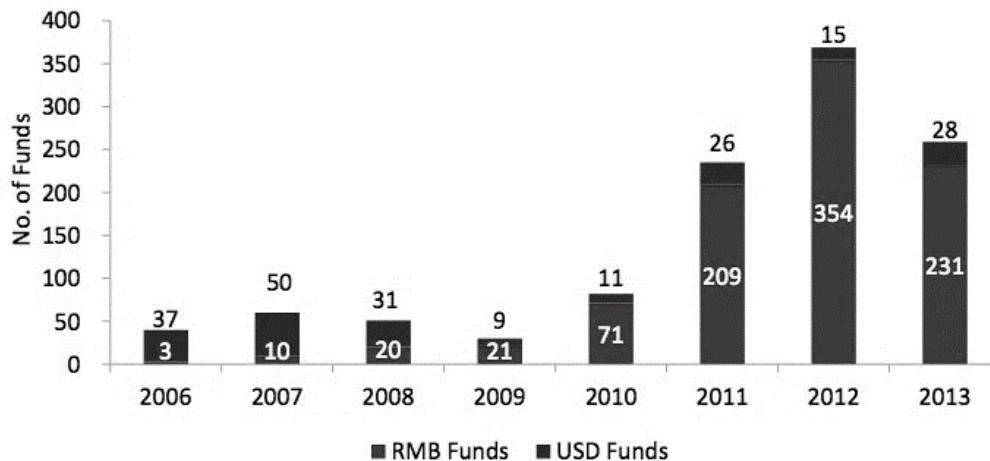
USD funds going RMB

¹ <https://www.m-brain.com/insights/industries/private-equity/chinas-pe-industry-grows-more-challenging-for-foreign-players/>

² <http://www.mergersandinquisitions.com/china-private-equity/>

Among the new RMB funds which have increased tremendously over the years (as shown in Figure 3), many are managed by GPs which previously raised funds in foreign currencies only.

Figure 3: No of RMB and USD Funds



Investors in USD funds are typically institutional investors such as China Investment Corporation (CIC), corporate funds and funds-of-funds. Before the capital control act kicked in, there was an ample supply of foreign currency. However, as a result of uncertainty related to capital controls, a growing proportion of USD funds are defaulting when the committed capital is called, hence raising USD funds in China is becoming increasingly difficult. We have witnessed a wave of foreign firms raising RMB funds and using them to invest in domestic projects (given the over-supply of RMB) – deals that are usually done in a swift and opportunistic fashion.

Role of sovereign wealth funds

The three main sources of funding in China are institutional investors (such as CIC), corporations, and high net worth individuals. In the first category a key contribution is made by sovereign wealth funds (SWF),³ which are government-controlled and are likely to come to dominate PE in China. Through direct or indirect participation, these funds function to standardize the investment

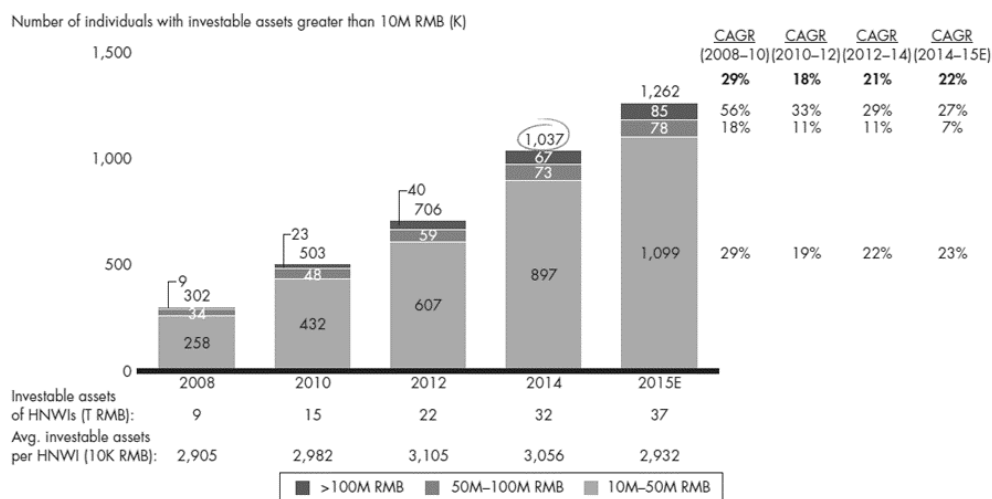
³ [https://www.bdo.com/insights/industries/private-equity/bdo-knows-international-private-equity-\(8\)](https://www.bdo.com/insights/industries/private-equity/bdo-knows-international-private-equity-(8))

