A New Chapter for Private Equity in China

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Over the past decade, private equity (PE) in China has been one of the most attractive areas of investment for investors worldwide. The industry has grown considerably and is now comprised of more than $175 billion of commitments to investable funds.[1] Recently, however, the drivers of economic growth supporting this extraordinary investment opportunity have entered a period of significant transition. This shift has created a challenging environment for PE investing, placing more demands on the capabilities of general partners (GPs) and investment savvy of limited partners (LPs) to generate outsized returns. In the next phase of PE in China, we believe the industry will continue to offer compelling opportunities for investment, but in different, and sometimes new, stages, sectors, and strategies.

Siguler Guff & Company, LP was one of the earliest multi-manager PE funds on the ground in China, having opened our Shanghai office in 2006. Our local team has nearly five decades of combined investment and operational experience in China, and currently maintains more than 30 local GP relationships. These relationships provide access to over 900 underlying portfolio companies at various stages of development across a variety of industries.

This paper seeks to illustrate our unique approach to identifying future investment trends and the next wave of successful private equity fund managers in China, by combining a bottom-up approach to research with a top-down overlay. While success stories during the early years of China's private equity lifecycle are not likely to be repeated, we believe that opportunity still exists for outsized returns. It is our view that investors can prosper in China's new PE environment as long as they adapt to the changing landscape, and the new set of risks and challenges they will face. We hope our views can enlighten the GP and LP communities during this critical period of change and uncertainty in China.

UNDERSTANDING CHINA'S GROWTH STORY

China's economy has seen extraordinary growth over the past decade, driven by market-oriented reform, industrialization, and urbanization. On average, GDP has grown 10% annually since 2003, making China the world's second largest economy.

Profit growth and valuation arbitrage, two of the most important sources of returns for PE managers in China over the past decade, have been propelled by strong GDP growth, rapid capital markets expansion, and the high trading multiples of the domestic A-share market (especially the ChiNext stock exchange). However, years of overexpansion have caused corporate debt levels to double, and Chinese companies can no longer rely on expanding production capacity to grow revenues. In recent quarters, GDP growth has slowed to less than 8%, reflecting a decreasing rate of population growth and a declining demographic dividend. It is against this backdrop that operational efficiencies, rather than indiscriminate capacity expansion, will become a top priority for Chinese companies and their investors.

Across our underlying portfolio companies in China, the median exit multiple was 80% greater than the entry multiple from 2005 to 2014. Interestingly, deals completed between 2005 and 2010 had median multiple expansion of 120%, while post-2011 deals experienced multiple expansion of only 20%. Faced with slowing GDP growth, many GPs have turned their focus to making operational improvements to drive profits. As shown in Exhibit 1, the growth in median

[1] Zero2IPO; includes deployable capital only.

net profit since 2011 has been higher than that of deals completed from 2005 to 2010, as a direct result of the implementation of such operational improvements.

Exhibit 1: Deal Metrics for PE Investments in China since 2005

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%**

Source: Siguler Guff database of non-venture capital, China-focused companies as of September 30, 2013.
Note: Deal metrics were calculated using data from 76 out of 275 deals in Siguler Guff's portfolio. Only companies where data was available were included in this sample.

We believe that a slowdown in China's economic growth will contribute to a healthier and more balanced economy going forward. Tremendous opportunities exist to invest in industries benefiting from China's "consumption upgrade," such as the consumer, mobile-internet, tourism, leisure, education, and healthcare spaces.

A more focused economy will help transform traditional manufacturing to a value-added, advanced form of manufacturing, characterized by high barriers to entry and technological expertise. Technology businesses will also take their cues from the astounding success of internet-based companies, such as Alibaba and Tencent, which have become $100+ billion enterprises in just a few years' time.

INEFFICIENCIES IN PUBLIC MARKETS CREATE AN OPPORTUNITY FOR PRIVATE EQUITY

The underdeveloped financial market has been a factor in the advancement of China's PE industry. Despite more than two decades of progress in the capital markets, bank loans continue to act as the major source of financing for companies in China. The majority of Chinese banks are state-owned and, therefore, most loans are made to state-dominated sectors such as transportation, telecom and energy. While the private sector now generates over 60% of the country's GDP, it accesses only 25% of the credit extended by domestic banks. As a result, small and medium-sized private companies — the key growth drivers of the country's future economy – have suffered from a significant funding gap. As depicted in Exhibit 2 below, the market capitalization of China's stock market, as a percentage of GDP, is much less than similarly sized economies.

