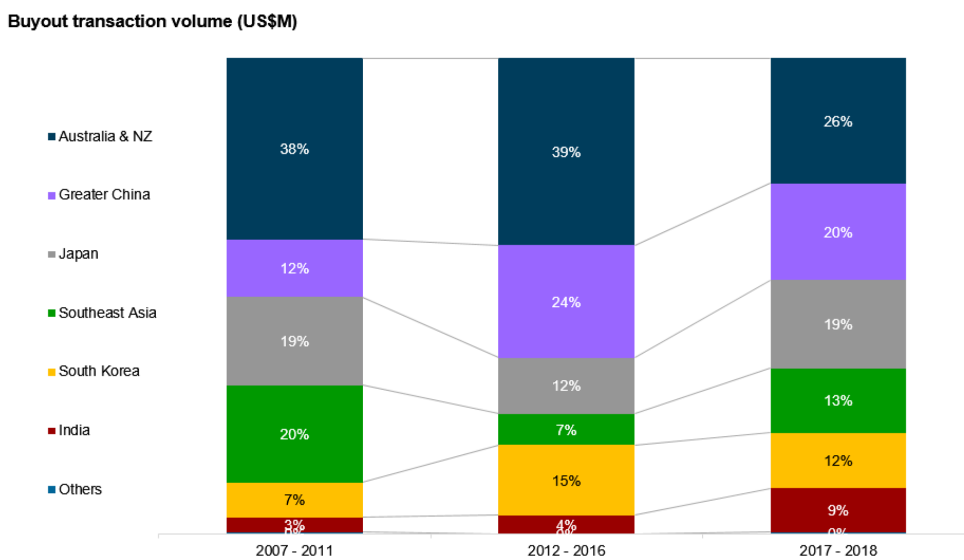
FEEDING THE DRAGON: DOES CHINA HAVE AN APPETITE FOR BUYOUTS?

May 3, 2019

Private equity investors have historically favored growth-stage investments in China as few true buyout opportunities existed. For entrepreneurs, an era of rapid economic growth meant that few were willing to sell controlling stakes in their businesses. For GPs, there seemed to be no shortage of fast-growing companies in need of expansion capital. But Hillhouse Capital's latest US$10.6 billion fundraise—Asia's biggest private equity capital raising to-date—has thrust China buyouts into the spotlight. As the market environment and private equity industry in China has evolved, we have observed the number and volume of buyout deals increase substantially over the last decade.

Exhibit 1: China's share of the Asian buyout market has increased significantly



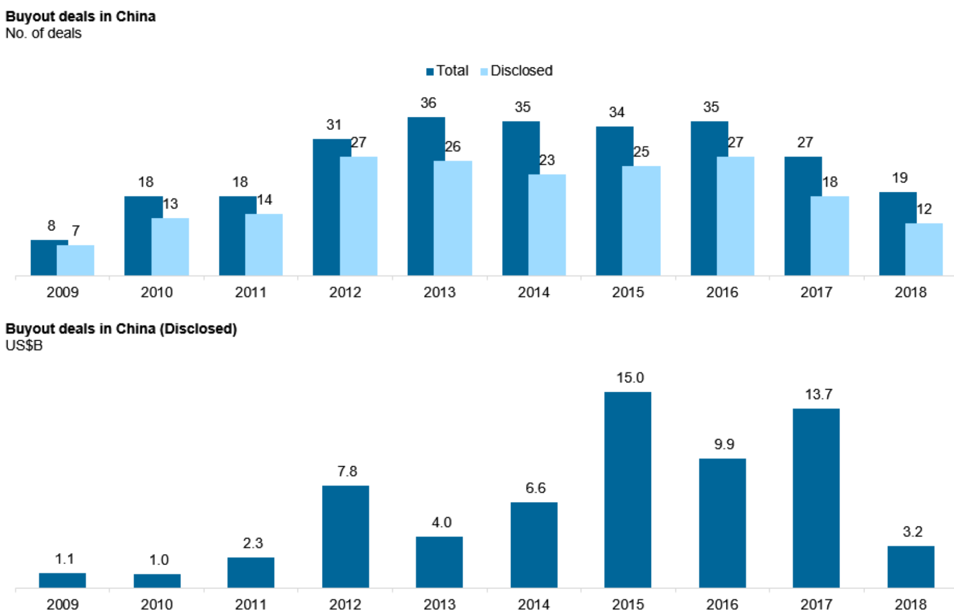
Source: Asian Venture Capital Journal (AVCJ)

As shown in Exhibit 1, Greater China buyouts (in purple) accounted for a mere 12% of total Asian buyouts from 2007-2011, doubling to 24% between 2012 and 2016. This follows the trajectory of a slowdown in GDP growth over the years. Between 2007 and 2011, China's GDP growth rate was upwards of 12% per year; there was limited competition for private equity opportunities and public markets flourished. The period between 2012-2016 saw China's GDP growth rate slow to below 10%. During this time, competition for deals increased and exit opportunities became more challenging as China closed its equity market to initial public offerings. Amid this market environment, opportunities for control investments rose dramatically.

