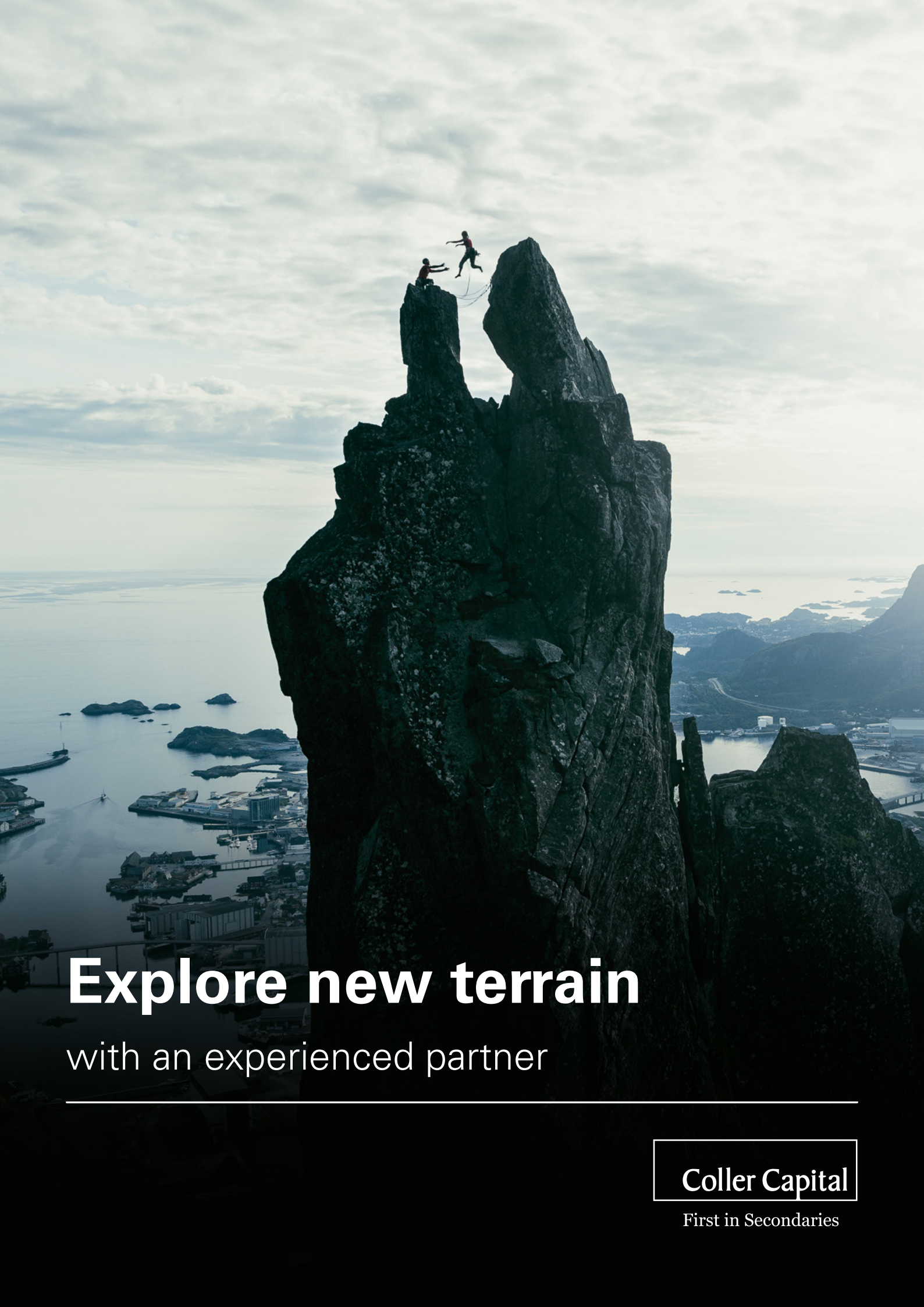


Existential crisis

Chinese GPs fundraise
for their lives



- ▶ Where investors are looking for green shoots
- ▶ Bridging the price gap in secondaries
- ▶ The flight to proven business models



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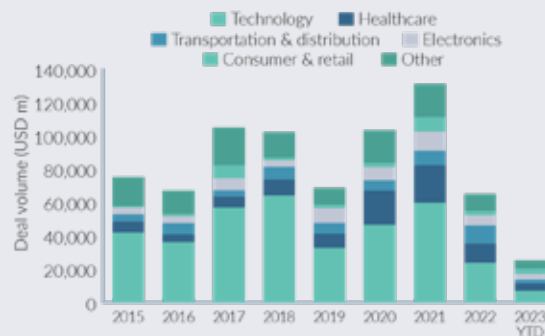
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China in six trends

1 Sectors: Technology in retreat

Growth-stage investment in China's technology sector peaked in 2018. By 2021, early and growth-stage activity was nearly at parity (compared to a 12-88 split in 2018). That continued last year as both fell by about half to USD 20.8bn and USD 24.1bn. The decline has continued in 2023. Investment in technology across all stages fell by 60% last year, but deployment was still more than the next two largest sectors combined. This is unlikely to be repeated in 2023. Technology currently leads healthcare with USD 7.1bn to USD 4.5bn.

China PE investment by sector



Source: AVCJ Research

China fundraising - US dollar vs renminbi



Source: AVCJ Research

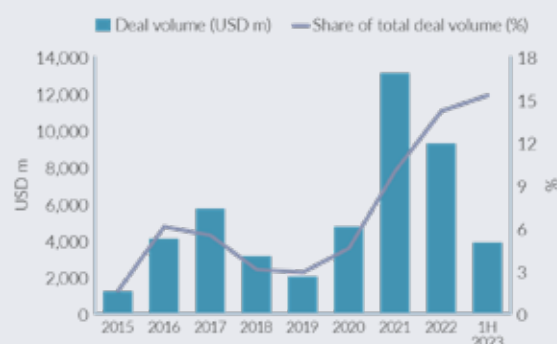
2 Fundraising: A bitter winter

The best fundraising strategy for China GPs appears to be delaying a return to market. In addition to global challenges confronting managers the world over, China is plagued by a string of local ones: a retreat from emerging markets, US investors hindered by geopolitical tensions, a recent history of regulatory volatility, a longer history of valuation mark-ups not crystallizing into distributions. Between 2015 and 2022, the annual average commitment to US dollar-denominated funds was USD 21.5bn. They have collected a paltry USD 6.1bn in 2023 to date.

3 Green-tech: Still in vogue

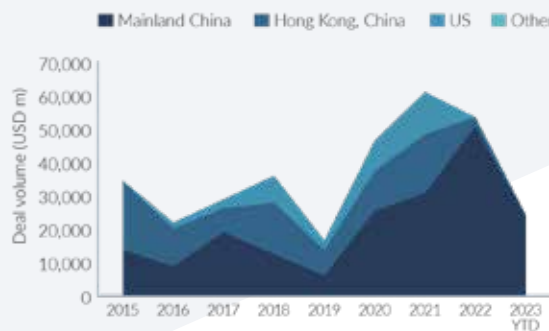
Green-tech surged in 2021 as investors targeted sectors expected to benefit from policy tailwinds in China. The trend has gained momentum. Investment in renewable energy, ecology, and cleantech reached USD 13.1bn in 2021 and USD 9.3bn in 2022; it stands at USD 3.8bn for 2023 to date. But with investment dwindling across the board, the green-tech share has risen from 10% to 14.2% to 15.3%. In 2020, it was only 4.6%. The electric vehicle value chain remains a focal point, but it's worth noting how recent investment charts a consolidation led by incumbent market leaders, often state-owned.

PE investment in China green-tech



Source: AVCJ Research

China PE-backed IPOs by location of offering



Source: AVCJ Research

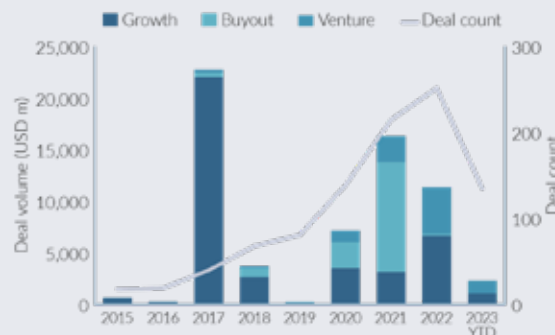
4 IPOs: A local story

China is poised for one its most disappointing years on record for PE exits. Proceeds amount to less than USD 1bn – compared to 12-month totals of USD 5.3bn in 2022 (a 14-year low) and USD 21bn in 2021. The picture for PE-backed IPOs isn't so bleak, with proceeds of USD 24.4bn from 111 offerings in the first eight months. Just over 200 IPOs generated USD 53.5bn across the whole of 2022. The caveat is that you need to list domestically. Despite talk of an offshore IPO revival, mainland exchanges are responsible for USD 93 of every USD 100 raised.

5 Semiconductors: No exception

China's white-hot semiconductor industry appears to have cooled in the eyes of investors, notably in the early and growth stages. The industry defied a decline in the broader technology sector in 2022. Exclude buyouts (the Tsinghua Unigroup restructuring) and investment more than doubled to USD 11.2bn, buoyed by the import substitution theme. Restrictions on exports to China have intensified, yet deployment for 2023 to date is USD 2.2bn. Moore Threads closed a new round at the start of the year, but other high-flying chip designers are conspicuous in their absence amid talk of valuation corrections.