behavior of capital markets and overcome market failures. To implement national macro-control and industrial policies, SWFs usually invest in innovative small- and medium-sized enterprises (SMEs), as well as industries 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, so LPs are advised to closely observe their investment strategies for insights into emerging opportunities.

High net worth individuals

HNWIs have investable assets of over USD 1M. These individual investors represent China’s private wealth. According to a survey conducted by Bain & Company and China Merchant Bank (CMB), private wealth in China surpassed RMB 100 trillion in 2014, growing at an annual rate of 16% from 2012 to 2014.⁴ The HNWI population exceeded one million in 2014, with a compound annual growth rate of 21% over the previous three years. By the end of 2014 their assets had reached RMB 32 trillion (~USD 4.7 trillion) as shown in Figure 4. In 2015, those numbers grew to 1.26 million (population) and USD 5 trillion.⁵

Figure 4: Information on HNWIs



Sources: National Bureau of Statistics of China; The People’s Bank of China; Shanghai Stock Exchange; Shenzhen Stock Exchange; CBRC Shanghai Office; UK HMRC; US IRS; Japan NTA; Korea NTS; Federal Reserve; Bank of Korea; Bank of Japan; World Bank; Bain analysis

⁴ <http://www.bain.com/publications/articles/the-evolution-of-chinas-private-wealth-market.aspx>

⁵ <http://www.prnewswire.com/news-releases/high-net-worth-trends-in-china-2016-300375012.html>

Until 2014, wealth preservation remained the top wealth management objective, followed by wealth inheritance (leaving wealth to later generations). HNWI's looked at overseas investment opportunities – Hong Kong and the US topping the list – to diversify their investment portfolios and spread risk. However, with the fluctuation of China's stock exchange, lowering returns on private banking products and tightening capital control, the choices for HNWI's are limited. Should capital controls continue, we forecast that money injected in PE and VC will increasingly shift to domestic sources of capital as personal investable assets grow.

Impact of Capital Control on fundraising

When the State Administration of Foreign Exchange (SAFE) passed a series of measures to restrict currency conversion and capital outflow in 2016, returns from previous investments within China could not be transferred abroad (and hence available for reinvestment in China). Afraid of their cash being trapped in this way, foreign investors are now reluctant to put in new capital. The restrictions have not only trapped foreign capital in Mainland China, compelling foreign investors to reinvest in RMB, but have meant less new foreign money entering this market.

From another perspective, default occurs more often than before when committed capital is called because of the lengthy, inconsistent process of currency conversion. To mitigate the risk of default and deploy capital efficiently, PE firms tend to call the committed capital once the fund is closed, as is common for corporate investors faced with higher risks of capital flow.

3. TRENDS IN TARGET FIRMS / INDUSTRIES

PE as the main source of funding

Chinese companies originally viewed PE less favorably, likening it to a tool invented by the West to take advantage of growth in the early stages of China's economic awakening. Most companies shied away from PE and leveraged bank loans as means to expand their business. As the

Chinese economy has developed, the equity markets have generally been unbalanced, underdeveloped and highly volatile, while loan issuance for state-owned enterprises is usually prioritized.⁶ This provides a fertile landscape for PE, partly because many Chinese funds have sprung up over the last 10 years, and partly because this asset class is seen to be capable of filling the gap left by domestic banks in the small and medium-sized enterprise space, particularly following the global economic downturn in 2008.⁷

With business owners' changing perceptions and the country's rigid capital markets, PE in China continues to grow, reaching approximately \$223B in value and 1,767 in deal count in 2016. We forecast that it will grow to reach \$300B over the next 7 years.