Exhibit 2: Stock Market Capitalizations Relative to GDP in 2013

Country	Market Cap (USD Billion)	GDP (USD Billion)	Market Cap as a Percentage of GDP
US[2]	24,035	16,800	143%
UK[3]	4,429	2,522	176%
Japan[4]	4,543	4,902	93%
India	1,139	1,877	61%
China[5]	3,918	9,240	42%

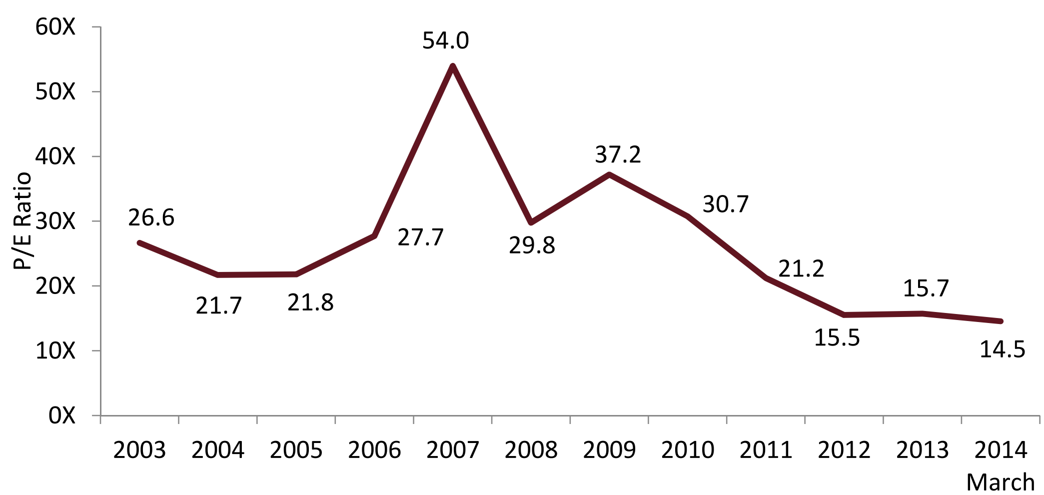
[2] Comprises NYSE and Nasdaq
[3] Comprises London Stock Exchange and Borsa Italiana
[4] Comprises Tokyo Stock Exchange and Osaka Securities Exchange
[5] Comprises A-share Stock Market

The volatility of China's stock market over the past ten years illustrates the fact that the country's capital markets have been unbalanced and underdeveloped. The public markets generated strong returns and traded at high P/E multiples when China was enjoying strong, double-digit GDP growth, and companies were aggressively seeking capital for business expansion. The Shanghai Composite Index traded at an all-time high of more than 6,000 in October 2007. However, as the public markets soared, the more glaring their shortcomings became. A rigid, approval-based IPO process not only created a limited supply of new listings on the exchanges, but helped to inflate a stock market bubble.

These elements, along with the Global Financial Crisis, contributed to the crash of China's stock market in 2008. The equity market crash only made things worse for companies seeking financing from traditional channels. As the Global Financial Crisis dampened expectations, private companies seeking equity financing in the public markets faced the reality of valuation declines. By the end of 2013, the Shanghai Composite Index was trading 65% below its historical high (just 24% above its all-time low in November 2008).

China's rigid IPO policy, in combination with the narrow M&A market and the suspension of A-share IPOs between October 2012 and January 2014, further limited access to capital for companies and also burdened the exit environment for PE managers. Today, there is a long list of companies still waiting to go public, as well as a great deal of capital "stuck" in the PE ecosystem. The exit environment should improve in the future as the China Securities Regulatory Commission (CSRC) carefully executes market reforms and switches its approval-based IPO listing requirements to a registration-based model. Though volatile in past years, as shown in Exhibit 3, we also expect valuation multiples of listed companies to gradually normalize.

