The Development of Private Equity in China

Chenlai Wang
Zhejiang University, Hangzhou, Zhejinag, 310058, China
3200103687@zju.edu.cn

Abstract. Private equity fund is a sort of fund for a small number of specific investors, with institutional investors as the main investors. Although private equity fund has formed a certain scale after ten years of rapid development in China, there are still some problems. Considering the problems of medium and long-term value revaluation and industrial upgrading, private equity fund will have a broad development prospect in China. While the opportunity and risk coexist, this paper analyses the development of private equity fund in recent years from the macro-viewpoint, then tries to discuss the challenges ahead of it and predict the possible future direction.

Keywords: China, private equity fund, development, problem.

1. An Overview of Private Equity Fund

1.1 Definition of Private Equity

A private-equity fund (abbreviation for PE) is a collective investment scheme of investing in unlisted equity, or the non-publicly traded equity of a listed company, as opposed to listed Public Offering shares.

1.2 Characteristic of PE

PE is also named as "unlisted equity capital". It is characterized by the non-public nature of fund raising, the value increment of investment purpose, the long-term investment cycle and the professional investment operation.

(1) In terms of fund raising, it can be known by its definition that PE is raised for a few institutional investors or individuals in a non-public way, and its sales and redemption are conducted by the fund manager through private consultation with investors, so it has the non-public nature of fund raising.

(2) The enterprises invested by PE, whether in the start-up stage, large enterprises in need of restructuring, or enterprises in urgent need of capital for rapid development, all contain great risks and uncertainties. Only high risk can bring high return, and the only criterion for PE project selection is whether it can bring high return on investment. The invested enterprises usually have good development potential and value multiplication for investment purposes.

(3) PE investment period is long, generally reach 3 ~ 5 years or longer; It's investment liquidity is poor, and there is no ready market for the transferors of shares in unlisted companies to strike a deal directly with the buyers. PE is a medium - and long-term investment with poor liquidity.

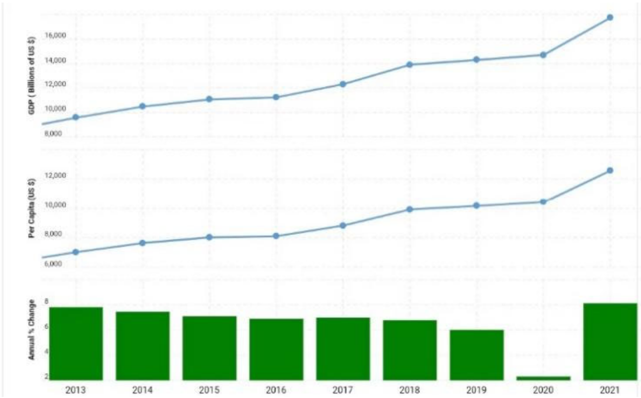
(4) Generally, PE adopts equity investment. Investors in the decision-making of the enterprise investment management have voting rights, often take part in the management of the enterprise. Therefore, investors must have a deep understanding of the invested enterprise industry and experience of enterprise management, so as to make the right investment decisions, and have the ability to supervise the investment company. The investment operation is very professional.

2. Private Equity Fund Development in Recent Years in China

2.1 Industry Development Environment Background

2.1.1 Background of Macroeconomic Development.

In recent years, China's GDP has maintained growth (the growth trend is shown in the following chart, from www.macrotrends.net). In 2020, China promoted epidemic prevention and control and economic and social development in a coordinated way, realizing GDP exceeding 100 trillion RMB for the first time, and all industries have been steadily stabilizing and recovering. Standing at the historical intersection of “the two Centenary Goals"(the goals, put forth by the Communist Party of China(CPC) at its 18th National Congress, are to complete a moderately prosperous society by the centenary of the CPC, and to build China into a modern socialist country by the centenary of the People's Republic of China (founded in 1949)), PE, as an important tool of direct financing and the main carrier of innovative capital formation, will play a more prominent role in thoroughly implementing the development concept and accelerating the construction of a new development pattern.



2.1.2 Regulatory Self-regulatory Environment.

China’s regulatory and self-regulatory environment is gradually improved, promoting the standardized development of the industry. The Company Law is the main legal basis for the establishment and operation of corporate-based private equity funds, while the Securities Law regulates the exit channels of private equity investments. The 13th National People's Congress deliberated and passed the revised Securities Law, which came into effect in March 2020. The Interim Measures for the Administration of Industrial Investment Funds was formulated in order to deepen the reform of the investment and financing system, promote industrial upgrading and economic restructuring, regulate the establishment, operation and supervision of industrial investment funds, and protect the legitimate rights and interests of the parties to the funds.

2.1.3 Development policy environment.

The business environment is improving.

China's business environment has risen from near 100th to 31st in 2020, and has been ranked as one of the world's most improved economies in terms of business environment for two consecutive years. The reform of capital market registration system continues to deepen - the launch of relevant regulations and regulations of the GEM and the Shenzhen Stock Exchange's simultaneous release of the reform of the GEM and pilot registration of relevant business rules and supporting arrangements to stimulate the development of the industry; Good long-term fund policy, boost the development of the industry.

2.2 Overall Industry Situation

2.2.1 Industry Scale.

China's private equity fund market scale has been increasing continuously, and it has become the second largest equity investment market in the world at present. Even under the impact of the pandemic, the management scale of PE continues to grow and the management structure of PE managers has been optimized. Both the management scale and the number of management of PE fund managers are increasing (the number of surviving PE managers raised from 17433 to about 25000 and that of funds managed by PE managers from about11 trillion CNY to nearly 18 trillion CNY), indicating the overall level of improvement.

