



温州肯恩大学  
WENZHOU-KEAN UNIVERSITY

**Is there an optimum exit strategy for private equity firms in China?**

In Partial Fulfillment of the Requirements

for the Bachelor of Science in Finance

LIU Rui

1025710

May, 2020

## ABSTRACT

Private equity (PE) is a form of financing that allows a company with greater potential to buy equity at a lower price and then sell the stock at a higher price through the company's management and operations. Private equity investment is of great value to economic growth and is an important driving force for the transformation and upgrading of the real economy. Especially when there is a bottleneck in development, those enterprises that receive private investment tend to outperform similar enterprises. The operating mechanism of PE consists of four steps: fundraising, project selection, investment management, and investment exit. The most important part of private equity investment is “exit”. This article will focus on the current state of private equity investment development in China and find the best exit strategy for Chinese private equity firms.

***Keywords:*** *Private equity, Financing, Exit, Investment, Chinese private equity firms*

## TABLE OF CONTENTS

I. Introduction .....	4
I.I Definition of private equity .....	4
I.II The role and status quo of private equity in China .....	5
I.III Definition of the most common exit strategy .....	7
I.IV China's PE exit status in quo .....	8
II. Literature review .....	10
II.I Global view of PE's exit .....	10
II.II Research of PE's exit strategy selection in the US and the EU .....	12
II.III Research of relative methodologies .....	13
III. Research Design.....	14
IV. Data & Basic Statistics .....	15
VI.I Basic Statistics.....	15
VI.II Correlations .....	17
V. Conclusion and Contribution.....	19
VI. Limitation and Recommendation .....	21
VII. Reference List.....	23

## INTRODUCTION

### *Definition of Private Equity*

Private equity investment is a method of financing, and it refers to the non-public way of raising funds to invest in non-listed companies. Private equity investment originated in the United States, and in 1923 the United States established the first private equity investment company by Benjamin Graham. In China, private equity(PE) is a neonatal financial industry and has become an important financing tool for unlisted small and medium-sized enterprises(SMEs). The China Venture Capital Institute defines private equity investment as Private equity investment refers to raising capital from institutional investors or wealthy individual investors through targeted private placement, which is mainly used for equity investment in unlisted enterprises. In the implementation process of the entire transaction, full consideration is given to the way in which the future capital is withdrawn, that is, the act of selling the assets or shares held for-profit through the public listing, inter-company merger or management repurchase. PE's operating mechanism includes four steps: fundraising, project selection, investment management, and investment

exit. In the private equity investment process, exit is the most crucial and risky step, which is directly related to the company and investors' benefit.

### *The role and status quo of private equity in China*

PE originated in the United States and was prevalent in developed countries such as the UK, Singapore, and France. PE was affirmed and has gained great benefits in a lot of financial industries all over the world. The successful experience of PE in developed countries proves that as a product of the combination of financial and industrial innovation, private equity can provide emerging companies with valuable funds for innovating and sustainable development, provide new industries and employment opportunities in societies, and promote the upgrading of industrial structure and consumption levels. PE as an important gear for the social economy is like the following three points: First, promote technological innovation. As an investment and financing mechanism that supports innovation, creativity, and entrepreneurship, PE has a keen sense of the future emerging industries. The world's leading technology innovation companies, including Intel and Apple, have all received support from private equity investment institutions. Second,

broaden the financing channels of SME. Due to PE's forward-looking professional vision, it can often help high-quality SMEs that are not eligible for bank loan conditions and listing financing to achieve financing and extraordinary development. Third, promote the improvement of the company's management structure. In order to control investment risks, private equity investment institutions are often involved in the management of the invested companies. Moreover, the private equity investment process includes management, and the PE company must manage the company and obtain corresponding benefits. In China, the industry standard is to charge companies 2% of the investment amount each year as management fees. Although China's private equity investment has achieved good development, from a global perspective, China's private equity investment is still in its infancy, and there are many obstacles in the development process, and it will gradually improve in the future. Mainly reflected in: first, at present, more than 80% of private equity investment institutions in China adopt the corporate system, but the private equity investment institutions of the company have double taxation problems and become the development path of local private equity firms. The new "Partnership Law" removes

organizational and tax barriers for the development of PE; second, the degree of specialization continues to increase. With the increase in the number of private equity institutions, the PE industry is increasingly competitive. More and more private equity investment companies pay more attention to the professionalism of their teams, and the level of professionalism of the team is gradually increasing.