Exhibit 3: Shanghai Composite Index Average Annual P/E Ratios



Source: Capital IQ

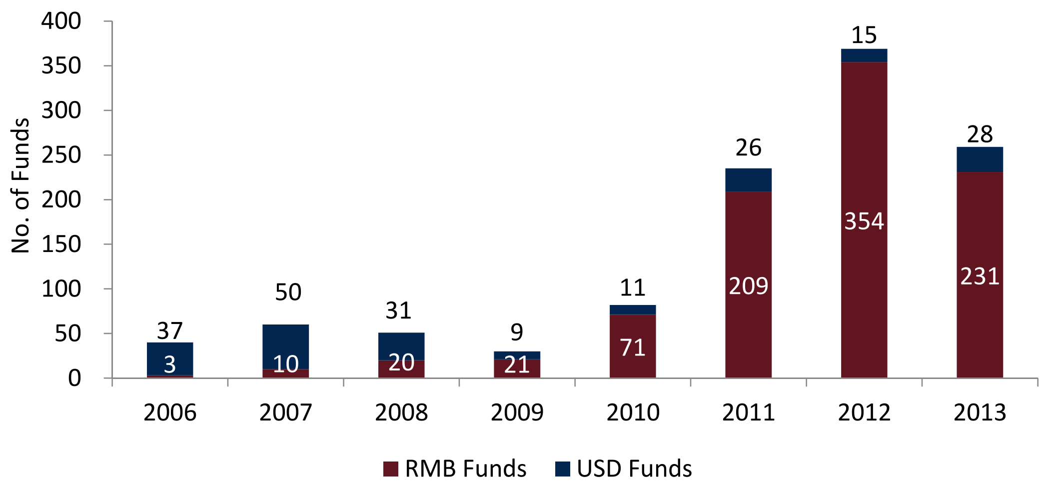
For these reasons, PE has played a significant role in China by providing equity financing to companies unable to access traditional funding channels. Most of the well-known, fast-growing companies in the private sector (e.g. Mengniu, Focus Media, Alibaba, and Belle) have benefited from capital infusions from PE funds. PE's ability to close the funding gap has generated outsized returns for investors in the country since the early 2000's.

OVERCAPACITY CAUSES RISING VALUATIONS

With the influx of PE capital in China, the issue of overcapacity (i.e. too much capital chasing too few deals) emerged in 2009. From 2010 to 2012, over 1,000 new RMB-denominated funds entered the market, as shown in Exhibit 4. RMB fund managers were attracted to the significant valuation gap between public and private companies, and the rush to invest was further fueled by government stimulus. RMB funds represented over 90% of the new funds raised in China over the period.

Many of these managers were opportunists with little PE experience chasing pre-IPO deals. This phenomenon inevitably drove up valuations, especially in high-growth sectors, as RMB funds had no problem paying high multiples for private companies as long as there was still some room for multiple expansion once those companies went public. As valuation multiples for ChiNext-traded companies started to come down, and operating performance for many portfolio companies was sluggish due to the macroeconomic slowdown, performance of RMB funds suffered. Consequently, we expect the number of new RMB fund launches to decline going forward.

Exhibit 4: New PE Funds in China by Denomination



Source: Zero2IPO

Over the past ten years, we have witnessed a correlation between the amount of capital invested in China and investment performance. Generally speaking, the more PE capital invested in a given year, the lower the returns. Across the 763 China-focused deals in our portfolio, transactions completed in 2011 (the year deal competition peaked) generated the lowest returns. Additionally, the average loss ratio increased significantly while aggregate returns declined. As shown in Exhibit 5, the highest average loss ratio of 57.2% and greatest number of deals completed both occurred 2011. Not coincidentally, that same year saw a large number of RMB funds coming to market, which drove average entry valuations higher.