Popular Sectors for Chinese PE Firms

Many PE firms are generalists with a certain sector of expertise/focus. As the industry matures, specialized funds have sprung up in technology, industrial goods, real estate, consumer & retail, and healthcare.⁸

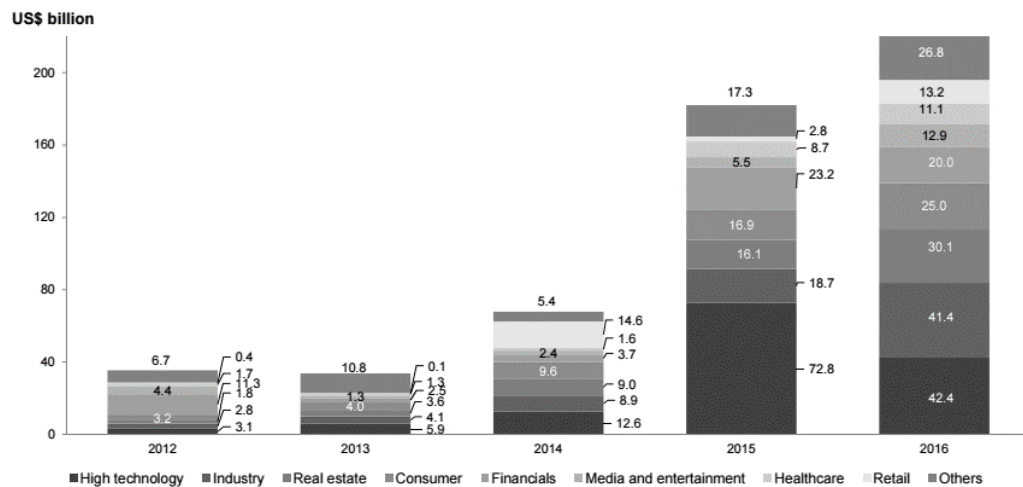
Technology: From Figure 5 we can see that high-tech funds represent close to 20% of the total value of PE deals. Their popularity reflects the ease with which the industry can scale and gather exponential growth. The success of BAT (Baidu, Ali Baba and Tencent) in China and the mega-IPOs of Facebook and Snap have attracted many entrepreneurs to the tech industry, leading to more potential targets for PE firms. Several tech-related themes have emerged.

⁶ <http://www.sigulerguff.com/sites/default/files/China-Private-Equity-Paper-December-2014.pdf>

⁷ <https://www.m-brain.com/insights/industries/private-equity/chinas-pe-industry-grows-more-challenging-for-foreign-players/>

⁸ <http://www.pwccn.com/en/private-equity/pe-china-review-feb2017.pdf>

Figure 5: Breakdown of PE Invested Sectors



The clean tech and environment protection sectors are rising in popularity due to China’s worsening environmental pollution situation. In addition, many MNCs now have sustainability targets. Demand for clean tech will not only come from the Chinese government but also the private sector.

Investments in the industrial goods sector, which takes up close to 20% of total investment, proved popular as China transitions from a labor-intensive economy to one driven by services and technology. As the manufacturing sector moves higher up in terms of value manufacturing, the demand for industrial goods will increase.

Real estate: Real estate has experienced tremendous growth since 2000.⁹ Investment in the real estate sector has proved attractive for PE firms as they can count on rental income and capital appreciation to diversify their portfolio.

Services: The services sector, such as consumer and retail, is significantly underdeveloped in China, prompting Chinese consumers to flock overseas to stock up on luxuries. The trend for greater consumption, especially of high-end premium goods,

⁹ <http://voxeu.org/article/just-how-risky-are-china-s-housing-markets>

clearly spells an opportunity for developing a stronger retail and consumer goods sector to satisfy domestic demand.