*Definition of the most common exit strategy*

The form of private equity withdrawal (1) IPO (initial public offering). It refers to the way in which private equity investment funds are value-added and exited from the capital after listing in the securities market after the company matures. The listing of enterprises is mainly divided into domestic listings and overseas listings. Domestic listings mainly refer to the Shenzhen Stock Exchange or the Shanghai Stock Exchange. The overseas listings are commonly found on the Hong Kong Stock Exchange, the New York Stock Exchange, and the Nasdaq. (2) Mergers and acquisitions. Mergers and acquisitions refer to enterprises that influence and control the operation and management of other enterprises by purchasing all or part of the equity (or assets) of other enterprises. (3) Equity transfer.

Venture capital was withdrawn through equity transfer. The income from private equity companies through equity transfer is second only to the initial public offering, and venture capital can be quickly withdrawn from the invested company and into the next round of investment. (4) MBO. This includes three different forms of management buyouts (MBOs), employee acquisitions and company acquisitions. The internal acquisition method is not an ideal way to exit. Usually, the repurchase terms will be set in the private equity investment agreement. (5) Liquidation exit mode. If the invested company has a financial loss for several years, or the investment institution believes that the company no longer has development potential, then they can only ensure that their funds will not be too big.

#### *China's PE exit status in quo*

The exit strategies of China's private equity investment mainly include IPO (Initial Public Offering), M&A (Mergers and Acquisitions), MBO (Management Buy-Outs), Equity Repurchase, Equity Transfer, Bankruptcy Liquidation and so on. China's PE has been developing very late, but it has made rapid progress. In 2017, the asset management scale reached 5 trillion RMB, and the investment amount exceeded 450 billion RMB.

However, as of March 2017, there were approximately 20,000 private equity funds in China, of which approximately 7,000 had investment records, and eventually there were at least 1,641 funds with at least one project exit. In other words, the fund that finally exits at least one project is less than 10%. In the choice of exit method, because of the high investment income through IPO exit, it is often the primary choice of private equity investment institutions, and it is also the most ideal way to withdraw investment.

However, through the more stringent conditions for IPO listing in China, the IPO preliminary preparation work and processes are cumbersome, and the queue review time of IPO is also very time-consuming. At present, China's capital market capacity is limited, and the IPO veto rate continues to rise, so the IPO exit strategy is going to be very difficult. This thesis aims to study the exit strategies of private equity firms in China. The research methods are going to be comparative analysis, chart data analysis, and case analysis. In the end, it is concluded that there is no optimal exit strategy for private equity firms in China.

## LITERATURE REVIEW

### *Global view of PE's exit*

The private equity (PE) industry has developed rapidly in China, and PE's assets have reached the level of trillions, so it has become a large-scale trusted financing industry for China's unlisted SMEs. The profitability of PE companies and their partners depends on the choice and execution of the exit strategy, which is the last critical step of the PE investment process. Through the reading of literature, we will further understand other research methods and theories that contributed to this paper. This thesis will focus on the advantages and disadvantages of PE's various exit strategies, aiming to find the optimal exit method in the Chinese market.