Exhibit 5: Average Deal-Level Returns by Investment Year

Year	Aggregate IRR	Aggregate Multiple	Avg. Hold Period (years)	Aggregate DPI	Avg. Loss Ratio	No. of Investments	Capital Invested (USD Thousands)
2005	68.8%	3.0x	6.3	263.4%	41.4%	16	12,843
2006	26.0%	3.0x	5.6	127.3%	16.9%	44	55,037
2007	20.2%	2.4x	4.9	116.1%	21.8%	67	59,612
2008	6.0%	1.3x	5.0	45.6%	43.1%	103	103,117
2009	17.7%	1.9x	4.2	57.3%	41.3%	72	71,953
2010	18.1%	1.7x	3.5	28.9%	30.8%	133	148,440
2011	5.6%	1.2x	2.7	11.4%	57.2%	163	175,673
2012	24.9%	1.5x	1.8	9.2%	25.3%	94	63,454
2013	53.1%	1.4x	0.7	6.2%	5.9%	58	26,903
2014	221.6%	1.2x	0.2	0.0%	0.0%	13	9,888

Source: Siguler Guff database of all China-focused companies, including venture capital. Please see additional information on performance calculations under Disclosures.

Note: Avg. Loss Ratio indicates the average percentage of invested capital held below cost.

Singapore-based Asia Private Equity Institute published a paper with similar findings for supply-demand dynamics and average returns using proprietary data of 11,724 PE transactions completed between 1991 and 2012. In their sample, total invested capital was $168.9 billion and the total dollar amount of exits was $198.6 billion. Thus, the industry has, in aggregate, returned more capital to LPs than was invested. However, there is a wide dispersion in the data, as over 60% of the investments were either capital losses or not exited. At the same time, there is a fat right tail in the performance distribution. Of the total sample of deals initiated before 2010, 23.5% had multiples between 3x and 100x. The extreme heterogeneity of deal performance thus presents a significant challenge for LPs when selecting managers in China's PE market.

TRACKING SHIFTS IN ECONOMIC TRENDS

China's regulatory landscape and competitive PE environment have seen significant changes in recent years. Both GPs and LPs who understand and adapt to these changes have the potential to generate strong returns in the future.

Deregulation

In the past, the Chinese government exercised tight controls in nearly all aspects of the economy. Government control often resulted in high operating costs for businesses, limiting reinvestment and business upgrades. We believe that China's new leadership is committed to economic reform. A key pledge of the current government is to allow the market to play a decisive role in resource allocation. This includes loosening the government's grip on the market and relaxing controls on the financial sector. Announced reforms include reopening the domestic IPO market, interest rate liberalization, deregulation of certain sectors, encouraging mixed public/private ownership structures, greater market access to foreign investors and, perhaps most importantly, the conversion of the IPO process from approval-based to a registration-based system.

Industrial Upgrade

Historically, the Chinese government endorsed an aggressive investment strategy in the industrial sector, resulting in overcapacity and declining corporate profitability. In response, the government has introduced policies to rationalize industries suffering from overcapacity such as steel, cement, coal, solar panels and shipbuilding. Moreover, the Chinese government has identified industrial upgrade as a high economic priority to combat low levels of innovation, excessive competition for low-end products, and a lack of advanced manufacturing and technological expertise. This trend should encourage PE investors to continue to invest in high-growth sectors and look for consolidation potential in traditional sectors.

Reforms in IPO System

We anticipate significant changes in China's IPO market over the next five years. Previously, as mentioned above, IPO candidates were subject to a rigorous approval process. Improving the IPO system will give underwriters and market participants more flexibility and move China one step closer to a registration-based system. Under the new system, the CSRC will be responsible only for determining whether applicants have provided full and accurate information prior to listing. The assessment of risks and valuations will be left to the market, similar to the IPO process in most developed markets. This will result in a more consistent exit channel for PE investors, in addition to rational market valuations.

Rebalancing Supply and Demand of PE Capital

As mentioned, the previous government stimulus plan, together with the launch of the ChiNext board, led to a periodic oversupply of PE capital, especially from RMB funds. In turn, the market overheated and valuations rose. Because of the moratorium on IPOs by Chinese regulators in late 2012, many RMB funds struggled to realize profits for their LPs. As a result, fewer new RMB funds have entered the market and the arena has become more rationalized, such that capital supply and demand have achieved equilibrium.

PRIVATE INVESTMENT OPPORTUNITIES IN CHINA TODAY

Historically in China, PE has favored traditional growth-stage companies given their proven business models, cash-generating ability, measurable business demand, and clear use of proceeds. In the past decade, over 2,000 growth-stage private investments were made in China and total capital invested in growth deals was more than twice the amount invested in venture capital (VC) deals.

