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PRIVATE EQUITY EXITS IN CHINA: IPO OR TRADE SALE?

Choosing the optimal exit route is the most critical step of any investment cycle. As a large number of PE and VC funds which have invested in Chinese companies over the past decade prepare to sell their stakes, Delia Zhang and Joanna Wang compare the relative benefits of Initial Public Offering (IPO) and M&A exit strategies.

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Overview

Alongside secondary buyouts, the M&A and IPO routes are the most common options for PE/VC funds when considering an exit strategy, and each of the latter two routes has its pros and cons. If you look at If you look at Chart #1 alongside you can see that the M&A route has become increasingly popular among Chinese companies, while the number of IPOs has fluctuated considerably.

However, despite the number of M&A transactions surpassing IPO exits over the last decade, the total number of actual PE investors involved in the two exit routes are comparable, as you can see in the table alongside. This is because each IPO case has, on average, four PE investors.

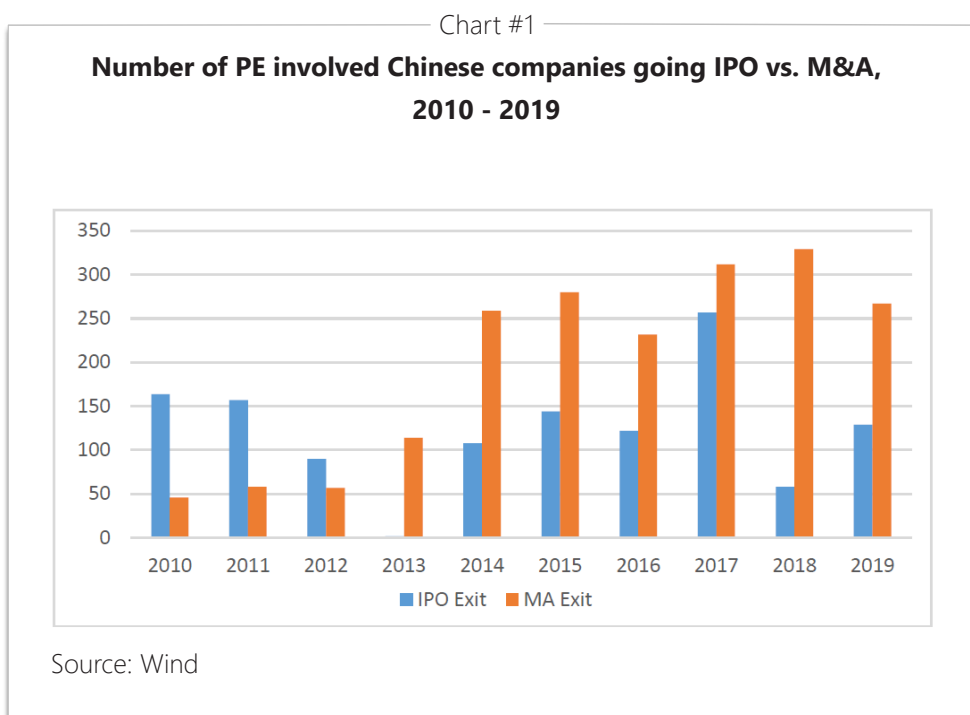


Chart #2

Number of PE investors involved in IPO and M&A since 2010

Year	IPO Exit	# PE Involved in IPO	M&A Exit	# PE Involved in M&A
2010	164	436	46	85
2011	157	520	58	98
2012	90	335	57	126
2013	2	5	114	286
2014	108	382	259	1000
2015	144	559	280	1059
2016	122	529	232	661
2017	257	1216	312	988
2018	58	397	329	963
2019	129	1013	267	703
Grand Total	1231	5392	1954	5969

Source: Wind

IPO options for Chinese companies

US market loses its attraction

The US stock market has long been the primary IPO listing place for Chinese companies in sectors such as TMT (Technology, Media and Telecom) and pharma because of historically strict listing requirements on the Chinese stock market.

However, although regarded as a mature and accessible place in which to list a company, there are disadvantages for Chinese companies thinking of turning to the US stock market. These include the high listing fee and maintenance cost, the strict disclosure and reporting requirements, and low valuation and liquidity due to little market recognition towards Chinese companies.

In addition market perception right now towards Chinese companies can be somewhat negative, not helped by the recent accounting scandal at Luckin Coffee which has greatly impaired the overall image of Chinese companies listed on the US market. Luckin was listed in New York in 2019 but earlier this year shocked investors when it said an internal investigation had found hundreds of millions of dollars of alleged fake sales last year, a move which wiped about 75% off the company's market value.

Legislation

In May this year the US Senate then approved the Holding Foreign Companies Accountable Act which requires certain foreign companies listed on US securities exchanges to disclose foreign government ownership or control.

In particular this means that Chinese companies will have to submit an audit that is then reviewed by the Public Company Accounting Oversight Board (PCAOB), a move that is currently not required as Chinese laws bar auditors' work from being transferred out of the country.

If the Act is subsequently passed by the US House of Representatives then Chinese companies planning to IPO on the US market will need to carry out extensive reforms to bring their companies up to global standards, especially in terms of their operations, management, and financial aspects, thereby complicating the IPO process. Companies that use accounting firms that cannot be inspected by the PCAOB for three consecutive years would be delisted from US securities exchanges.

Meanwhile another concern for Chinese companies thinking of an IPO in the US is the possibility of being short sold by foreign institutions, as has happened to a number of Chinese

companies over the past decade. So if you take all these concerns together, it means that PE investors supporting ongoing IPO deals will need to re-evaluate the costs and benefits of a US listing. Considering PE's comparatively short holding period and high expectation of return, an IPO in the US might now be less attractive in the short run.