From the perspective of the development of the global PE industry, it shows a favorable development trend. According to an article from McKinsey's official website (Green, Hayes, Seghers, and Zaets, 2018), the global value of private equity exports has exceeded \$500 billion annually over the past five years. Additionally, private equity firms completed 2,475 exits in 2017. East Asia has experienced a growing and

substantial development with this new finance as many aspects of global finance have migrated to developing and emerging markets such as the Chinese market over the past 15 years (Robertson, 2015). China is now one of the largest economies in East Asia, therefore, the research on China's neonatal economic industry can be a good analysis of its current performance and future direction.

This is an era of economic globalization, so as China copied the US PE system, it successfully developed rapidly in China. Nonetheless, emulation is not an eternal method of success, differences in national conditions and institutions directly affect the future of the economic system. The differences between the Chinese and the American legal systems have led the Chinese authorities to focus on the development of PE and have enacted relevant laws to limit it (Guo, Ge, Hsu, H, & Fung, 2019). These conditions and restrictions directly affect the exit decision of PE companies. With the rapid development of the industry, the degree of difficulty of PE companies exiting has also increased, making the road to success more difficult and complicated.

### *Research of PE's exit strategy selection in the US and the EU*

From the select trend of exit strategies, IPO is the company's first choice. The previous studies for European private equity firms seem to regard IPO as the “preferred” exit path pointed by Jenkinson and Sousa (2015). Previous studies on private equity exits have mostly focused on different aspects of IPOs as exit strategies. However, recent empirical evidence suggests that trade sales are the most common exit routes (Anker and Stärk-Johansen, 2015). Additionally, according to Golman (2014), in the first two quarters of 2014, US secondary PE transactions reached \$19.1 billion, which was the highest level since 2007. However, China's PE companies have different risks of exiting under different policies and economic environments. As the thresholds and requirements for IPOs in China are getting higher, the firm scale, legal conditions, and time conditions make many companies not preferred IPOs (Zhang, 2018). So, the research on the global market, the European market, and the American market cannot be summarized here as the situation that the Chinese market is facing. Therefore, research on the private equity exit strategy should be covered in different regions.

### *Research of relative methodologies*

None of the above literature has been studied for "optimum". Is there an exit strategy for "optimum" in China's PE industry? This thesis will be studied using the following few methodologies. According to the chart analysis method mentioned by Folus (2015) and the latest PE annual report from Bain & Company (2019), this article will use the chart analysis method for preliminary analysis. In addition, this article will combine the case study method applied by Kim (2014) and make it a more intuitive and clear research method: collect a sample of company data and compare factors such as ROI and time in the same amount of capital invested. Moreover, the method of comparative analysis will be used in this article. According to Wang's study (2012) about the UK exit strategy. Wang's study focused on the secondary buyouts exits, as Wang only has data on a relatively small number of companies she does not differentiate between IPOs and trade sales as alternative exit routes. Therefore, the comparison will be more complete and objective.

## **RESEARCH DESIGN**

This article will use, frequency analysis, correlation analysis and descriptive statistical analysis. This article will focus on descriptive research. First, the HPR (Holding Period Return) and the annualized return are obtained from the existing data, because we need to adjust the unit of return and duration. Then put the data obtained by the four methods into a sheet and find the standard deviation of each method to assess their risk. Finally add the correlation matrix to verify the correlation between them.

## DATA&BASIC STATISTICS

### *Basic statistics*

	HPR	MEAN Annualized Duration	MEAN Annualized HPR	Annualized Duration SD	Annualized HPR SD
IPO	24.8382	4.7458	0.7113	1.7199	0.9607
M&A	4.5455	1.4016	2.5581	0.6398	4.9937
MBO	0.3826	3.1463	0.1045	1.9457	0.1379
Equity Transfer	1.9206	2.5558	0.9400	2.0732	2.1833

HPR=Holding Period Return= (Exit Amount-Investment amount)/Investment;

Annualized Duration=Days/365;

Annualized HPR=(1+HPR)<sup>1/Dutation</sup>-1;

Annualized Duration SD is the standard deviation of annualized duration;

Annualized HPR SD is the standard deviation of annualized HPR;

CORR is the correlation coefficient of each method's HPR and duration.