Healthcare: China's vast and aging population is the result of its One-Child policy. As a result of the demographic shift towards the older generation, demand for high-quality health care has risen sharply. While the policy has now been scrapped, the 'small family' mentality is engrained, and most developed cities in China have low overall fertility rates.

Not surprisingly, most of the above industries are similar to those supported by the Government as part of its 12th Five-Year Plan for National Economic and Social Development. Therefore, the use of private capital will accelerate and play a much larger role in the growth of these industries.

Key Investment Philosophies

Long term sustainability, operational improvements and building trust are the main themes of Chinese PE firms. To probe the investment philosophy of Chinese PE firms, we selected five market leading PE firms and researched their approaches to investment. (Findings summarized in Figure 6).

Figure 6: Investment Philosophy of Various Chinese PE Firms

	 HONY CAPITAL	 CITIC CAPITAL 中信资本	 国家开发银行 CHINA DEVELOPMENT BANK	 鼎晖投资 CDH	 BRIGHT STONE 明石创新
Operations Improvement	X	X		X	X
Market Expansion		X			
Long Term / Sustainable	X			X	X
China Focused	X	X	X		

In all of these firms, trust is a major consideration when selecting a company to invest in. The Chinese legal system is underdeveloped and the interpretation and enforcement of law remains questionable. The legal framework (agreements and side letters) serves more as a guide than to establish the rule of law. As such, a large portion of due diligence is spent understanding how management thinks and building a high level of trust.

Most Chinese PE firms invest almost 100% of their capital in domestic companies as the local market provides ample deal flow and opportunities. As PE is a local business, networks built over a long period of time will prove useful if they focus their attention on mainland China as opposed to moving overseas. However, some larger funds have begun investing in overseas company for two main reasons:¹⁰

1. Looking for technology with high growth potential that has not yet reached China,
2. Looking for products or services that might be lacking in China.

Pure PE funds focus on a level of operational improvement over a long-term horizon. The only exception in our survey is CDB Capital, as it is a subsidiary of the Chinese Development Bank and may perhaps not have sufficient operational experience. We hypothesize that having some operational expertise will attract more target companies to work with PE firms, as entrepreneurs believe that GPs can create value in their business rather than just providing financial expertise.

We also found that an accurate valuation of the company is not as important in China compared to the rest of the world. Most PE firms are flush with cash and often less sensitive to exact valuation methods. GPs primary motivation is not necessarily to make money for their investors: many feel that having a trusted relationship with an entrepreneur is more important, as gaining

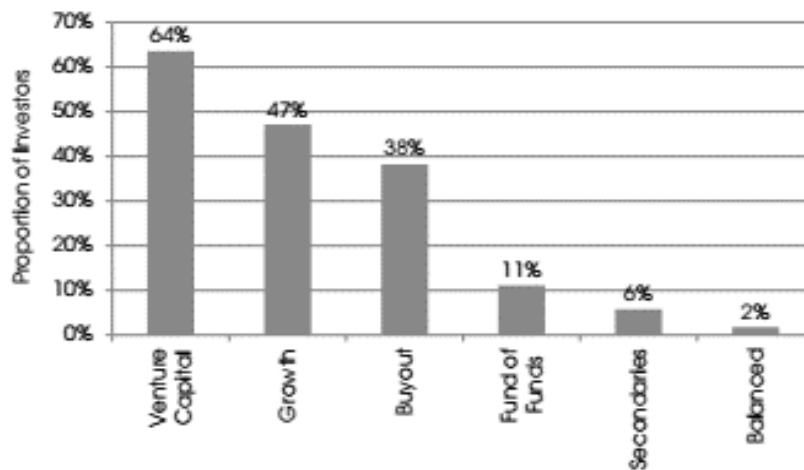
¹⁰ <https://digiday.com/media/chinese-private-equity-just-bought-first-ad-tech-firm-u-s/>

access to a good deal flow seems more challenging than raising capital, particularly given the large amount of dry powder in the country.¹¹

Majority Deals vs Minority Deals

According to Figure 7, VC and growth deals still dominate the market and a minority position is the most way to approach a target company. However, the landscape is changing as the buyout market will soon be a standalone category.