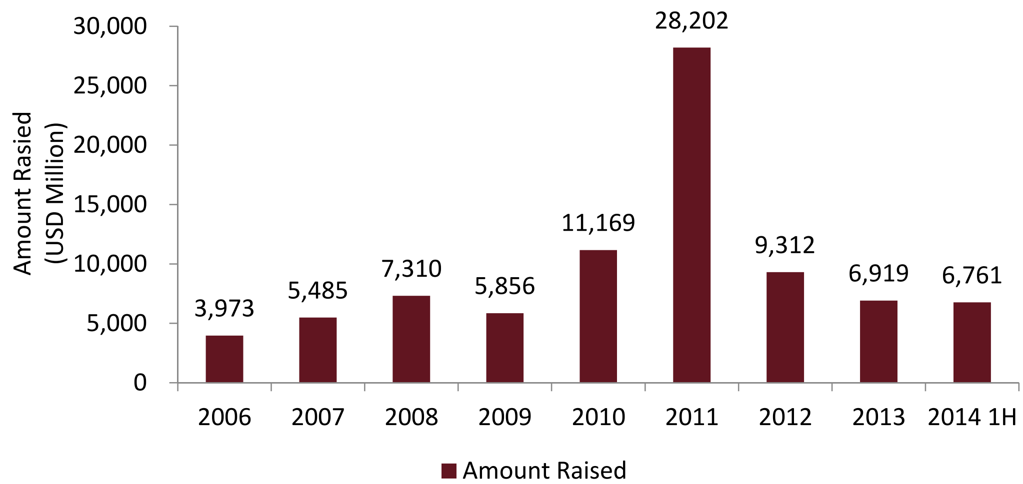
However, in recent years, many PE managers invested in traditional growth-stage companies have struggled to achieve their targeted return thresholds. This has forced PE managers to adapt their strategies and focus on opportunities in earlier stage companies in high-growth sectors. For example, the emergence of a number of large internet companies in China has transformed the VC investment ecosystem, igniting competition for early-stage, technology-focused VC firms from later-stage growth investors seeking to cash in on the new wave of China’s social, media consumption and consumer behavior.

In the VC space, we have observed that the healthcare and technology/media/telecommunications (TMT) industries have become increasingly popular targets for GPs. As China has become the largest market for internet and smartphone users, an increasing number of new investment opportunities are expected to emerge. In addition to experiencing traditional growth, VC investments in the TMT sector seem to be propelled by adapting new technology and/or encouraging different forms of consumption behavior. We have observed more investment into rounds A and B than in the past, representing over 65% of VC invested, with a heavy focus on healthcare and TMT.

We have also observed clear VC fundraising cycles. As shown in Exhibit 6, the VC space has grown more than six-fold during the last decade to over $28 billion at its height in 2011. However, 70% of the capital raised in 2011 was through RMB funds, which are categorized as VC funds but typically, invest in early growth-stage deals or in pre-IPO companies. The market cooled dramatically in

2012 and, since late 2013, we have seen increasing capital flow into early-stage VC funds, which will likely lead to a new wave of early-stage TMT investments.

Exhibit 6: VC Fundraising in China

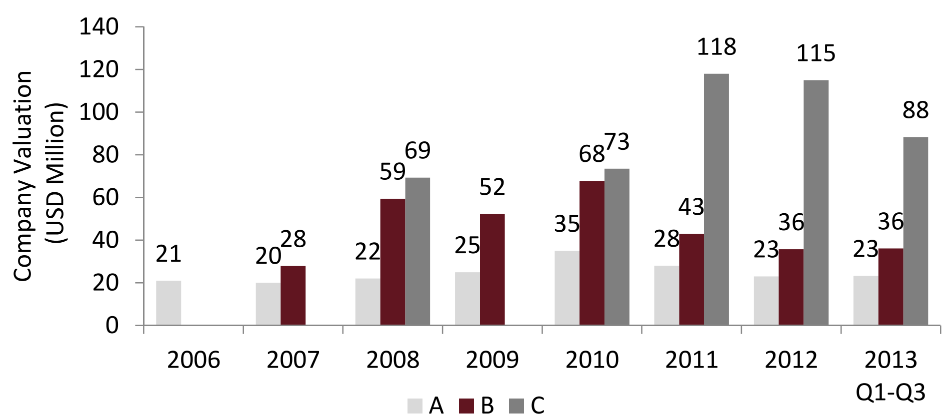


Source: Zero2IPO

Note: Zero2IPO has a relatively broad definition of VC, which includes early-stage and early growth-stage funds. As a result, a large number of early-growth/growth capital RMB funds are categorized as VC in this sample.