According to the above table, the forty exit cases collected by each method are integrated and analyzed. In terms of average returns (HPR), IPOs have an absolute advantage, ranking first with a return of 24.8382 times. However, there are two variables for this article's data: returns and time. The conversion of time from days to annual rate is to make the units consistent for easy comparison. From the perspective of the second

column, the IPO is the longest duration exit strategy. It is obvious in time that M & A is the shortest exit strategy. Then, this article refers to the concept of Annualized HPR, which is the annualized rate of return during this time of investment. From the third column of data, it can be compared that the annualized returns of M & A and Equity Transfer are higher than those of IPO.

The purpose of seeking SD (Standard deviation) is to find the stability of the time spent or return of this strategy. It can also be regarded as a risk assessment item. In contrast, the SD of the Annualized HPR of the IPO is the most stable, close to 1. M & A's Annualized HPR has the highest SD, close to 5.

Correlations

**Correlations**

		AHPRIP			
		O	AHPRMA	AHPRMBO	AHPRET
AHPRIPO	Pearson Correlation	1	-.047	-.299	.054
	Sig. (2-tailed)		.773	.061	.742
	Sum of Squares and Cross-products	36.918	-9.035	-1.582	4.500
	Covariance	.947	-.232	-.041	.115
	N	40	40	40	40
AHPRMA	Pearson Correlation	-.047	1	.153	.339*
	Sig. (2-tailed)	.773		.345	.032
	Sum of Squares and Cross-products	-9.035	997.497	4.222	147.965
	Covariance	-.232	25.577	.108	3.794
	N	40	40	40	40
AHPRMBO	Pearson Correlation	-.299	.153	1	-.089
	Sig. (2-tailed)	.061	.345		.584
	Sum of Squares and Cross-products	-1.582	4.222	.760	-1.074
	Covariance	-.041	.108	.019	-.028
	N	40	40	40	40
AHPRET	Pearson Correlation	.054	.339*	-.089	1
	Sig. (2-tailed)	.742	.032	.584	
	Sum of Squares and Cross-products	4.500	147.965	-1.074	190.675
	Covariance	.115	3.794	-.028	4.889
	N	40	40	40	40

\*. Correlation is significant at the 0.05 level (2-tailed).

Pearson correlation coefficient is a statistical analysis index that reflects the degree of level correlation;

AHPRIPO is the mean value of annualized HPR by using IPO strategy;

AHPRMA is the mean value of annualized HPR by using M&A strategy;

AHPRMBO is the mean value of annualized HPR by using MBO strategy;

AHPRET is the mean value of annualized HPR by using Equity Transfer strategy.

The figure above is the data obtained by the data analysis software SPSS. Correlations represent the correlation of time and return for each exit strategy. Pearson correlation represents the correlation coefficient. As shown in the figure above, AHPRMA and AHPRET have a significant correlation.

## CONCLUSION AND CONTRIBUTION

Through this article, research in the Chinese private equity industry finds that in China, private equity companies do not have the best exit strategy. The “Optimum” depends on the investment strategy in different situations.

This thesis, through the study of the exit mechanism of private equity investment, hopes to contribute to the Chinese PE industry. The operation of private equity investor needs to go through four stages of fundraising, investment, management, and exit. The exit is the ultimate goal of private equity investment and an important part of achieving profitability. The exit of private equity investment refers to the process in which an equity investment institution or individual sells its equity capital in the market to recover the investment and realize the investment income after the development of the venture capital invested by the equity investment institution is relatively mature. The exit is to judge an investment institution. An important reference for profitability indicators. Only a smooth exit mechanism can provide continuous liquidity and development for PE funds. The exit mechanism of PE is related to the two parties: for PE investors, the exit mechanism is