PE investment in China's semiconductor industry



Source: AVCJ Research

Largest China PE deals, 2023 to date

Investee	CNY-denominated	USD m
Fortune COFCO	Yes	21,000
Shein	No	2,000
Xiamen Hithium Energy Storage Technology	Yes	4,500
Farizon Auto	No	600
Far Eastern Horizon Financial Leasing	Yes	4,000
Anhui YOFC Advanced Semiconductor	Yes	3,244
SolarSpace	Yes	3,000
Eswin	Yes	3,000
QingTao Energy Development	Yes	2,700
Yibin Libode New Material	Yes	2,578
SJ Semiconductor	No	340
Yunnan National Titanium Metal	Yes	2,272

Source: AVCJ Research

6 Investment: Renminbi rises

Two deals account for one-fifth of the USD 25.3bn invested in China so far this year: Fortune COFCO received CNY 21bn (USD 3.1bn) from an assortment of state-owned enterprise and government-linked investors; and Shein raised USD 2bn from several offshore investors. The former is more reflective of the market. Of the country's top 25 deals, 19 were completed by renminbi-denominated pools of capital. This reflects a challenging US dollar fundraising environment and perhaps founders, with one eye on local regulators and local capital markets, becoming more discerning about sources of capital.

China fundraising: Zombie apocalypse?

A pullback by US investors is exacerbating difficult fundraising conditions in China. Most managers are either delaying their return to the market or pulling every lever to secure commitments

Denied access to traditional sources of capital amid a challenging global fundraising environment, Chinese GPs are facing an existential crisis. Absent the restoration of cordial US-China relations or a sharp uptick in returns, many managers must rebuild their LP bases or risk descending to zombie status – dragging out holding periods to maximise fees while nursing faint hopes of rejuvenation.

“It’s hard to kill a GP because the cost structures are so flexible, it’s just human capital. They will hunker down and try to ride out the market,” said Edmond Ng, a managing partner at fund-of-funds Axiom Asia. “It should be a good time to make investments, so maybe in a few years, some of them can come back and raise more money. But track record is the big problem.”

Ng wryly observed that track records, especially in China’s early and growth-stage space, are so concentrated that much of the value can be traced to a handful of companies: the likes of social commerce player Pinduoduo, short video platform Kuaishou, and social networking giant ByteDance.

Monolith Management, likely the only China GP to close a first-time fund in the past 18 months, can claim a piece of that story. Xi Cao, the firm’s founder, made partner at Sequoia Capital China within two years, largely on the back of an investment history anchored by Kuaishou. He established Monolith in 2021, raised a hedge fund, and in February closed a debut VC fund on USD 264m.

Cao relied on more than just Kuaishou. The GP commitment to the fund is around 20%, according to two sources close to the situation, while some LPs in the hedge fund agreed to transfer a portion of their interests to the VC vehicle. Endowments, family offices, and fund-of-funds also feature. ▶



“It’s hard to kill a GP because the cost structures are so flexible, it’s just human capital”

– Edmond Ng

Monolith declined to comment. But a source close to the process said that the firm's rawness might be a blessing. "If you benchmarked China funds with 7-10-year records against the US, a few would be first quartile, most would be second quartile. It might be easier for a 'blank slate' than an established GP because you aren't selling a track record that doesn't hold up," the source noted.

Levels of discomfort

Above all, what Monolith managed to achieve was momentum. The fund launched last November with a target of USD 200m and reached a first close of USD 185m in January, by which point a degree of fear-of-missing-out had kicked in. It is difficult to make stardust stick to a fundraise when LPs are reluctant to commit to anything at all in China, let alone as an early investor.

"In late 2022, the base case was that the worst of COVID would be behind us by the second quarter of 2023 and by summer China would be normalising. It all happened faster, there was a moment of euphoria, but now it's all doom and gloom," said one fund-of-funds LP. "It's unclear how strong the recovery will be, so the bar is high for China. If you don't have to do anything – and there isn't much incentive to do anything – you just wait."

As one of a cluster of fund-of-funds with Asia-focused vehicles and mandates, this investor is bound to the region to some extent. LPs managing global programmes out of other markets are not. Several Canadian pension funds have, publicly or privately, confirmed that direct investments in China are on hold. Multiple US and European institutions have halted China fund commitments.

"We've effectively stopped putting capital to work in China. We think the risk-return trade-off in the near to medium term just isn't there," Michael Barzyk, global head of private equity at Allstate Investments, told the Mergermarket Private Equity Forum in New York in April.

Sentiment in the US has soured to the point that investor relations professionals and placement agents claim there is no point marketing there. One estimated that the US has accounted for 60% of the capital raised by China managers over the past decade; now it's 10%. Four in five endowments and foundations have put investments on hold; the rest are still deploying in

China or looking to sell fund positions.

Edward J. Grefenstette, president and CIO of The Dietrich Foundation, is less harsh in breaking down the market across all investor types. One-third are saying a hard no to more China, indefinitely; another third is not liquidating positions but planning to pause at least through 2023 for further study and may reengage with China thereafter; and another third is still open to the idea of investing in the country.

"They are probably pausing modestly but need to spend more time on the ground with managers to re-evaluate prospects. We are in that category. Having honest, face-to-face meetings with GPs and other trusted market participants is critical for us," Grefenstette said, adding that Dietrich's China exposure has dropped from 35% in 2020 to 26% today due to distributions, markdowns, and fewer new commitments.



One US pension fund expressed similar sentiments, highlighting plans to re-map the China market later in the year. Several others described their stance as not anti-China, but they noted the difficulty in getting investment committee approval for anything China-related.

Troubles writ large

For country-focused GPs, geopolitical and performance concerns represent a troubling overlay to already difficult conditions. A US-based LP accustomed to deploying half its USD 200m annual budget overseas may find that – because of the denominator effect and rising interest rates making bonds more attractive on a relative basis – it only has USD 100m and gives it all to US GPs.

"Whatever they have, the US market might satisfy them. At the same time, they only need build a portfolio that clears their obligations. If that's a 12% return, why shoot for 18%? In this context, bond yields are very important right now," said Axiom's Ng.

The challenges are already visible in China fundraising data. Around USD 19.8bn was committed to US dollar-denominated funds last year – down slightly on 2021 – but HongShan (formerly Sequoia Capital China) and Qiming Venture Partners together accounted for nearly 60% of the total. As of mid-June 2023, USD 5.4bn had been collected across half a dozen closes. ▶



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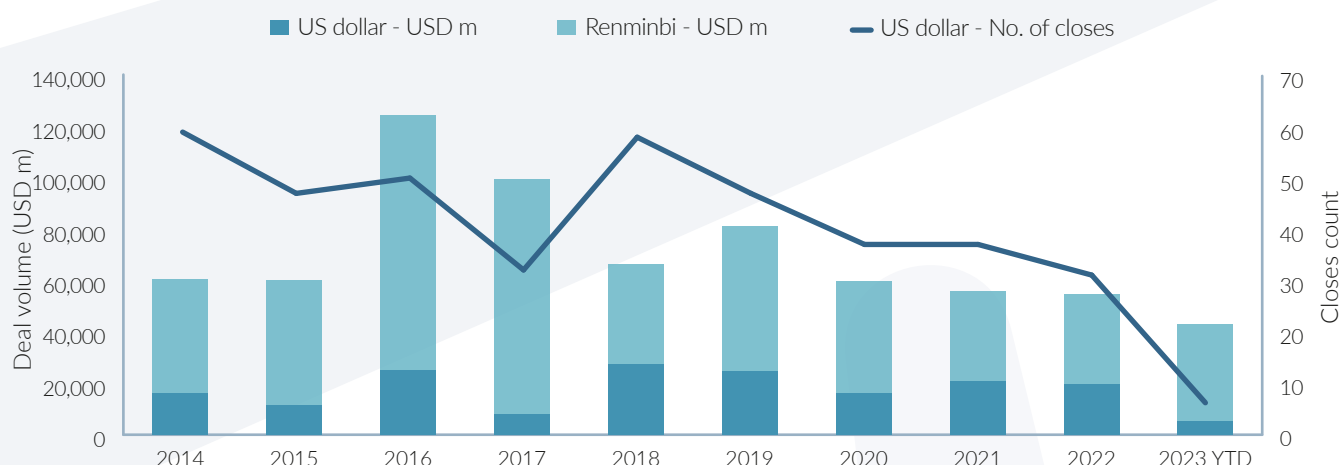


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China private equity fundraising



AVCJ Research

Several of the larger funds to achieve final closes in the past 12 months did most of the work prior to the outbreak of war in Ukraine in early 2022: Qiming is one example; Primavera Capital Group, which closed its fourth fund on USD 4bn in February following an extension to the fundraising period is another.

Much the same applies to smaller managers. GenBridge Capital launched its second fund in early 2021, reached a first close of USD 300m within a few months, and then ran into trouble in 2022. It secured a one-year extension and did a final close on USD 400m in May. The fund is smaller than hoped for, but the amount is workable, said a source close to the situation.