A driver of increased buyout activity has been low interest rates where banks—both domestic and international—have been more aggressive at lending and facilitating large-cap leveraged buyout (LBO) deals. Typically, the leverage ratio of Asian LBO loans is 3.5-4x earnings but up until 2017, multiples as high as 5.8x were not uncommon.[1] According to Bloomberg, leverage on buyout loans across Asia has risen to levels last seen before the global financial crisis, with US$9.2 billion of financing in the pipeline – up 25% from the previous year.[2]

However, last year witnessed a drop in the number and volume of buyout deals in China (Exhibit 2).

Exhibit 2: Buyout deals in China by number and deal value



Source: Asian Venture Capital Journal (AVCJ)

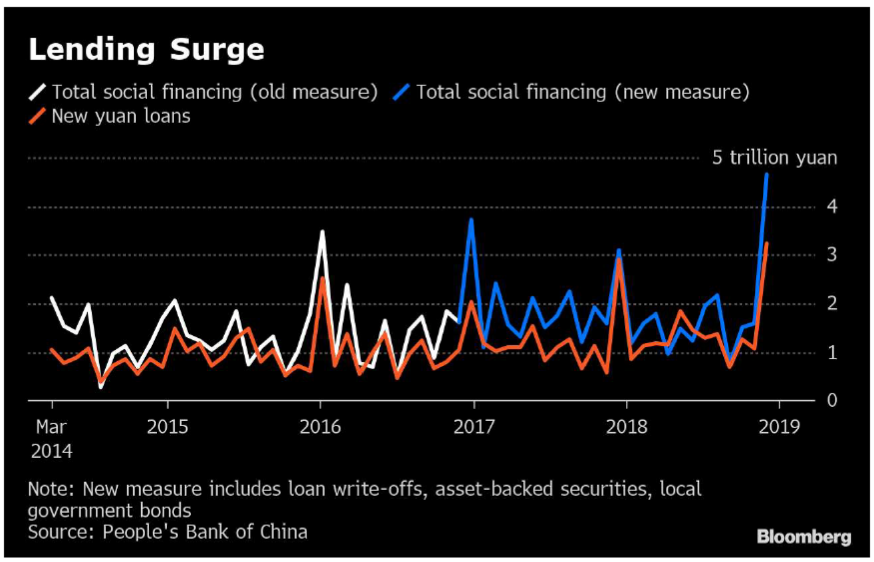
In our view, this is in part due to uncertainty over the US-China trade war as well as a deleveraging effort by the central government in an attempt to deal with concerns surrounding rising debt. We

[1] JP Morgan, data for large-cap LBOs as of Aug 29, 2017
[2] "Leverage in Asia buyout loans is edging back to 2007 levels", *The Business Times,* May 26, 2018.

anticipate that the Chinese government's pro-reform stance, easing monetary policy from the People's Bank of China (PBoC) and fiscal stimulus in the form of tax cuts will mean that we likely won't see a repeat of the 2018 lows moving forward.

Improved liquidity recently, as the government looks to slow its tightening, means that funding for such deals should be more readily available. In line with this, the China Banking and Insurance Regulatory Commission announced a major boost in bank lending, calling for domestic banks to double their lending to private-sector enterprises, ensuring that no less than 50% of financing goes to private businesses in the next three years.[3] As shown in Exhibit 3 below, Beijing's loosening of controls has already started to take effect as evidenced by the spike in lending early this year.