Figure 7: Proportions of Investors Investing in these Companies



Until now, buyout opportunities existed but were not preferred. There are 4 main drivers of this:

1. *Entrepreneur ownership* – Most public companies in China are first-generation family-run companies (a consequence of the late modernization of its economy). Entrepreneurs are often attached to their company and do not want to give up control.
2. *High growth rates* – Since China opened its door to foreign investors in 1989, the economy has experienced tremendous growth. The future looks great for company owners and they want a large part of the upside.

¹¹ <https://knect365.com/superreturn/article/6ff3f424-371b-4bab-8950-4a99cf23c1dc/how-renminbi-funds-took-over-chinese-private-equity-part-1>

3. *Opportunity cost for investments* – GPs do not want to pursue buyout transactions given the abundance of other compelling investment opportunities, or to risk entrepreneurs walking away from a deal if they insist on a controlling stake.
4. *Lack of operational expertise* – Operational demands are extremely heavy and can absorb a lot of GPs' time if they pursue a buyout opportunity. Operational talent is rare in China and it can be hard to hire someone with the right fit to manage a portfolio company.

However, we forecast that this landscape will change quickly and that buyout funds will grow to be at least equal to growth equity. Our rationale is as follows:

1. China's economy is slowing down and the economy faces a middle-income trap, which will likely constrain the growth of businesses.
2. As businesses are passed down, the next generation may not be interested in running the company or more open to letting other parties take control, preferring the capital gains that come with exit.
3. Professional managers are now more available, and many have had the opportunity to work in other MNCs and can take on the challenges in growing a business through operational improvement.
4. PE firms are raising bigger funds than ever and have more incentive and the financial prowess to do buyouts, rather than letting dry powder sit by.

4. TRENDS IN EXITS

Drivers of Exit Trends

The PE industry benefited from a surplus of highly attractive deals (low-hanging fruit) until 2015, opportunities attributed mainly to the high rate of economic growth at that time. PE funds could easily identify exit opportunities with average 18.6x P/E ratios, having entered with average 10.5x

P/E ratio at the beginning (Figure 8). The boom between 2005 and 2015 was heavily driven by low capital availability for the private sector, the entrance of international PE funds and deregulation of capital control.

Figure 8: Deal and Exit Multiples

Year Invested	Median Entry Price-to-Earnings (P/E) Multiple (TTM or FTM)	Median Exit/Current P/E	Multiple Expansion	Median Net Profit Growth CAGR
2005-2010	9.8x	21.0x	+120.0%	11.0%
2011-present	12.8x	14.8x	+20.0%	18.7%
Total	10.5x	18.6x	+80.0%	11.6%

Given that 2013 to 2015 was a major period for exits, the industry is facing more challenges in finding attractive investment opportunities.¹² With the slow-down of the Chinese economy due to a drop in labor surplus since 2015, firms are finding it more difficult to achieve the multiple expansion of the past decade.

A wide range of exit methods are being used in China's PE industry, which can be categorized in three main classes:

IPO – The number of IPOs in conventional A-stock listings has dropped drastically since 2015, due to a tightening in IPO approval requirements. Only 32% of exits were closed via domestic IPO in 2016, compared to 74% of in 2011.¹³ IPOs in domestic stock exchanges are still happening, such as the IPO of ZTO Express, but companies are also reaching further afield, such as Ali Baba listing on the NASDAQ.