Extensions are increasingly commonplace as GPs stay in the market for protracted periods. Sinovation Ventures closed its debut growth fund on USD 600m in February, short of the USD 1bn target after two years of effort. The firm reached a first close on its latest VC fund in April of last year, remains USD 200m short of the USD 500m target, but plans to extend, according to a separate source close to the situation.

Genesis Capital and GL Capital have both completed several closes and are more than two-thirds of the way to their respective targets, but they continue to push on despite passing the two-year mark, other sources said. Industry participants

have mixed views as to whether a GP would be best served closing a fund short of target and focusing on deployment or staying open in search of additional commitments.

"If you are 70% to target and want to stay open for another 18 months, I would ask how many deals have been done already and are there any up rounds pending. I've seen investors rush to a final close because they've added eight solid assets since the first close, distributions are coming through, and there's the possibility of an early secondary," said Vincent Ng, a partner at placement agent Atlantic Pacific Capital.

Conversely, a manager might hold a fund open and continue seeding it in the hope of attracting new investors. LPs generally appreciate the opportunity to look before they buy, but Dietrich's Grefenstette warns that a manager who closes two early deals in the anticipation of raising USD 300m and ends up with half that amount will likely experience portfolio construction issues.

GPs not already in the market are slowing deployment and delaying the point of return. Some do not have that luxury; they have run out of capital and need more to stabilise their teams. "You have to be seen to be doing something," Atlantic Pacific's Ng argued, noting that it pays to be proactive with LPs rather than waiting for the feeding frenzy when conditions normalise.

Largest China funds raised since 2017

Fund	Manager	USD m
Boyu Capital Fund V	Boyu Capital	6,000
Primavera Capital Fund IV	Primavera Capital Group	4,000
Boyu Capital Fund IV	Boyu Capital	3,600
Sequoia Capital China Expansion Fund I	HongShan	3,600
Primavera Capital Fund III	Primavera Capital Group	3,400

Source: AVCJ Research

That said, Atlantic Pacific is wary of taking on any China mandates. Several other placement agents expressed the same view. Asante Capital is open to China business, with Ricardo Felix, the firm's head of Asia, pointing to a recent improvement in sentiment and a positive experience working with local managers. Ten months ago, he would have hesitated even if approached by a top-tier GP.

And those managers are reaching out. "The quality of our China deal flow has never been higher. Firms that I've been reaching out to since I moved to Hong Kong are now sending me messages over LinkedIn, asking to talk," said Niklas Amundsson, a partner at Monument Group, another placement agent. "The good news is they want us; the bad news is they really need us."

Getting creative

Tapping underpenetrated sources of capital is typically high on the wish list. As a result, nearly every Chinese GP is spending more time in the Middle East. Shirley Hu, a managing director at Oceanpine Capital, believes interest from these LPs is gradually tilting the fundraising environment in a favourable direction, highlighting the "abundance of capital and relative geopolitical ease."

Other investors and advisors claim the opportunity is being overhyped. From sovereign wealth funds to family offices, there is plenty of capital in the Middle East, but accessing it requires patience, persistence, and a willingness to accommodate different agendas. "I think the region is being falsely branded as a Klondike for fund managers," Ludvig Nilsson, founder of Jade Invest, told AVCJ in April.

Nevertheless, the Middle East, North Asia, and Southeast Asia are regularly cited as attractive targets for China fund commitments. Concentrating on constituencies that might be less negative on the country is a key theme, which takes in everything from overseas Chinese money to Asia-based institutional investors like sovereign

wealth funds and insurance companies.

There is also increased focus on non-traditional forms of capital – typically family offices and corporates – that aren't necessarily restrained by the denominator effect or by conservative institutional investment committees. Chris Lerner, formerly of Eaton Partners and MSA Capital and now CEO of asset manager Asia Heritage, noted that approaches to these investors must be underpinned by strategic rationale.

"It comes down to thinking about what value you can bring to different kinds of investors," he said. "Can you offer insights to a group that might become an equity partner in your holding company, an LP in your fund, or someone who uses you as a channel for co-investment and learning? What can you offer besides 2/20 because 2/20 with no DPI [distributions to paid-in] isn't attractive anymore."

Atlantic Pacific embraced this philosophy when working with a GP on a recent co-investment pitch for a technology deal. It targeted family offices and corporates in Southeast Asia that have exposure to natural resources that form a key part of the company's supply chain. These groups were invited to invest alongside the fund to build familiarity ahead of a possible commitment to the fund.

Co-investment is one of several incentives offered to prospective LPs alongside stakes in the GP and access to secondaries. There are two principal paths for secondaries: an incoming investor is invited to make a stapled commitment in conjunction with the purchase of interests in older funds; or an existing investor is encouraged to re-up using part of the proceeds generated through a secondary transaction.

Neither path is easy to navigate, according to one secondaries advisor. First, incoming investors are typically asking for USD 5 of secondary for every USD 1 of primary commitment, compared to 1:2.5 in the US. Second, Chinese GPs look to cram as many assets as possible into continuation funds, diluting the impact of standout portfolio

companies and thereby eroding the price investors are willing to pay.

Jason Sambanju, a partner and CEO at secondaries specialist Foundation Private Equity, believes the bid-ask spread is narrowing as GPs accept that discounts must be steeper than 20%. This doesn't necessarily translate into more deal flow: rationalisation of pricing expectations on the LP side can be more haphazard and then there's no guarantee a secondaries investor can syndicate a deal once it is agreed.

Ultimately, though, the new fundraising reality is forcing the issue. "Every established US dollar manager must think about whether its US LPs will come back for the next fund," said Sambanju. "The pin dropped in 2022, so it's new. If it is going to generate more deal flow, it won't happen until later

done well and what you've done not so well and make improvements. Then you must have an intellectually honest conversation about the market and the state of your portfolio," he said. "If you just come out with the same pitch and target geographies you think are less penetrated or more open to China, it won't work."

There are examples of bounce-backs in Asia – Advantage Partners in Japan and Pacific Equity Partners in Australia – where GPs have experienced difficulties at the portfolio level, taken stock, endured a difficult fundraise, but ultimately emerged stronger. In each case, introspection led to tweaks in strategy and best practice, and the managers didn't rush back to market as changes took hold.

China's PE hierarchy has evolved over the last 20 years, with certain GPs fading and others coming the fore, but no one can identify a bounce-back. Explanations for this range from the relative youth of most firms to a pervading cult of personality whereby the power and economics rest with an individual who is reluctant to submit to internal cross-examination.

Fundraising in China will continue to favour a select number of firms who float above the carnage below as their peers compete for a smaller pool of international capital. To some extent, it's not personal and it doesn't have to be protracted. Dietrich's Grefenstette sees the current struggles as a function of the macro rather than the micro and he is willing to wait for a government-led return to pragmatism.

But there will also be questions about the sustainability of existing investment strategies in a comparatively lower growth environment and the viability of exit routes that historically have relied heavily on US capital markets. GPs always claim differentiation; now they will be asked to prove it.

"Some zombie GPs will emerge and then consolidation will follow. There will be those who really take it on the nose and those who will very successful," said Monument's Amundsson. "China's been a bit of a beta market to date. We are about to find out who adds value the way they say in the pitchbook." ■

"It comes down to what value you can bring to different kinds of investors"

– Vincent Ng

this year or sometime next year, or even 2025. But I think we will see more continuation funds."

For managers still struggling to make a breakthrough on fundraising, there are more fundamental pivots. Numerous China GPs have sought to rebrand themselves as pan-Asian – despite reservations among LPs about their ability to deploy beyond China – while others are turning to renminbi funds as a means of keeping the fees rolling in and their franchises intact.

However, this is merely delaying what Asia Heritage's Lerner regards as an essential period of introspection for China managers – and an inevitable moment of reckoning if they are to reclaim the affections of international investors based on performance.

"You need to look at your team, your focus, how you've run your business, what you've

Investment: Deployment patterns

Private equity investment in China remains in the doldrums yet local investors claim to see green shoots. Where, when, and how they engage with the market is likely to differ from previous cycles

People thought that there would be a second wave of COVID-19 in China but it appears to have ended quickly. From food and beverage to real estate to transportation, activity has heated up,” said Yongbing He, CIO of local PE firm CPE, told AVCJ in April. “When people realised the pandemic was really over, there was a very clear turning point and the Chinese economy began to recover.”

The recovery proved to be a false dawn, with GDP growth limping from 2.2% in the first quarter of 2023 to 0.8% in the second. Exports were falling, consumer spending was weak, and the property sector – which accounts for about 30% of GDP – was in turmoil.

Meanwhile, private equity investment remains stubbornly low. It reached USD 8.8bn and USD 12.8bn for the same two periods; the average for the prior eight quarters was USD 25bn.

“My impression is that investors are still searching for direction, at a slow pace. The trend of everyone swarming and rushing into a particular theme has faded, and there is no longer as much intense competition. Overall, there is still a strong wait-and-see sentiment in the market,” said Yichen Zhang, founder, chairman and CEO of Trustar Capital.