closely related to the recovery of investment and the realization of investment income. The amount of investment income and the rate of return on investment depend on whether the exit can be smoothly and Which way to exit: For the invested company, the exit mechanism means the end of the relationship with the PE and the relationship between the interests and the interests. The exit mechanism of PE is the accelerator and amplifier of investment capital, providing the necessary liquidity, continuity, and stability for PE. Without a safe and reliable exit mechanism, PE will be difficult to develop. The exit strategy is the last and crucial part of the PE operation process. The success of PE is largely reflected in the effectiveness and success of the exit. Therefore, the choice of the exit strategy is very important for the healthy development of China's PE. By reading this article, I hope that China's PE companies will correctly understand the importance of exit strategies. Rational choice is your own strategy, and you can't blindly pursue seemingly optimal strategies such as IPO. Reasonably analyze your situation and choose the most appropriate strategy.

## LIMITATIONS AND RECOMMENDATION

This thesis has been subject to many restrictions, the first was data collection. Private equity, as its name implies, is a non-public fundraising method. Therefore, the thesis has encountered many limitations and difficulties in collecting data. Many large private equity firms have not publicly disclosed their information. For example, in the process of collecting 50 cases with MBO exit, the database was transferred back to nearly a decade ago to collect enough samples. In the tables exported from the database, a lot of information was lacking, and there were very few complete case durations and returns.

The second limitation is that China's PE database is too rare. PE data only exists Bloomberg Labs, CVsource, PEdata, China Financial Information Network, and Wind. However, in the process of collecting data, it will be found that there were too few companies that disclose information and the data was incomplete. Finally, this article chose Wind, a relatively robust terminal. So here is a suggestion for people who want to write PE related papers in the future, using Wind database.

Third, the sample of this article is relatively small and spans a long period of time. The

longest case comes from 2014. After several years of development of the PE industry and restrictions or release of Chinese legal conditions, there may be slight differences from the arguments and assumptions of this thesis.

## REFERENCE LIST

- Baker, H. K., Filbeck, G., & Kiymaz, H. (Eds.). (2015). *Private equity: opportunities and risks*. Oxford University Press.
- Folus, D., & BOUTRON, E. (2015). Exit Strategies in Private Equity. *Private Equity: Opportunities and Risks*, 215.
- Fonseka, M. M., Colombage, S. R., & Tian, G. L. (2014). Effects of regulator's announcements, information asymmetry and ownership changes on private equity placements: Evidence from China. *Journal of International Financial Markets, Institutions and Money*, 29, 126-149.
- Green, A., Hayes, W., Seghers, L. and Zaets, E. (2018). [online] Available at: <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/private-equity-exits-enabling-the-exit-process-to-create-significant-value#> [Accessed Jul. 2018].
- Guo, H., Ge, Y., Hsu, C. H., & Fung, H. G. (2019). How Did the Elimination of the Window Guidance Policy Affect IPO Performance in China? A Stochastic Dominance Analysis. *Emerging Markets Finance and Trade*, 1-15.
- Golman, J. (2014). Exit Strategy: Why Secondary Deals Are Becoming First Choice. *Forbes*. [online] Available at: <https://www.forbes.com/sites/jeffgolman/2014/05/20/exit-strategy-why-secondary-deals-are-becoming-first-choice/#6ccf7d6439ea> [Accessed 20 May 2014].
- Jenkinson, T., & Sousa, M. (2015). What determines the exit decision for leveraged buyouts? *Journal of Banking & Finance*, 59, 399-408.
- Kim, J. (2014). The Rise of Private Equity in China: A Case Study of Successful and Failed Foreign Private Equity Investments.
- Robertson, J. (2015). *Localizing global finance: The rise of western-style private equity in China*. Springer.
- Wang, Y. (2012). Secondary buyouts: Why buy and at what price?. *Journal of Corporate Finance*, 18(5), 1306-1325.
- Zhang, X. (2018). Simu guquan touzi tuichu fangshi yanjiu [Research on the exit method of private equity investment]. *Duiwai jingji maoyi daxue*, 17(36), 2-3.