Buy-out – Different buyout deals include mergers & acquisitions (M&As), secondary buyouts and management buyouts. Buyouts have increased drastically as an alternative

¹² http://www.bain.com/Images/Baln_rePORt_Global_Private_equity_report_2015.pdf

¹³ <https://zhuanlan.zhihu.com/p/24271720>

to IPO opportunities in China domestic stock market: for example, secondary buy-outs experienced an increase from 8% of exits in 2011 to 31% in 2016.¹⁴

Others – Other options include the option exchange and liquidation. Liquidation is the last choice when the investment is deemed to be a failure, as either the invested portfolio has no more growth potential or is facing bankruptcy. There has been little activity in this category recently.

The key drivers impacting the exit markets are:

- Tightened IPO approval requirements leading to a less attractive option¹⁵
- Recent booming of RMB funds established in China; there are more PE funds available to conduct buy-outs rather than relying on IPO as a form of exit

Impact of IPO tightening and capital control on exits

On 4th July 2015, the Chinese government suddenly announced that all IPO requests in A-stock would be suspended and all approvals delayed, with more stringent assessment and investigation of eligibility.¹⁶ This was widely perceived as a temporary approach to stabilize the A-class stock market, which had experienced a sharp crash in Q3 2015. The Shanghai Stock Exchange index dropped from 6200 to 2000 in two months.¹⁷ The move sent a strong negative signal to PE firms who were planning to exit via IPO in 2015. Before 2015, domestic IPOs were the preferred choice of most PE funds. Subsequently, many had to make the tough decision either to postpone an IPO indefinitely or to find alternative exits. Delaying exit is a challenge for most GPs because they need to fulfil returns to their LPs in a timely manner. As a result of the

¹⁴ http://www.360doc.com/content/16/0815/19/8507568_583447747.shtml

¹⁵ http://www.chinadaily.com.cn/business/2014-01/15/content_17238584.htm

¹⁶ <https://www.ft.com/content/352256cc-e2e2-11e6-8405-9e5580d6e5fb>

¹⁷ <http://money.cnn.com/2015/07/09/investing/china-crash-in-two-minutes/>

ruling, more exits were carried out in the form of listing on the National Equities Exchange and Quotation (NEEQ) and via M&As.¹⁸

All parties involved in the IPO policy change are lobbying the Chinese government to restore its former more investor-friendly nature. The tightened process has not only caused difficulty for PE exits, but has negatively impacted financing for many other profitable companies. On 11th December 2015, the IPO suspension was removed, but the tightened measures remained in place.

The Chinese government has begun initial investigations to transition from the current approval-based IPO system to a more flexible registration-based system, which is expected to be ready by May 2017.¹⁹ Under the current system many companies go through a cumbersome and lengthy review process before final approval. In the new registration-based system, stock underwriters will decide whether to offer shares of a company to the public and at what price, while the regulator will ensure that the listing company adequately informs potential investors about aspects of its business. PE funds are currently considering the impact of the system's execution.

Capital control: Starting from second half of 2016, Chinese central bank put in place several measures to limit capital outflows to slow down the depreciation of the RMB.²⁰ Capital outflow and depreciation of the RMB were driven by increasing foreign investment, fluctuating stock markets, liberalization of regulations, and an anti-corruption crackdown. It has become extremely difficult for capital to leave China without bureaucratic approval and an investigation procedure.

Capital control generated widespread anxiety among international PE funds by making it difficult to repatriate earnings to LPs' home countries following a successful exit. It also created a barrier for domestic investors to invest in offshore PE funds. For the foreseeable future, the Chinese

¹⁸ <http://www.investorscn.com/2016/08/01/11282/>

¹⁹ http://english.gov.cn/state_council/ministries/2017/02/11/content_281475564805676.htm

²⁰ <https://www.ft.com/content/02ab9faa-d595-11e6-944b-e7eb37a6aa8e>

government will maintain a stable exchange rate as one of the top priorities of the central bank.²¹ Tight capital control measures should be expected whenever the RMB is under depreciation pressure. Offshore PE funds and Chinese domestic investors looking for offshore opportunities should always factor this risk into their investment decisions.