The valuation gap remains a sticking point. While venture capital investors note that founders have begun to adjust their pricing expectations downwards, private equity is still in limbo. More mature companies tend to be less cash-hungry than start-ups and the recent pick-up in the economy – and in public markets – has eroded their willingness to compromise.

Prevailing market conditions – including a risk-off mentality among GPs still mindful of the recent ►



“My impression is that investors are still searching for direction, at a slow pace”

– Yichen Zhang

uncertainty – have made the pricing process almost impossible. One solution, according to Thomas Chou, co-head of the Asia private equity group at law firm Morrison Foerster, is to rely on convertible notes and warrants, which allow valuations to be deferred until the target's next priced equity round.

"Founders and their existing investors are starting to accept that down rounds and recaps may be the only means available to offer a valuable lifeline to bridge a company to a meaningful subsequent round of financing and ultimate liquidity event," said Chou.

"As deals have started to pick up on the back of this, the market is stabilising and we are slowly seeing a return to priced equity rounds, with convertible notes raised in the last 12-18 months finally converting into equity," said Chou.

Peak to trough

In most cases, valuations peaked in the first half of 2021. The subsequent downturn was driven by intensifying crackdowns on platform internet companies and property developers, a decision to ban commercial actors from the after-school tuition space, and a post-IPO investigation of ride-hailing player Didi Chuxing that struck fear into those pursuing US listings.

Any hope for a turnaround, and a rebound in public and private markets, was extinguished by COVID-19 lockdown measures, principally in Shanghai. Numerous private equity investment professionals and LPs got stuck in the city while on trips during Chinese New Year.

"Uncertainty as to what will happen next and whether there will be unexpected regulatory changes is the main reason for US dollar investors struggling with China. It's worse than China-US tensions, which aren't new. Some of former President Donald Trump's rhetoric was very anti-China, but it didn't stop people investing in China," said Niklas Amundsson, a partner at placement agent Monument Group.

Positive signs began to emerge at the end of last year. China's post-pandemic re-opening aside, there was no transformative announcement or definitive turning point around which the industry could rally. Rather, some investors – not all – pointed to snippets that gave them more confidence.

For example, the investigation into Ant Group ended with a less draconian punishment than many had envisaged; Premier Qiang Li made the strongest statement in recent memory supporting the private sector; and several foreign investors won approval for financial services investments, including a move by Warburg Pincus to acquire a stake in a domestic fund management house.

Sifei Xiong, a managing director at CICC Capital, observed in April that since reopening, China had introduced various measures to boost economic growth. Fred Hu, founder, chairman, and CEO of Primavera Capital Group, added that policymakers realised they "went too far and too hard in the tech crackdown in 2020-2022." Now, the focus is on a course correction and a regulatory reset to boost investor confidence and rejuvenate entrepreneurship.

The Chinese government is described by some investors as being caught between two performance indicators: driving economic development and ensuring political stability. There is a general expectation that economic development will be prioritised over the next couple of years.

"It's like when you ride a bicycle and you lean too far to one side, you need to rebalance. And right now, in China, the weak side is the economic side, obviously," said one investor.

Of policy, geopolitics

Still, there were some takeaways from the disruption, including the importance of understanding regulations and establishing red lines. Forebright Capital, for example, now excludes sectors with ties to public welfare or a reliance on customer relationships, said H.W. Chen, a partner at the firm. CPE avoids policy-sensitive assets in areas such as finance, real estate, basic medical care, and media.

Investment strategies are also being influenced by China's deteriorating relationship with the US, with several managers seeing little chance of improvement in the medium term. Beijing's engagement with Moscow amid the ongoing Russia-Ukraine war hasn't helped matters.

Even though numerous high-profile Western officials, including US Treasury Secretary Janet Yellen, have warned of the damaging impact of

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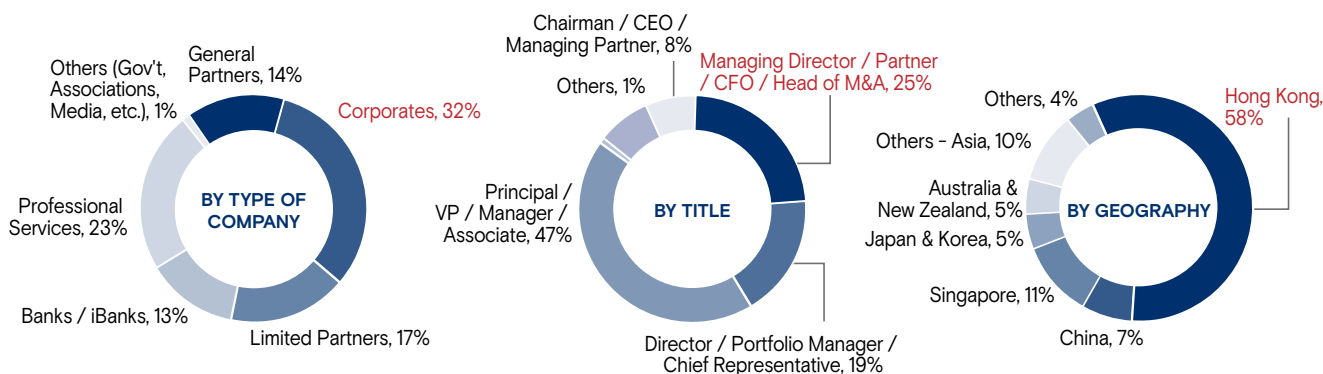


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decoupling from China, the phenomenon now seems to be apparent in trade volumes. China's exports to the US and Europe fell 17% and 7.1% year-on-year in the first quarter, but this was counterbalanced by significant growth in exports to Southeast Asia and Russia.

China-focused private equity investors play down the implications of decoupling. Trustar's Zhang observed that 70% of global trade is in intermediate goods – whereas 30 years ago it was 70% finished goods – and complex global supply chains are not easily disrupted by tariffs. A Chinese manufacturer could move only the latter stages of production to Vietnam and avoid all tariffs imposed by the US.

"While some attempt to revamp global supply chains and relocate the original specialisation,

a group of high-earners on USD 48,000-plus who represent 10% of the population, boast a collective GDP equal to that of Japan, and are only going to grow in number.

"As the second largest global economy, China will contribute to almost one-third of the global GDP growth in 2023, based on IMF estimates. China is looking to a clear post-COVID recovery this year and the market expects GDP growth of more than 5%," said Andrew Li, head of Greater China at Advent International. He also highlighted the moderation in valuations of late.

Mode of engagement

A "China for China" strategy is gaining popularity among certain players as a means of investing in the country while minimising the decoupling risk. In contrast to the "exporting to China" model whereby sales teams are deployed locally to market international products, it involves creating a China operation that has greater autonomy and develops products for local consumers.

Capvis, a Switzerland-headquartered buyout firm with total invested capital of more than EUR 3.5bn (USD 3.8bn), is active in China to the extent that it helps European portfolio companies expand there. For example, last year it facilitated Gotha Cosmetics' acquisition of iColor Group to accelerate growth with local brands in China and develop production facilities to address the broader Asian market.

"China for China is often the best way forward. Local competition is so intense you must be on the ground or you risk losing the market. It's important to give the China operation some independence, with its own R&D and engineers to roll out localised products," said Wolf Stein, co-head of Asia at Capvis.

"The exporting to China strategy will become more challenging: it will not work unless you have a super dominant market position and most international companies do not."

China's appeal relative to other markets is not limited to its size and growth prospects; the country is also at a different point in the economic cycle. The government is not risking recession by raising interest rates in a bid to curb inflation. Indeed, the central bank recently announced monetary easing measures. ►

"Local competition is so intense you must be on the ground or you risk losing the market"

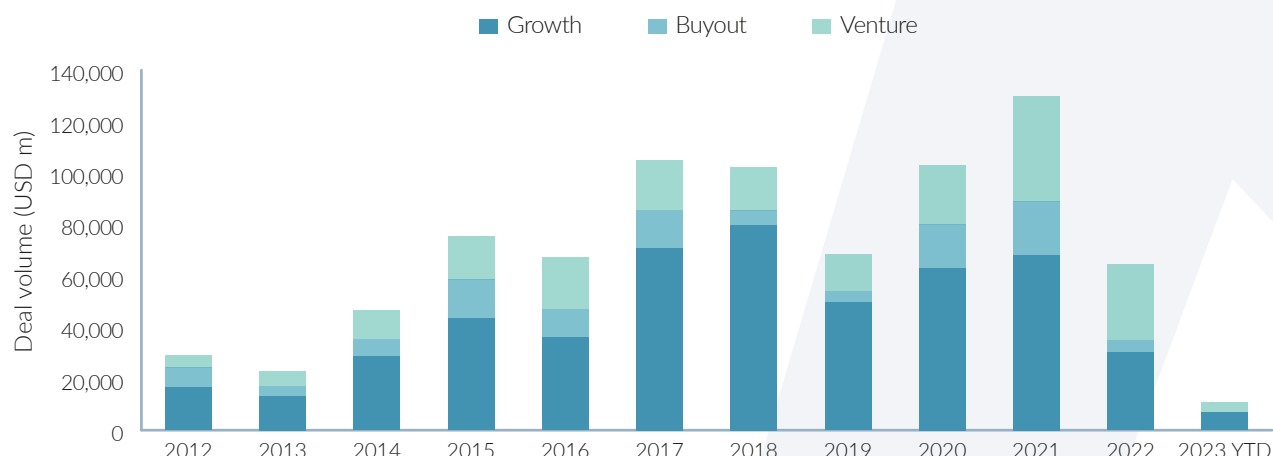
– Wolf Stein

it significantly increases production costs. This creates a paradox as the goal to achieve supply chain security conflicts with the goal to contain inflation – to pursue supply chain security at any cost, one must accept inflation at any cost, and ordinary people end up bearing the burden," Zhang added.