2.2.2 Fundraising.

The basic operation process of equity investment fund is: fundraising - investment - management - exit. Fundraising, as the first stage in the process, plays a crucial role whose size determines the development prospects of the private equity industry. In 2017, the scale of capital raising reached a record high. Even at record highs, it was still difficult to raise money. Since the implementation of the new regulations on capital management in 2018, the fundraising time has lengthened and the scale of fundraising has declined, leading to a year-on-year decline in the total scale. In the first half of 2020, it was particularly difficult to raise funds due to the impact of the COVID-19 pandemic. Only 1,069 funds in the market completed a new round of fundraising, with a total amount of 432.840 billion yuan, a year-on-year decrease of 29.5. It eased in the second half of the year, but the overall decline could not be reversed. Among them, the new record venture capital fund raising is relatively optimistic, while the merger fund and private equity fund new record scale decline, more than half of all think that raising more difficult.

2.2.3 Investment.

In terms of different industries, according to the development plan formulated by China, the investment in strategic emerging industries has been significantly increased, and the proportion of investment in semiconductor, pharmaceutical and biological industries and medical devices has increased.

From the perspective of investors, institutional investors, although less than before, are the main source of funds for private equity investment funds. By the end of 2020, the main investors in private equity funds were institutional investors, contributing 8.17 trillion CNY, accounting for 86.7% of the total.

From the perspective of investment direction, investment in small and medium-sized enterprises, high-tech enterprises, start-up science and technology enterprises increased significantly, expanding financing channels for small and medium-sized enterprises, and vigorously promoting supply-side structural reform and innovative development.

2.2.4 Exit.

With the promotion of the pilot registration reform system of the Science and Technology Innovation Board(also named as Sci-Tech Innovation board, a new trading platform in the Shanghai Stock Exchange (SSE) independent from the existing main board, focuses on companies in high-tech and strategically emerging sectors and other measures, the withdrawal environment of private equity investment funds has been optimized, and the overall situation of withdrawal is in a good direction.

From the perspective of exit methods of relevant exit cases, the main exit methods are "agreement transfer", "enterprise buyback" and "New Third Board listing", which account for nearly 80% of all exit times. From the perspective of actual withdrawal amount, the actual withdrawal amount of "agreement transfer", "domestic IPO" and "enterprise repurchase" accounted for a relatively high proportion, accounting for about 85% in total.

From the industrial distribution of relevant withdrawal cases, the top five industries in terms of the number of withdrawal cases were "computer application", "capital goods", "medicine and biology", "raw materials" and "medical devices and services", with a total number of 2369, accounting for 65.5%.

3. Consideration on the Development of Private Equity in China

From the first corporate-type venture capital fund was established in 1993 and listed on the Shanghai Stock Exchange, it has gone through more than 20 years. In these more than 20 years, our development has developed from the initial exploration and initial stage to the current standardized development stage under unified supervision, and many qualitative changes and leaps have taken place in the middle. However, compared with the foreign development history of more than 60 years, we still need to learn from the development of private equity.

The first is the fundraising end. It can be seen that the fundraising dilemma of the industry has not been effectively improved. Since the implementation of the new regulations on capital management in 2018, the scale of fundraising has been declining year by year. Even for the head institutions, it is not easy to raise funds, and it will be more difficult for small institutions to meet each other. And Matthew effect, that is, the strong are stronger, the weak are weaker, making the big institutions get more eyes, small institutions are not easy to raise money, it is more difficult to move forward barely maintain, the industry will usher in a reshuffle.

As for the exit, the registration system reform is like a spring rain, which has largely solved the exit problem that has plagued domestic private equity investment for more than 20 years, but it is still difficult to exit. It is difficult to exit the domestic market because of the shackles of listing audit mechanism and the narrow exit channels of holding investment. Although the listing returns are higher, the exit efficiency and certainty are obviously insufficient.

4. Conclusion

China has the world's largest industrial manufacturing sector, which in turn has a greater pool of fast-growing private companies with strong financing needs, and, unlike smaller economies such as Japan, South Korea, Taiwan and Hong Kong, a robust base of social mobility. With the intensification of China's capital market reform, including deepening the reform of the GEM registration system, promoting the new third board market stratification and the reform of board spinning machine, etc. A standardized, transparent, open, dynamic and resilient capital market will eventually provide a more solid exit guarantee for private equity to serve economic development. And once China's long-term capital matures with the help of policy, unleashing trillions of potential funds, there is enough to support domestic companies to exit onshore. It is believed that the private equity market will become more mature under the proper policy implementation.

References

[1] James Chen. Private Equity Explained with Examples and Ways to Invest. July 28,2022.
[2] Gerdjie Zhou. The performance and characteristics of Private Equity. August,2007.
[3] China Daily Editorial Office. The Two Centenary Goals. China Daily, June 30, 2021.
[4] China Investment Information Services LTD. Sci-Tech Innovation Board -Introduction.
[5] 2021 China Private Equity Investment Industry Research and Outlook Report (in Chinese). Baidu Wenku.
[6] Xinhua. Multilateralism will revive world economy faster. China Daily, June 12, 2021.
[7] 2020 Private Equity Fund Exit Report (in Chinese). Financial Town network.
[8] Zhiwei Zhang. The Development of Private Equity Investment Fund in China (in Chinese).
[9] 2020 China Private Equity Investment Industry Research and Outlook report (in Chinese). Baidu Wenku
[10] Analysis of Private Equity Status in 2019(in Chinese). Baidu Wenku.