Preferences in Exit Options between China and US

Exit options in the US include IPO, trade sale, strategic buy-out and leverage capitalization. In China, 74% of PE deals exited via NEEQ in 2016 (70% of US PE deals exited through a strategic buyout). Only a minority of deals exited via IPO in both China and the US. US PEs have become the experts in selecting, acquiring, fixing up and exiting from industrial companies, while Chinese PEs are still trying to figure out the best way to deal with a fragmented market, non-existing management and missing corporate controls observed in firms there.²²

5. MANAGING LP'S FUTURE EXPECTATIONS

Co-Investment Trends

The Chinese central government has recently taken a major role in supporting and encouraging VC start-up investment to boost growth in emerging areas of the economy, specifically centered around digital technology. Part of this effort has resulted in the creation of new investment structures that allow foreign organizations and domestic financial investors to co-invest in “special purpose” entities. Whether as a start-up or as a business spun out from a multinational company’s (MNC) existing Chinese business, this new type of co-investment structure is being used to establish standalone Chinese entities compliant with Chinese licensing laws and listing regulations by opening them to investment from Chinese VC, PE or other investors.

LP allocations and LP landscape

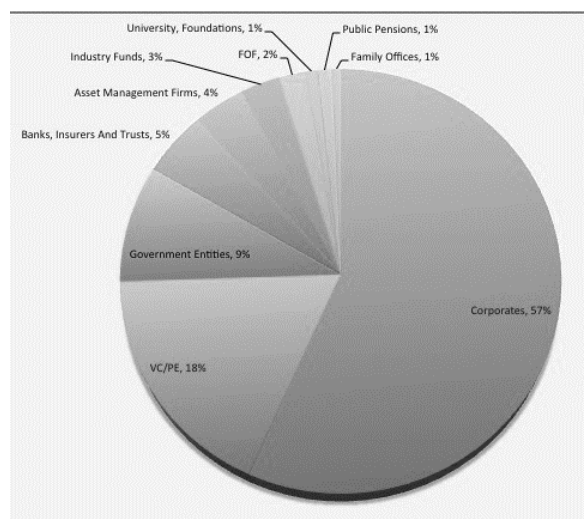
²¹ <http://www.businesstimes.com.sg/government-economy/china-will-crack-down-on-illegal-activities-to-keep-forex-market-stable-regulator>

²² <https://www.linkedin.com/pulse/why-private-equity-soars-china-stalls-peter-fuhrman>

Around 57%²³ of Chinese limited partners (LPs) plan to maintain their allocations to PE, compared to last year's 34%. Only 4% of LPs plan to reduce PE allocations, significantly less than last year's 22%.

Corporations continue to dominate the LP landscape in China (Figure 9), taking a 57% share of all LP types allocating to PE and VC funds. The number is little changed from last year's 56%. The second most important LP group is the PE/VC investors themselves, with an 18% share. They are followed by government entities, banks, insurers and trusts, asset management firms, government-guided industry funds, and funds-of-funds. In contrast, the biggest LP groups in developed markets, including pension funds, endowments and foundations, continue to be small and unimportant among ChinaVenture's list of 8,787 LPs on record.

Figure 9: Major Type of LPs in China



Around 61% of PE funds have a fund life of seven to eight years, 29% of funds have a life of between five and six years, and 8% of funds have a life of less than four years. This breakdown

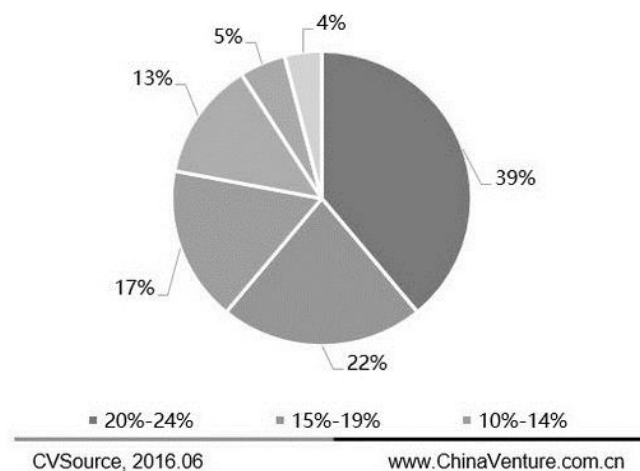
²³ <https://www.chinamoneynetwork.com/2016/07/12/limited-partners-in-china-plan-to-increase-private-equity-allocations> and Chinaventure.com.cn