Several pan-regional GPs have indicated the China allocation in their current funds will be lower than in previous vintages, but others demur. One investor noted that, while the pace of deployment in China has slowed, the overall allocation should not fall because the country has such strong fundamentals.

Time and again, investors point to the growth potential China has yet to realise: a GDP per capita of USD 12,000, still trailing developed markets by some distance; industrialisation and urbanisation that are ongoing and irreversible;

China PE investment by value



Source: AVCJ Research

“From an absolute risk point of view, each market has its own risks. While the West is worried about a potential economic recession, China has already started to recover and focus on growth and job creation,” said Frank Tang, chairman and CEO of FountainVest Partners.

None of the China-focused managers interviewed by AVCJ has plans to develop expertise in other markets. Several have ventured into new geographies to make acquisitions, but investment theses are infused with some kind of China relevance. Two GPs that have established offices in Southeast Asia said their primary motivation was to work with Chinese entrepreneurs who are expanding into the region.

Others have returned to China after exploring Southeast Asia and India. The challenges they encountered are well-known: companies that are too small for relatively large China funds; fragmented markets that lack homogeneity; complex legal and regulatory environments. Joe Ngai, Greater China chairman at McKinsey & Company, spoke for many when he observed that “the next China is China.”

“China holds several advantages over other markets, primarily due to its status as the largest single market in the world, offering a more unified landscape in terms of currency, monetary policy,

legal and administrative systems, language, and customers,” said Rongjing Zhao, a partner at Morrison Foerster.

“Additionally, China’s ‘talent dividend’ or ‘engineer dividend’ is another strong comparative from a highly-integrated industrial ecosystem, supported by a targeted higher education system for engineering, which has produced a large pool of skilled labour.”

Target areas

Healthcare specialist CBC Group started out as a predominantly China-focused investor and then grew into a pan-Asian platform. However, the firm is now accelerating its pace of investment in China, deploying around USD 1.5bn over the past 12 months across PE, credit, and infrastructure strategies.

“This is the best time to go overweight China – a market with the lowest valuations and the highest growth potential globally. But we are investing in a different way, focusing on companies with good liquidity. We must adapt to different stages in the market,” said Fu Wei, founder and CEO of CBC.

“I don’t think the capital markets will be good over the next two years. Innovative pharmaceutical companies will not receive unlimited financing, so they cannot afford to make mistakes.”

Not for the first time, an emerging trend being championed is the gravitation towards control investments. Over the past decade, the buyout share of overall China deal flow has fluctuated between 5% and 20%, averaging out at 13%. GPs reference three primary buyout types.

First, multinationals divesting assets as part of China exit strategies. He of CPE said that his firm is in dialogue with US technology companies regarding such deals. Second, special situations opportunities have emerged from the difficulties of the past two years, typically involving businesses with high debt loads or where major shareholders need liquidity.

Third, Chinese companies listed in the US are looking for partners to support take-private transactions. The buyout share hit 20% in 2015 following a swath of similar deals. Forebright is still active in the space, completing privatisations of digital power transmission equipment manufacturer Jinpan Electric and IT outsourcing service provider iSoftStone. Both relisted domestically at higher valuations.

Even though growth capital activity has dropped off significantly, the likes of Trustar and FountainVest expect to continue investing in the space to build ecosystems around their buyout portfolios. Chou of Morrison Foerster added that growth deals are still getting done, albeit at more prudent valuations and at a much more selective pace than before the pandemic.

CPE, meanwhile, believes control and majority transactions in China exhibit the same growth-driven characteristics. This is because leverage buyouts (LBOs) are still rare in the local market and Chinese companies follow different cash flow

management practices to their US peers.

“China is a developing country and many companies are in a fast growth period, which means they tend to reinvest every penny they earn into development, to create second or third growth curves. They rarely prioritise cash for dividends, which makes it difficult to do traditional LBO-type investments,” said CPE’s He.

As for sectors, technology, new energy, and consumer are frequently tagged favourites. To some, reports of the death of consumer technology are greatly exaggerated. The latest artificial intelligence business models characterised by OpenAI’s ChatGPT are viewed as game-changers, with several investors suggesting they represent an opportunity to reshape internet companies.

New energy, including renewables, resonates with investors because it is aligned with China’s overall development direction and policy support is likely. Deep-tech and semiconductors are presented in the same context – often with a buyout angle as well as a growth agenda given regulators are generally keen on consolidation as a means of delivering efficiencies and industry upgrades.

Still bullish?

Not all investors will act on opportunities with the same level of aggression. Some are struggling to raise capital and cannot pursue even the most compelling of deals; others have broader remits and may find more attractive risk-reward elsewhere; and still more might be haunted by the difficulties of the past two years, and either still working through existing China portfolios or reluctant to build new ones.

China-focused managers don’t necessarily have this flexibility: they are inextricably tied to the country and have mandates to deploy capital there. Enduring bullishness is understandable, but Primavera’s Hu makes his case in a broader economic context that is relevant to all investors.

“I believe global investors will, sooner or later, regain comfort about investing in China,” he said. “China is not about to go away and its importance in driving global growth and value creation continues to rise. In the medium to long term, China and the US will be two of the world’s largest and most consequential private equity markets.” ■

**“China is not about to go away
and its importance in driving
global growth and value creation
continues to market”**

– Fred Hu

Deal focus:

Serving coffee at scale

M Stand has added another twist to China's coffee chain growth story, rooting its value proposition in offline experience and leveraging online capabilities to achieve speed and efficiency

China-based coffee chain M Stand emerged into the zeitgeist in 2021 as an impromptu photography studio. Snap-happy consumers queued outside stores to take pictures of themselves in front of the sleek and modern yet often quirky design aesthetic.

Investors noted the buzz and moved to capitalize on it. CMC Capital led M Stand's Series A in early 2021 and re-upped in a CNY 500m (USD 77m) Series B led by BA Capital and GenBridge Capital several months later. Even as PE investment in China cratered – falling from USD 130bn in 2021 to USD 64bn in 2022 and USD 8bn in the first quarter of 2023 – M Stand prospered.

The company recently closed a Series B extension amounting to several hundred million renminbi led by local social commerce platform Little Red Book. Like everyone else, Little Red Book was sold on a compelling expansion story. M Stand had only 10 stores in 2021. There are now 350 directly operated outlets in core shopping districts across 30 cities, positioned as Starbucks for the younger generation.

Kimi Ge, CEO and founder of M Stand, observes that every crisis can turn into an opportunity. Launched in 2017, the company was prudent in its expansion, adding one new store each year. The pandemic changed everything. M Stand survived as many of its competitors faded away, enabling Ge to negotiate attractive leases with a string of shopping malls in 2020.

He was not deterred, even when a second round of COVID-19 swept through China, prompting widespread lockdowns and leading to more retail casualties.

"Launching a business involves taking risks regardless of the market conditions. We believe



"Coffee has rich consumption scenarios: it could be pay-and-go or a place to engage in pleasant conversation"

– Kimi Ge

China's coffee shop industry has entered a new era of opportunity in the past two years, and I didn't want to miss out. This kind of chance may not come again," said Ge. "Staying true to your beliefs and holding course is very important, but you must also understand the competition and the market dynamics."

CMC also acted quickly, according to Ophelia Zhang, a director at the PE firm. The entire process, from due diligence to signing the investment agreement, took a little over one month.

"It was a quick decision, but not a hasty one. We had conducted extensive research on the market and studied many participating companies over a two-year period, which left us with a wealth of knowledge," Zhang said. "M Stand was a perfect match for our investment strategy – in terms of unit economics and potential for growth."

Heavy traffic

To some extent, M Stand is part of a new generation of offline-to-online Chinese brands. In 2021, with customer acquisition costs out of control and traffic saturated, investors realised that the online growth story was topping out. CMC calculated that pure online players hit an invisible ceiling as annual revenue neared CNY 1bn and return on investment decreased significantly thereafter.

"In contrast, offline growth is more linear," Zhang added. "If we don't consider single-store sales growth, overall growth is linked to the number of stores. Companies such as Starbucks and Luckin Coffee have demonstrated the potential upside of having 10,000 stores in China – a much higher threshold than in the e-commerce space."

That said, the private equity firm wasn't overly concerned about M Stand's growth potential. The key question was whether the company had the capability to sustain robust unit economics when so many retail chains evidently did not. The industry was peppered with binary outcomes: some stores perform very well; others were wiped out.

Zhang's research led to the conclusion that M Stand's brand was strong enough to prevail in high streets and shopping malls across different cities. The company needed capital to scale.