As shown in Exhibit 7, our proprietary database clearly indicates an upward trend in valuations in later VC rounds, mostly because of the increased supply of capital for early growth-stage opportunities. However, only a handful of top-tier VC funds have produced outsized returns in China, and those returns have been achieved by relatively few "homerun deals". Such skewed returns make it imperative that investors select disciplined and experienced VC fund managers.

Exhibit 7: Median Company Valuations for VC Investments by Financing Round



Source: Siguler Guff database

While potential returns for VC investments can be enticing, the risks associated with these investments remain high. For example, there were more than 1,000 Groupon-like companies in China in 2011 when the concept of "deal-of-the-day discounts" emerged. However, fewer than five have survived. In China, for every huge winner, there are at least six failed companies and 10 others that are non-performing[6], underscoring the risk of overcapacity in the internet and TMT sectors.

To successfully invest in the region, it is critical to identify GPs that recognize emerging trends, exhibit investment discipline and experience in their sector(s) of focus, and have execution capabilities. GPs who invest in different stages of start-ups should have expertise within their stage of focus, as later-stage start-ups tend to be more competitive due to better performance visibility. On a more micro level, GPs should have the ability to effectively allocate resources in order to optimize portfolio company operations while uncovering the company's market potential. More than just being capital providers, GPs should serve as active advisors providing necessary guidance to their portfolio companies.

ADAPTING TO CHINA'S EVOLVING PRIVATE EQUITY ENVIRONMENT

It is becoming increasingly important for investment teams at growth-oriented funds to have in-depth industry knowledge and operational expertise to support and drive the growth of their portfolio companies. At times, the knowledge and expertise needed to effectively manage portfolio companies must come from outside of the investment firm. Siguler Guff has identified three strategies that traditional growth funds in China are beginning to explore: an operationally focused strategy, a sector-focused strategy, and an adaptation strategy which may include M&A, PIPE (private investment in public equity), and buyout investments.

Operationally Focused Funds Partnering with Industry Leaders

We have witnessed a trend where PE firms are adding experienced corporate leaders to their staffs. Many of the most successful PE firms also maintain a network of outside operating partners to better execute post-investment plans. In either case, these industry leaders offer valuable and unique operating knowledge that even the most highly experienced investment professionals can lack. Specifically, these leaders know how to accelerate growth in businesses and turn around failing ones. We have seen this strategy implemented in various ways by GPs. Traditional PE firms tend to hire outside consultants that can aid in business expansion and improvement plans for their portfolio companies. Other GPs have built in-house teams with wide-ranging areas of expertise including human resources, corporate strategy, marketing, supply, and IT management, which portfolio companies can leverage as needed. GPs with in-house teams oftentimes also maintain networks of external operating partners across various sectors that can be tapped to help implement new strategies and add value to portfolio companies.

Specialized Sector-Focused Funds

We have observed an increase in the number of sector-focused funds in the market, especially across the TMT, healthcare, and clean technology sectors. These sectors have become increasingly popular as GPs recognize an opportunity to invest in specialized industries with high barriers to entry. In order to become more specialized, PE firms are adding seasoned professionals with non-investment, sector-specific expertise to their staffs. In the healthcare sector, for example, GPs are hiring physicians, professionals with experience in medical devices, and pharmaceutical industry experts to assist with investments.

Our general observations suggest that firms with sector-focused investment strategies communicate and make investment decisions more efficiently than generalist funds. On the other hand, generalist funds will benefit from broader deal flow and have more flexibility to reallocate capital as the investment climate changes. Sector-focused funds may occasionally also have to tolerate higher prices given their sector focus constraints, whereas generalist funds might pass on

[6] Homerun deals defined as investments with over 5x returns, non-performing deals defined as investments valued at or exited at less than at-cost value or with at-cost value for more than 2 years.

a particular investment if the valuation reaches a critical threshold. Interestingly, we are seeing a trend where generalist funds are becoming more sector focused, with many of these funds becoming more disciplined with regard to their target industries.