Exhibit 3: Lending set to increase as controls loosen



Though cultural issues surrounding buyouts still exist, in recent years, challenging growth prospects and subdued exit markets, have led to a growing cultural acceptance for company owners to partner with a controlling sponsor. According to a survey done by Bain & Company, 50% of Asia-Pacific companies that were bought with a minority stake in the past two to three years had path-to-control provisions, up from 34% in their 2017 survey.[4]

One such example of an entrepreneur selling out is Taiwan's Ruentex Group, which sold most of its stake in Chinese hypermart operator Sun Art Retail to Alibaba (Ruentex retained a 4.67% stake post-transaction). The move allows Alibaba to increase its offline retail presence while providing Sun Art with the digital capabilities that are part and parcel of being a member of Alibaba's

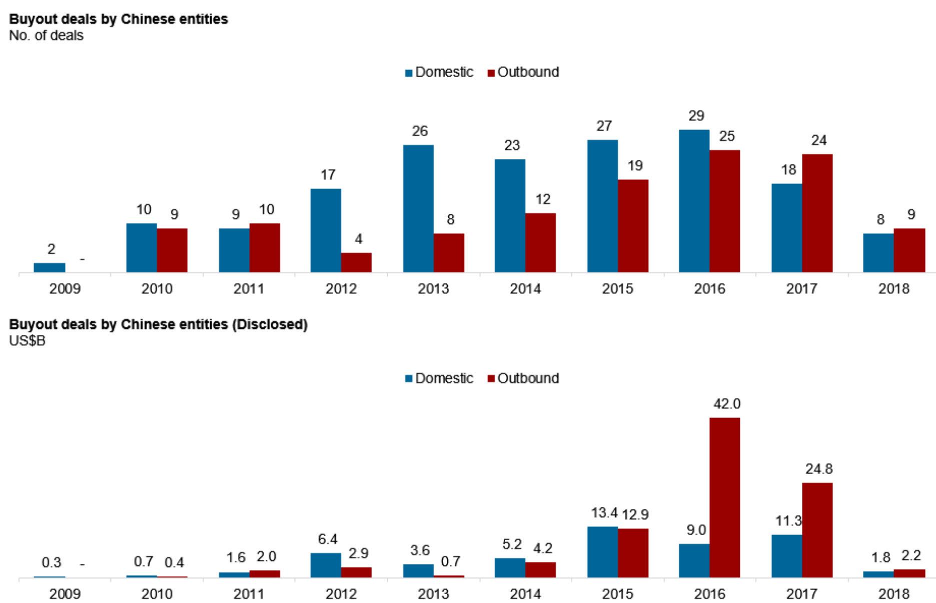
[3] "China tells banks to double private-sector corporate loans", *Nikkei Asian Review,* November 14, 2018.
[4] "Asia-Pacific Private Equity Report 2018", *Bain & Company*, March 15, 2018.

ecosystem. While this particular transaction did not involve private equity money, we have seen a growing trend of similar corporate carve-outs in PE.

Multinationals are exiting their core and non-core divisions in China driven by the inability of these firms to compete with local players and drive growth via local customization. McDonald's sold 80% of its Hong Kong and mainland China business to CITIC Capital and Carlyle, citing plans to ramp up restaurant openings and offer a "digital retail experience" to its customers. CITIC Capital alongside Baring Private Equity Asia also led the acquisition of Wall Street English from education group Pearson, in another corporate carve-out.

One trend we are witnessing in the buyout space is the surge in foreign acquisitions by Chinese firms. Chinese firms went on a spending spree in 2016, picking up overseas brands and valuable technology that would help China's transition towards an economy driven by domestic consumption (See Exhibit 4).