Despite the rapid expansion, M Stand adhered to many of its guiding principles. For example, each location features a unique design that is

tailored to its surroundings, which turned it into a photo hotspot and helped drive traffic – an attractive proposition for any shopping mall. Today, though, these idiosyncrasies are essential to the company's vision to enrich consumption scenarios.

There is a roughly equal split between two store types: large premises of 100–150 square metres and small ones of about 50 sqm.

M Stand matches store types and locations based on geographical position, the surrounding customer base, and the needs of the local consumer scene. "Coffee has rich consumption scenarios: it could be pay-and-go or a place to engage in pleasant conversation. We cover them using various store types and sizes," Ge said.

M Stand has sought to shift its profile from background to a thousand photos to quality coffee at affordable prices. Menu prices might be high, but customers who sign up to the membership programme receive discounts of up to 50%, depending on their purchase history. The average price paid is CNY 5–CNY 10 cheaper than Starbucks.

Most traditional coffee shops use dark roast coffee beans, known for their long shelf lives and stability. M Stand opts for the light roast variety because they are fresher and retain more of the original flavour. These beans are also relatively sweet tasting – a popular characteristic among Chinese consumers.

At the same time, the company embraces innovation. Top sellers include coconut ice coffee (infused with a whole coconut) and oatmeal cookie latte (served in edible cups made of oatmeal cookies).

Zhang recognises the importance of product-market fit and competitive pricing but argues that companies must do more to build strong brands. What impressed her about M Stand was the detail. She recalls seeing a barista with a tattoo bearing the company's slogan: Stop wishing, start doing and thinking it resonated effectively with younger generations.

Ge suggests that M Stand's growth ambitions are the most powerful force binding the brand to its employees. "We are a young and fast-growing brand. Growth is a keyword in our corporate culture: we want to achieve it with our employees and share it with our customers," he said. ■

China secondaries: Willing sellers?

Few, if any, LPs are so desperate to divest China exposure that they will sell fund positions at any price. The main sticking point for secondary transactions is a disconnect on valuations

AirPower Technologies casts a long shadow over PAG's secondary transaction. The private equity firm is working on a tender offer whereby secondary investors would take out positions in its first three funds – should the LPs holding them be willing to sell – and make a stapled commitment to Fund V in the process. AirPower accounts for much of the USD 10bn in net asset value (NAV) feasibly up for grabs.

This acknowledged star asset, which cuts across Funds II and III, was formed through the merger of two Chinese companies acquired in 2017 and 2018: Yingde Gases and Baosteel Gases. It is also on the fast-track to an exit. An agreement to sell the business to Hangzhou State-owned Capital Investment & Operation, at an unspecified valuation, was announced in May.

For incoming secondary investors, the prospect of a near-term distribution strengthens the underwriting case. One industry participant describes the ideal scenario as an exit happening post-pricing and pre-closing: the investor can treat it like a deferral and recycle the proceeds from the distribution into the deal, thereby improving the return.

Selling investors, meanwhile, face a dilemma. They are giving up the distribution in return for divesting their entire interest in the fund, typically at a discount to NAV. Calculating the value attributed to the rest of the portfolio is one concern. Sellers must also factor in the risk of regulators thwarting an AirPower sale and the extent of their desire to sever ties with the fund, manager, or geography.

Secondary players interested in anchoring the transaction submitted first round bids earlier in the summer. Fairview Capital, PAG's advisor, notified ►



“With tender offers, you never know what you are going to get in sales volume until the process closes”

– Damian Jacobs

those moving forward to the next round in early July with a view to finalising the lineup in August, according to three sources familiar with the situation. The process is still underway. Fairview didn't respond to a request for comment.

One LP with exposure to multiple PAG funds noted that the initial guidance on pricing represented too steep a discount to justify selling through the tender. A secondary investor, explaining why his firm declined to pursue the deal, said that respect for PAG as a manager was outweighed by "scepticism as to whether there would be enough buyers" and the uncertainty around AirPower.

The Carlyle Group's attempt at a similar deal involving a USD 18.5bn US buyout fund underscores the challenges of tender offers. The firm hoped to generate sales volume of up to USD 2bn, but reportedly ended up with about USD 500m in March. Even if secondary investors agreed a generous USD 1 of staple for every USD 2 of secondary, the commitment to Carlyle's new fund would be meagre.

"With tender offers, you don't know what you are going to get in sales volume until the process closes, and when the size of the staple is contingent on how many people sell, the sponsor doesn't really know what the upside will look like," said Damian Jacobs, a partner at law firm Kirkland & Ellis. "There might be conditionality around minimum sales before the buyers are obliged to go ahead and trade."

Pressure points

PAG is one of Asia's largest private equity firms with more than USD 50bn in assets under management (AUM) and a footprint that encompasses the entire region. Yet over two-thirds of the portfolio earmarked for the secondary transaction, including the crown jewel asset, is in China.

Doubts over seller interest reflect a broader reality about China secondaries. Even though a combination of geopolitical tensions, targeted regulatory upheavals, a weak economy, and uncertainty over exit timelines has made LPs wary of new fund commitments, that doesn't mean they are willing to offload their existing exposure at fire sale prices.

"It has been suggested that there might be

some pressure to sell interests in portfolios in China," said Martin Yung, a Hong Kong-based principal at HarbourVest Partners. "When global portfolios come up that have Asian exposure, there are invariably some China-focused funds, but pricing tends to not be attractive for sellers."

This sentiment is echoed by Zhan Yang, a principal and general manager of Collier Capital's Beijing office, who notes that the opportunities he sees typically involve relatively mature funds of five to seven years old. This suggests the rationale for selling is "managing liquidity rather than just trying to get out." A truly desperate seller would be willing to offload 18-month-old funds that haven't been fully called.

Global secondaries transaction volume came to USD 44bn in the first half of 2023, down from USD 58bn 12 months earlier, according to Greenhill. Pricing held reasonably steady, but it remains at a 10-year low with the average portfolio across all strategies transacting at 80% of NAV. Buyout portfolios went for 83% in the first half, while venture and growth was at 70%, up slightly on the 2022 figure.

Greenhill observed that activity was primarily driven by LP portfolio management intended to free up investment capacity. Many investors held back, waiting to see how the market would shake out following the release of fourth-quarter valuations. However, a narrowing of the price gap – driven by redounding public markets, not meaningful movement on the private side – is expected to stimulate more activity.

Sellers continue to include LPs that found themselves overallocated to private equity following public market corrections. "Most of the activity we are seeing is liquidity and overexposure-related and is being applied generally," said James Ford, a partner at law firm Allen & Overy. "Portfolios might be so large that sellers expect mosaic bids, and then buyers have their own priorities as to specific sponsors and funds."

One secondaries advisor noted that China funds are increasingly included in these global portfolio sales to get feedback on pricing because there aren't enough recent trades in the market to form an opinion. This doesn't necessarily lead to a favourable outcome.

"If your motivation is liquidity, then selling



China doesn't get you enough money. You're better going for infrastructure, credit, or blue-chip buyout," said the advisor. "People are worried about taking a hit on their P&L [profit and loss] statement this year because they aren't getting many distributions. There is no upside to voluntarily taking a 50%-plus hit on part of your portfolio. You would look stupid internally."

The Carlyle secondary that failed to generate much interest was priced at 81% NAV. For the PAG transaction, after the first round of bidding, Fund I was priced at 50% and Funds II and III at 71%-74%, two of the sources familiar said.

The only comparable tender offer-plus-staple in Asia was done by TPG Capital in 2018 for two funds with a combined corpus of around USD 7bn. The deal was worth USD 1bn, with USD 1 of primary capital committed for every USD 2 of secondary sold. PAG may aim for a similar ratio but given current market conditions, 1:3 might represent a best-case scenario, according to another industry advisor.

PAG's portfolio has some element of geographic diversification and is buyout centric. Most pure China funds tend to be crammed with minority positions in early to growth-stage technology companies. Prices offered by prospective buyers reflect this. Several advisors

said that, when discussing potential secondaries with GPs, they emphasize that selling LPs should be comfortable taking a 40% discount.

"A lot of China portfolios are growth and venture-focused, and they continue to hold companies at their last-round valuations, which might have been set up to two years ago. This means the marks on the books do not necessarily reflect the reality," said HarbourVest's Yung.

"At the same time, a lot of secondary investors have global investment mandates and are applying a global lens to find the most attractive risk-adjusted opportunities across the globe."