Hong Kong becomes more popular

Businesses listed on the Hong Kong stock market face similar risks to those operating on the US exchanges, but the Hong Kong stock market in general has a higher tolerance towards Chinese companies. As such an increasing number of quality Chinese companies are now considering an IPO in Hong Kong, or to have a dual listing in both Hong Kong and the US. For instance following the example of Alibaba, tech giants JD.com and NetEase recently dual listed in Hong Kong to add to their US listings.

Chinese companies that fail to meet the listing requirements of the Chinese stock market will now likely choose the Hong Kong stock market as their primary listing place instead of the US, and we expect this trend to continue into the near future.

Chinese stock market

Meantime the Chinese stock market has undergone its own transformation in recent years, and is now structured in the following way:

- *The main board market is composed of the Shanghai Stock Exchange and the Shenzhen Stock Exchange*
- *A small and medium-sized enterprise board market only on the Shenzhen Exchange*
- *The ChiNext market, founded in 2009, is a NASDAQ-style*

subsidiary of the Shenzhen Exchange for innovative enterprises and high-growth firms

- *The Shanghai Sci-Tech Innovation Board, known as the 'STAR' market, was launched in 2019 and is geared towards technology start-ups*

Carrying out an IPO in China has been historically known for its strict review process, while frequent regulatory changes have also imposed great uncertainty on the process. Indeed in recent years the IPO pass rate has fallen from 91% in 2016 to as low as 60% in 2018.

However despite this many PE/VC investors still see a domestic IPO as their favored exit route, mainly due to the high valuations that can be achieved. Indeed stocks on the Chinese A-Share market are currently enjoying higher premiums than any other market in the world. For instance if you take the Sci-Tech Innovation Board and ChiNext then the average trading PE ratio of stocks listed is 81 and 48 respectively (as of early June). Needless to say, the current high PE ratio is a huge attraction for PE/VC investors when maximizing exit returns.



Reforms

A number of reforms are now set to make the Chinese market even more popular. In particular, in order to build a more standardised, open and dynamic capital market, the China Securities Regulatory Commission has undertaken several fundamental capital market reforms in recent years. These include:

- *Launching the IPO registration system for the Sci-Tech Innovation board and ChiNext market*
- *Relaxing listing requirements to attract more quality companies*
- *Strengthening the regulations for*

information disclosure and investor protection.

- *Improving the de-listing process*

For instance, the first measure above has greatly increased certainty for investors and shortens the IPO timeline to five to six months. As such it is forecast that IPO numbers in China will reach a record high in 2021, surpassing the previous peak of 438 in 2017.

Last year the IPO pass rate on the Sci-Tech Innovation Board was 96%, while the pass rate on the remaining boards was 89%. There have currently been 70 listings on the Sci-Tech Innovation

board since it was created in March last year, representing more than a third of the total IPO number in China and showing that the exchange has become an important channel for enterprises entering the capital markets.

Over the next few years the China IPO is likely to become the most popular exit route for PE/VC investors in China. However in the longer run - with an increasing number of companies listed on the Chinese market - valuations are likely to return to more normal levels, at which point investors are likely to turn to other exit options such as M&A.



M&A options for Chinese companies

An alternative to an IPO is for PE/VC investors to sell their shares in a company to a third party acquirer who is usually a strategic buyer in the same industry.

An M&A exit will be the preferred option in industries not at the top of the government's IPO agenda. Thus, we will continue to see M&A dominate "old school" sectors such as chemicals, industrials and consumer goods.

In this context, the target company will enhance its competitive and financial position, while also allowing it to expand its product and service offering, strengthen business relationships, increase brand recognition, and increase capacity at a lower cost.

Price is always one of the key factors, but not the only determining factor, in a M&A transaction. Ultimately shareholders and management will choose the

most suitable buyer who can bring the best strategic value in addition to financial value. In some cases the seller will opt for a strategic buyer with more synergy and higher deal certainty but at a relatively lower price.

Advantages over an IPO

Compared to an IPO strategy, an M&A strategy has some clear advantages:

- *It can be adopted by all kinds of companies, while an IPO strategy is often more feasible for companies with high growth potential*
- *The strategic buyer is usually willing to pay a premium when seeking a controlling position*
- *The strategic buyer brings more synergy value, benefiting the target company in the long term*
- *It can provide a quicker exit for investors who are not subject to a lock-up period*
- *It can be relatively lower cost in contrast to an IPO listing fee*

Uncertainty

On the other hand, the M&A process is often seen by investors as relatively complicated. Although the process itself can be standardized, in practice it involves a certain level of uncertainty.

A successful M&A deal requires strong deal logic, solid planning and process execution, and an effective negotiation strategy. Engaging the right financial advisor to design the deal strategy and structure, as well as execute the process, is crucial.

M&A as an exit option for PE/VC in China will continue to evolve and its advantages become more obvious when Chinese IPO valuations return to more normal levels.

Although a trade sale may not yield the highest multiples relative to an IPO, it can still often offer the best route. At the same time, the PE investor will receive cash upon closing a deal rather than having to wait to sell down their stock over a number of years once it is listed. Indeed if the equity stake is substantial, then exiting after an IPO can remain a challenge.

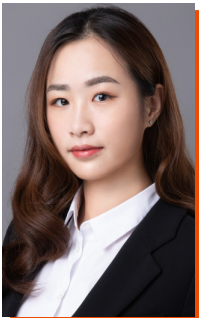
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Delia Zhang is an Associate Director at InterChina's Corporate Finance team with over 10 years of cross-border M&A and equity financing experience. Delia holds a bachelor degree in Electrical Engineering from Zhejiang University and a master degree in professional accounting from Macquarie University. She is also a member of Australian CPA.

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