reflects a lengthening of average fund duration in China compared to last year, as LPs are becoming more comfortable with longer fund terms.

Hurdle rate

A majority of LPs (71%)²⁴ prefer a hurdle rate of 5% to 14%, down from last year's 84%. Around 8% of LPs prefer a hurdle rate of 15% to 19%, and 17% prefer a hurdle rate of 20% to 24%. Based on Figure 10, in terms of PE/VC's actual internal rate of return, around 39% of funds achieved an internal rate of return of 20-24%, and 22% of funds recorded returns of 15%-19%, an extremely strong result.

Figure 10: PE/VE Generated Returns in China



Dry Powder

Chinese PE/VC funds have an aggregate RMB 2trillion²⁵ (USD 291B) of dry powder, or capital ready to be deployed, at the end of 2016 according to data released by Chinese research firm Zero2IPO Group. The record amount of dry powder comes after an impressive year for

²⁴ <https://www.chinamoneynetwork.com/2016/07/12/limited-partners-in-china-plan-to-increase-private-equity-allocations> and ChinaVenture.com.cn

²⁵ <https://www.chinamoneynetwork.com/2017/02/13/private-equity-and-venture-capital-dry-powder-reaches-291b-in-china>

fundraising in 2015, when 2,438 new funds raised RMB 1.37trillion (USD 199B), as compared to a total fundraising value of RMB 785B (USD 114B) in 2015.

In terms of investment, 9,124 deals were inked last year by PE/VC funds with combined deal value of RMB 745B (USD 108B), up from 8,365 deals worth RMB 525B (USD 76B) in total deal value registered in 2015, according to Zero2IPO. "Total fundraising, total investment and total deal volume have all set records last year, indicating rapid growth in equity investments," said Ji Li, director of Zero2IPO's research center. "The numbers show a completely different picture to what is commonly referred to as the 'venture investment winter' last year, showing that the equity investment market in China will have ample reserves for a long time to come."

6. CONCLUSION

China's PE industry has been experiencing huge recent growth in fundraising mainly driven by RMB funds. RMB funds have been growing dramatically in both invested value and the number of funds over the past 10 years. This trend is set to continue due to the strengthened capital controls put in place in mid-2016. Currently the main sources of capital for PE funds in China are institutional investors, corporations, and high net wealth individuals.

Many PE firms are generalists with a specific sector focus, but sector-dedicated funds have started to spring up as the Chinese PE industry matures, notably specialized funds in healthcare, clean-tech, high-tech and consumer & retail funds.

Long-term sustainability, operations improvement and building trust are the main themes of Chinese PE firms. Although VC and growth equity are the two most popular PE investment types, we see buyouts catching up rapidly.

A wide range of exit methods are used in the Chinese PE industry that can be classified in three categories: IPO, buyouts and others. Due to easing IPO approval processes, exits in China are projected to move from NEEQ listing to IPO in the future, while the buy-out option will remain the second most favored choice for investors in China.

Corporations continue to dominate the LP landscape in China, taking a 57% share of all LP types allocating to PE and VC funds in China. PE/VC investors are the second most important LP group in China, with an 18% share. They are followed by government entities, banks, insurers and trusts, asset management firms, government-guided industry funds, and fund-of-funds. PE/VC will play bigger roles in the future LP landscape. LPs are demanding higher hurdle rates as the risks increase. Investors are encouraged to follow SWFs closely to understand the China market.