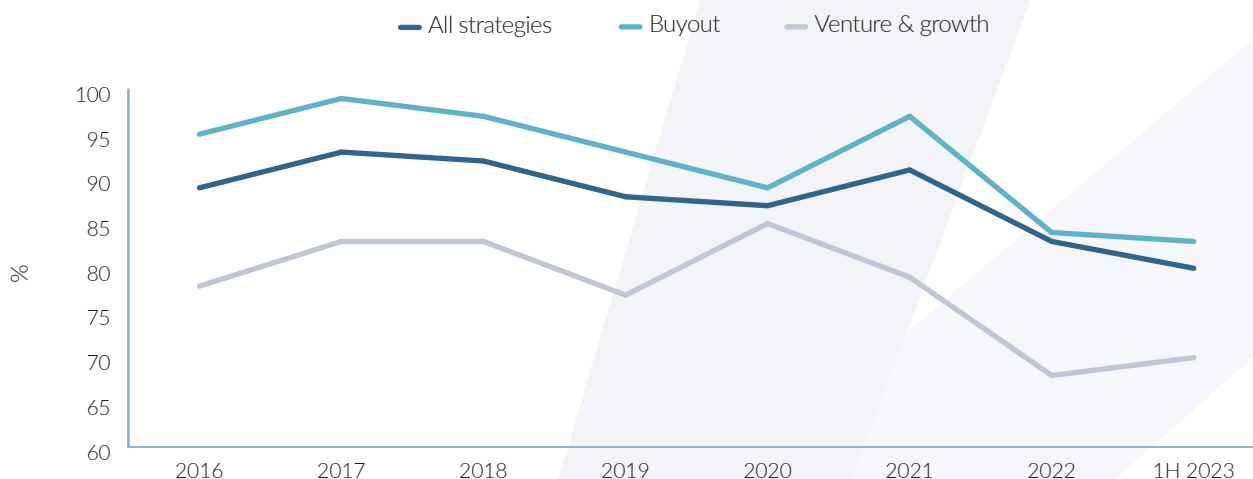
On the quiet

Nevertheless, removed from the portfolio sales that characterise the top end of the market, there are sellers that are both willing and perhaps flexible on price.

Vincent Ng, a partner at placement agent Atlantic Pacific Capital, has been asked to advise on sales of individual interests in China funds, mainly by family offices and corporates. Balance sheet and cash flow issues tend to be the key motivating factors, not geopolitics.

"They want liquidity, will accept some kind of discount, but they aren't desperate. They might take cost plus some carrying value for the

Global secondaries pricing as percentage of net asset value



Source: Greenhill

“If we think the price is good enough to compensate for the potential risk, we wouldn’t hesitate to go in”

– Zhan Yang

interest, like cost plus 10%,” he said. “However, in situations where there is a severe need for cash or there has been a change in strategic direction, it becomes a question of ‘What is the biggest discount I can take?’”

Kirkland’s Jacobs recalls a Hong Kong family office selling off China fund interests during COVID-19, but that was simply a function of the high level of China exposure portfolio-wide. Most of the time, liquidity-driven sales involve mixtures of random interests, perhaps two brand-name funds and an assortment of lesser-known funds because the family office is jettisoning relationships it no longer regards as core.

“When people sell single positions in China funds, there is usually a specific reason for getting out and deals tend to trade at a significant discount,” Jacobs said. “And I hear they are struggling to find buyers.”

One option is to ask the GP to find a buyer by reaching out to its existing LP base and wider network. Several China managers are said to have offered to acquire fund interests from LPs personally – as demonstration of their belief in the portfolio, although often at cost – or sought to match-make buyers with potential sellers as a sweetener for coming into a new fund.

Steve Byrom, co-founder of institutional advisory firm Potentum Partners, has received proposals from multiple Chinese GPs looking to sell fund positions. They include some highly successful managers willing to accept steep discounts, and the sellers come from across the institutional investor spectrum.

“LPs are selling very quietly, they are not going

through advisors, sometimes because they don’t want to draw attention to the geopolitical angle,” Byrom said. “For some, it is geopolitics. For others, it was triggered by perceived stroke-of-pen risk around online education and restrictions placed on technology companies. And then there’s been very little liquidity in the market.”

Buyers are acutely aware of the same issues. Policy risks, for example, are hard to predict or quantify. Investors flag the recent crackdown on corruption in healthcare procurement that has seen hospitals and pharmaceutical companies targeted and the way in which regulators favour certain sectors for IPOs almost regardless of company quality.

Coller exercises caution when looking at portfolios with exposure to certain industry verticals. Yang points to biotech, which saw a flurry of deal activity at elevated valuations in 2020 and 2021 as investors looked to take advantage of stock exchange provisions allowing IPOs by pre-revenue companies.

“The music stopped in the first half of 2021 and valuations dropped significantly for new investments. However, existing investments were still marked at last-round valuations,” he said. “There’s no revenue or performance data, so it’s difficult for auditors to call for markdowns, but this gives LPs a false sense of value.”

This doesn’t mean deals can’t get done. The discount to NAV that secondaries investors expect to pay is an output, not a starting point. It is arrived at by assessing each asset in a portfolio and how it is likely to perform through liquidation, aggregating the results, and dividing by the target return.

The secondaries investor cited earlier said that he solves for a higher target return in China compared to a few years ago, which implies a bigger discount across the board. But pricing is specific to a situation and to an individual investor’s perspective on companies, industries, and risks over a certain timeframe. For the time being, sellers do not appear to view the world in the same way.

“If we think the price is good enough to compensate for the potential risk, we wouldn’t hesitate to go in,” added Yang. “The challenge is sellers being uncomfortable with the discount rate and refusing to transact.” ■

The innovation game: China GPs play safe

China investors have abandoned their previous high-risk-high-return approach in favour of proven business models and profitability. Hotspots like autonomous driving, biotech, and SaaS are no exception

CowaRobot comes from the unfashionable backwaters of autonomous driving. The Chinese company has built up a solid business in the sanitation vehicle space through deals with some of the country's largest manufacturers of industrial vehicles. Orders exceeded CNY 500m (USD 69m) in 2022.

Earlier this year, CowaRobot closed a US dollar-denominated funding round at a valuation of about USD 1.5bn. Industry participants were surprised, and not just because the deal wasn't publicly announced. CowaRobot's rise juxtaposes broader challenges for the autonomous driving industry as robotaxi players struggle to live up to their hype.

"CowaRobot originally focused on smart suitcases that can automatically follow their owners. Even when it transitioned to autonomous sanitation vehicles, they travelled at low speeds on fixed routes," said one investor with exposure to autonomous driving.

"The technology is more like sweeping robots than L4 or L5 self-driving technology [where there is a high level of autonomy or full autonomy] on high-speed roads. That they were able to secure funding at such a valuation, especially at this moment, is beyond my expectation."

This investor's portfolio includes WeRide, a leading robotaxi player that isn't expected to maintain its USD 5bn valuation when it returns to market for new capital. WeRide's situation is not unique. It reflects a general frustration with the pace of commercialisation for robotaxis, which has prompted some companies to focus on lower-level autonomy that is already being rolled out.

"Since last year we have noticed a lot of Chinese L4 players attempting to enter the ADAS [advanced driver-assistance system, or L2] ►



"There's been a clear shift towards prioritising profitability over growth potential across all geographies and market levels"

– Ramon Zeng

autonomy] space to generate revenue,” said Skylar Liu, a director at Prosperity7 Ventures, a growth equity fund established by Saudi Arabian oil giant Saudi Aramco.

Liu was speaking to AVCJ in June, shortly after Prosperity7 made its first investment in China’s intelligent driving technology industry. It backed Hyperview, an ADAS provider that works with a string of domestic carmakers and has achieved mass production on 30 models.

Prosperity7’s decision was influenced by the view that most companies working on L4 solutions will struggle to pivot to ADAS, given the need to adapt embedded software platforms and reengage with hardware providers. Others, such as Chuanfu Wang, chairman of BYD, have gone so far as to dismiss unmanned driving as impractical. He claims ADAS is the only way forward.

This captures a broader mindset shift among Chinese PE and VC investors that coincides with a sharp slowdown in deployment. Investment hit USD 21.6bn in the first half of 2023, the lowest six-month total in nearly 10 years, according to AVCJ Research. Less than two years ago, in the second half of 2021, USD 73.2bn was put to work.

Investors in China are plagued by an assortment of headaches – economic uncertainty at global and local levels, geopolitical tensions with the US, and a difficult fundraising environment. When they do pull the trigger on a deal, they favour more proven business models. Risk appetite for cutting-edge innovation remains, but only when it is underpinned by sensible economics and sightlines to profitability.

Ramon Zeng, a general partner at DCM, a cross-border investor with China exposure, has noted the same trends playing out globally since the first half of 2022. “There’s been a clear shift towards prioritising profitability over growth potential across all geographies and market levels. This has permeated public markets and private markets, encompassing various sectors,” he said.

Healthcare in transition

Nevertheless, the phenomenon takes on a particular form in China, largely shaped by regulation. Biotech was a beneficiary of the boom, attracting investment of USD 19bn between 2020 and 2022, up 5x on the prior three years. VCs

were responsible for 60% of deal flow, drawn by the prospect of helping start-ups take advantage of stock exchange exemptions permitting IPOs by pre-revenue biotech companies.

Shanghai’s Star Market, the most prominent onshore exit channel for high-growth start-ups, previously required candidates listing under this mechanism to have at least one asset in phase-two clinical trials and expect to achieve a market capitalisation of at least CNY 4bn. Now, though, informal guidelines have been issued that effectively mean companies must be profitable, according to two investors, according to two sources.

Casualties include Rongsheng Biotech, which terminated its Star Market IPO process this month, despite winning approval to list last December. The move was triggered by exchange officials lodging four questions relating to high sales costs and the authenticity of revenue. In 2023 to date, six biotech start-ups have abandoned IPOs on the Star Market and 14 have walked away from A-share listings.