New Approaches Adopted by Traditional Growth Funds

M&A
With organic growth becoming more challenging to achieve, traditional growth funds have started to use M&A and cross-border strategies to accelerate growth in portfolio companies. This practice is relatively new and is still largely unproven for Chinese companies. The risks associated with M&A in China lie in the integration process after the merger. Data on Western PE funds show that only 30% of acquisitions are ultimately successful. In China, we know the challenges are even greater as a result of the potential for opaque financial reporting and embellishment of selling stakeholders during negotiations.

Cross-border transactions entail additional risk, as they attract extra regulatory scrutiny, and can provoke cultural conflicts and operating team issues. Encouragingly, traditional growth funds have started to strengthen their internal expertise and operating teams to execute such M&A deals.

PIPEs
In certain traditional sectors, public companies can present lower valuation multiples and better established operations, making them attractive targets for private investment. The most astute GPs have been able to benefit from this strategy. In order to succeed, GPs must maintain discipline, structure deals directly with corporations, and insist on favorable terms. These terms may include higher structured returns, more current pay, equity-debt hybrid securities, influential governance within the company, and more flexible exit opportunities.

Buyouts
Buyouts are beginning to present a unique investment opportunity in China. In the past, few “true” buyout opportunities existed, and the ones that did not attract much attention. The lack of buyout opportunities was driven, in part, by entrepreneurs unwilling to sell a controlling stake in their businesses while valuations were increasing. GPs did not often pursue these transactions given the abundance of other compelling investment opportunities available, namely high-growth companies that were in need of expansion capital. Buyout transactions are typically more complicated and require more resources to complete.

Further, PE firms risked being rejected as energetic entrepreneurs saw the potential for higher profits by remaining independent. For PE firms with the appetite to acquire these companies, the investments could backfire without a team of experienced professionals to manage the businesses. Combining all of these factors, the risk-reward ratio did not justify such ventures on a large scale.

Moreover, there have been few success stories across buyout deals in China. One issue was that that PE funds usually adopted the traditional buyout model, which often entailed overwhelming operational demands that PE managers did not have the expertise to handle. Frequently observed issues included hiring “parachuted” professional managers with little local experience, misaligned economic interests, and ill-defined roles for the owner/founder of a buyout deal.

However, as the market environment has evolved, buyout transactions in China (at varying degrees of debt and in various forms) have experienced steady growth over the past few years. According to Zero2IPO, the total amount of capital raised by local buyout funds tripled from $849 million in 2012 to $2.5 billion in 2013. In the first half of 2014 alone, total fundraising for buyout funds reached nearly $1.5 billion.

We believe the following factors make buyouts attractive in the new chapter of PE in China:

- Former growth companies entering a stage with bottlenecks or constraints for further

growth
- Succession issues with first generation entrepreneurs
- Increasing availability of professional managers
- Multiple arbitrage between different capital markets creating opportunities for take-private deals
- Government push for industry consolidation, especially in traditional manufacturing sectors
- The need to deploy more capital per deal for large PE funds
- Increasing access to leverage (though still limited)

Consequently, we believe the buyout market in China will soon become a viable standalone investment category. There are certain growth funds in China starting to emphasize the need to make at least one buyout investment during their fund's life. Those managers that understand this trend and seize the opportunities accordingly could replicate the success of growth funds in the early 2000's.

CONCLUSION

As the PE industry in China adopts a new development model amid a slowing economy, we believe that both challenges and opportunities lie ahead for investors.

Certainly, the low-hanging fruit is gone, and GPs cannot rely on the macroeconomic tailwind that enabled them to invest and generate returns across the board in the past. Nevertheless, we believe that GPs with adaptive investment strategies, strong operational skillsets, and sector-focused resources will be able to achieve risk-adjusted returns in China's transforming economy.

Likewise, it has never been more challenging for institutional LPs to allocate capital to PE opportunities. We believe that the key to success for LPs is to have historical perspective, in-depth knowledge of and experience within the local market, a deep-rooted local presence, and a fresh outlook when evaluating both established and emerging GPs. LPs who are able to successfully navigate the changing landscape will continue to be successful PE investors in China.

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