Exhibit 4: Foreign acquisitions by Chinese firms hit an all-time high in 2016

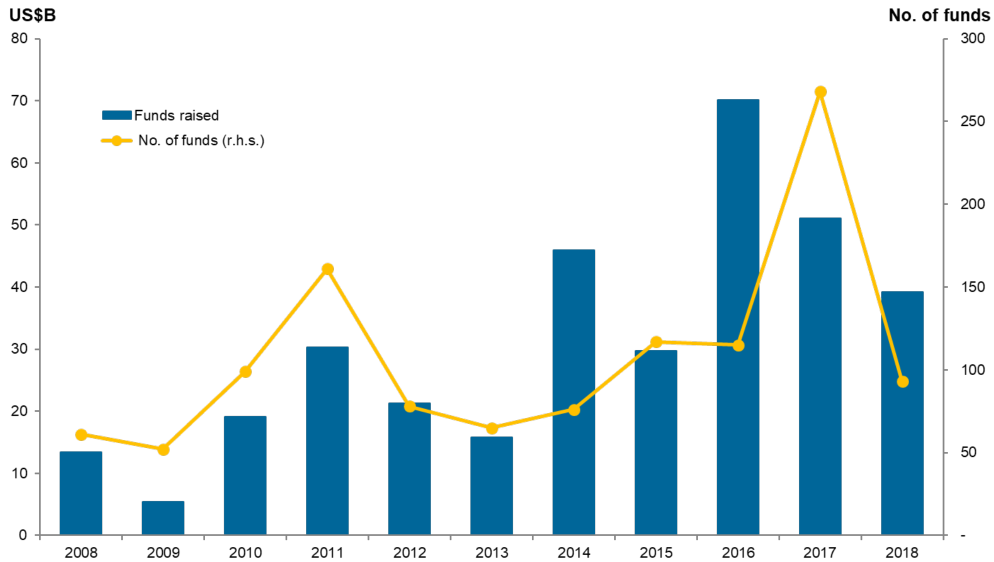


Source: Asian Venture Capital Journal (AVCJ)

We have since noticed a slowdown in the pace of overseas acquisitions as Western governments have stepped in to reject some transactions particularly in the technology sector. For example, the US Committee for Foreign Investment in the United States (CFIUS) blocked the potential buyout of 80% of the LED business of Philips by Chinese buyout fund GO Scale Capital. China's own government too has reined in deal making by implementing policies to curb what they deem as "irrational" outbound purchases in sectors such as entertainment and real estate.

In recent years we have observed that the number of growth and buyout funds raised in China has risen dramatically, doubling from 2016 to 2017 (see Exhibit 5). With this also comes a surge in the amount of capital raised in the Chinese market, which saw a peak in 2016. Although the amount of funds raised has since come down in the past two years, the underlying trend is clear. As the country's private equity market evolves to resemble more mature buyout-heavy markets like the US and Europe, GPs are raising increasingly larger funds to meet the growing size of acquisitions. It is not uncommon today to see both established fund managers and emerging managers in China raising funds north of US$1.5 billion.

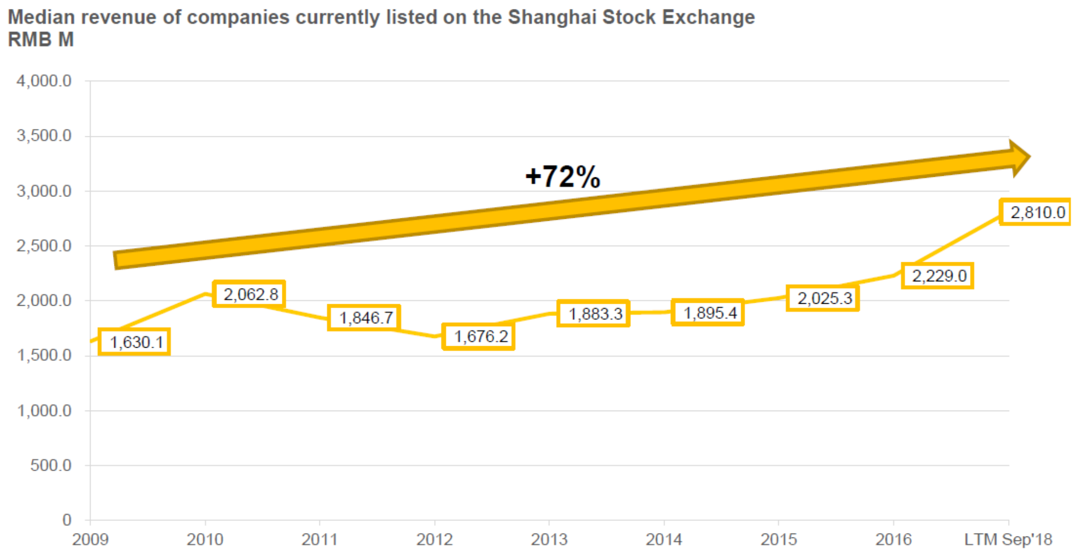
Exhibit 5: Amount of capital raised in China has surged



Source: AVCJ.

This begs the question: Is there too much competition in the market for too few deals? In our view, the opportunity set in the Chinese market is robust enough to support the increase in the number of large funds. Not only has the number of target companies in China gone up, so has the size of these companies. As indicated in Exhibit 6, the median revenue of companies listed on the Shanghai Stock Exchange has increased by over 70% since 2009, requiring larger check sizes to consummate such deals.

Exhibit 6: Chinese companies are larger in size compared to before



Source: Capital IQ

GPs who previously dominated the mid-market are naturally moving up the private equity food chain, leaving gaps for new managers to fill. At Axiom, we closely monitor the shifts in the landscape to identify the best segments within which to deploy capital.