Meanwhile, international markets have been unforgiving, with the XBI, which tracks US biotech stocks, down over 50% from its 2021 peak. According to EY, 55% of emerging biotech companies globally don’t have enough cash to stay in business beyond two years, with 29% unlikely to last one year. In China, conditions are exacerbated by centralised drug procurement squeezing margins on new drug sales.

“Novel drug development is a luxury in the current environment, as capital markets won’t give you unlimited funds to burn. The capital market will remain challenging in the coming two years, making it hard for new drug developers to raise funds,” Wei Fu, founder and CEO of CBC Group, told AVCJ in April after his firm helped local player Hasten Biopharmaceutical buy a portfolio of mature drugs.

“As a rational investor, we must employ different strategies to navigate markets in different stages. We need to focus on companies with strong liquidities in the current market condition.”

The Hasten deal demonstrates how the focus has shifted to companies that can generate cash flow. Sources familiar with the situation claim that CBC is looking to exit the novel drug development space and concentrate on later-stage investments, though Fu denied this.

The same sources said that Boyu Capital



has already suspended novel drug investments. Indeed, the GP's most recent healthcare investment is a USD 660m buyout of Hong Kong-headquartered medical device manufacturer Quasar Medical. Meanwhile, CPE, another mid-market GP, is currently reconsidering a moratorium imposed on buyouts about three years ago.

CPE's recent activity in healthcare includes participating in a CNY 2bn round for Sangon Biotech, an outsourced R&D specialist. Shirley Lin, a partner at GL Capital, which co-led the deal with CPE, entered 2023 expecting the market to be sluggish with plenty of targets available at reasonable valuations. "In fact, valuations have not undergone the expected adjustment to date as

shooting for 5x when they know 2x would suffice. To some industry participants, it is a familiar scenario.

"In 2018, during China's economic deleveraging phase, many growth funds told their LPs that their next funds would focus on buyouts. However, when the economy rebounded and several emerging sectors gained momentum, they quickly abandoned their buyout strategy," said Yichen Zhang, founder, chairman, and CEO of Trustar Capital.

Metrics re-examined

While Zhang believes that the current shift towards buyouts will last longer than the previous cycle, the market downturn has not only impacted how managers think about investment stage. They are also reshaping their investment methodology.

For example, software-as-a-service (SaaS) lost its allure last year after several public market corrections wiped billions off the value of global industry leaders. Many Chinese GPs pulled back, but CDH Investments was not among them.

The private equity firm recently led a CNY 200m Series B for 1Data, a robotic process automation (RPA) start-up that serves supply chain managers. Conviction around the asset was built on close analysis of previous behaviour, and a belief that the prevailing valuation metric of price-to-sales ratios – some start-ups raised capital at multiples as high as 50x – was unhelpful.

"Investors were solely focused on the growth rate, overlooking profitability. However, if a company's sales costs are too high, and these costs do not fall as the business scales up, there must be an inherent flaw in the business model," said Qizhi Guo, a senior partner in CDH's venture and growth capital unit. "The company may never achieve profitability."

Where once investors threw capital at SaaS companies as if they were consumer-internet start-ups and scale would conquer all, now there is a general recognition that sustainability means reaching a net profit margin of 15% by the time annual revenue crosses the CNY 200m threshold.

These sentiments were echoed by DCM's Zeng, who prioritises two metrics when assessing a start-up's long-term pricing power: sales efficiency and gross margin. While GPs always try to strike balance between growth and profitability, right now Zeng is advising certain companies to dial

"Valuations have not undergone the expected adjustment to date as many investors show interest in late-stage and buyout healthcare deals"

– Shirley Lin

many investors show interest in late-stage and buyout healthcare deals," she said.

At the same time, the definition of late-stage appears to have evolved. When the Hong Kong Stock Exchange emerged as an offshore listing channel for pre-revenue biotech companies, investors considered pre-IPO deals as late-stage because of the promise of fast returns.

Then the bubble burst, and with companies trading below their IPO prices, the prospect of swift exits evaporated. Suddenly, late-stage was defined based on size and profitability, several investors observed.

The emphasis on conventional late-stage deals is also a consequence of limited activity during the pandemic, one healthcare-focused GP added. Investors recognise that LPs want to see returns, and they are wary on taking on excessive risk by

down growth in order to conserve cash flow.

"We place greater emphasis on cash flow, when selecting portfolios and in portfolio management. Companies with positive cash flow are more likely to secure exits," he said. "We encourage our portfolios to strengthen their management and achieve self-sustainability at an earlier stage rather than pursuing rapid and uncontrolled scaling."

Opinion is divided as to whether the lessons learned in recent years will lead to a fundamental change in behaviour or just become footnotes in a history of repeated booms and busts.

One school of thought is that the traditional philosophical divide between US dollar funds and renminbi funds – the former are typically labelled as risk-tolerant whale-hunters, the latter as risk-wary conservatives – is narrowing.

At one Beijing-based venture capital firm, there have been just two investments so far this year. Both are "little giants" – niche operators that leverage innovative capacity to build significant market share. It represents a departure for a GP that has backed the likes of WeRide and LiDAR supplier Innovusion, but it was deemed necessary given the difficult US dollar fundraising environment.

For now, the emphasis is on deploying renminbi capital and this means adapting to the expectations of local investors. "The renminbi market cannot accommodate large-scale stories. Companies like Alibaba needed the US dollar market to grow to their size," the manager said.

Little giant philosophy

Renminbi funds are targeting two main opportunity sets: spinouts from established companies and little giants. These are unlikely to deliver to achieve multi-billion-dollar valuations, but they have predictable trajectories in smaller markets. A little giant might go public with a market capitalisation of CNY 3bn–CNY 20bn, the manager added.

There have been instances of little giants outgrowing their potential on the back of policy support. Hikvision has become the dominant player in China's video surveillance space with a market capitalisation of CNY 300bn, eclipsing the four "AI dragons" – SenseTime, Yitu Technology, Cloudwalk, and Megvii Technology – that received substantial funding from US dollar investors.

The company was patient, spending little as the

AI dragons pushed ahead with face recognition solutions, and then acting decisively when the technology became mainstream. Once a buyer from SenseTime, Hikvision developed its own algorithms to complement its existing hardware. This end-to-end offering enabled the little giant to overcome the would-be whales.

"What happened to Hikvision is very similar to what is happening in autonomous driving. Car makers are accumulating data, so there's no need to build autonomous driving algorithms," said one venture capital investor who has backed a leading local electric vehicle manufacturer.

"Those algorithms will become less scarce technology, and then the car makers can leverage their data reserves to launch their own autonomous driving services. The current L4 developers will end up going nowhere."

This would appear to vindicate the notion of backing a stable business that offers immediate cash flow over a less proven but more cutting-edge technology. However, the newfound discipline doesn't hold true across all industries, as ably demonstrated by the excitement around generative artificial intelligence (AI).

Dozens of academics and entrepreneurs are looking to build large language models (LLMs) given the absence – for now – of a Chinese equivalent to US-based OpenAI. Interestingly, renminbi funds are leading the way. According to local financial advisor Xiaofanzhuo, 70 LLM start-ups raised capital in the first eight months of 2023. The split was 58–12 in favour of renminbi funds.

There are various explanations for this, from US dollar investors avoiding politically sensitive areas to LLMs being a good fit for the little giant profile. That said, these deals are happening despite the substantial costs and risk involved, especially as China's technology giants develop their own LLMs.

"The academic papers were out there, but no one was sure how to productise the foundation model. OpenAI demonstrated it was possible and others want to follow," said Gan, founding managing partner of Ince Capital Partners, who expects to make a couple of investments in the space.

"But yes, they need a lot of money, a lot of data, a lot of computing power, and a lot of engineers to build the infrastructure." ■

Deal focus:

Aerofugia's eVTOL tilt

China's TH Capital regards eVTOL as the best way to leverage electrification of the skies. Aerofugia became a preferred target by virtue of its Geely ties and commitment to tilt-rotor technology

The 2024 Paris Olympics could be the moment when electric vertical take-off and landing (eVTOL) vehicles achieve mass-market recognition. Group ADP, which manages the city's airports, plans to open five vertiports and the vehicles – known as VoloCity air taxis – will use the existing helicopter route network. EVTOL start-ups around the world are racing to achieve certification as service providers.

Germany's Volocopter and China's AutoFlight have both reached agreements with Groupe ADP with a view to being ready for the Games. AutoFlight said last month that it would run services from Pontoise Vertiport, which opened last year at Pontoise-Cormeilles Aerodrome, located northwest of Paris.

"Transportation from airports to city centres will be one of the first commercial landing scenarios for eVTOL. Everyone is monitoring this market closely. The Olympics will be the technology's first major showcase," said Fei Peng, an investment director at Tsinghua Holdings Capital (TH Capital), which recently led a CNY 100m (USD 13.8m) Series A for Aerofugia, an eVTOL unit of Chinese automaker Geely.

With China's unmanned aerial vehicle (UAV) space becoming crowded – and DJI enjoying a position of dominance – aerospace investments have gradually shifted towards eVTOL, which are often compared to electrified helicopters. Peng sees it as a natural evolution from pizza carriers to people carriers.

"In the field of electric aviation, it is widely recognized that development must proceed from small to large, from carrying cargo to carrying passengers. We've already invested in the UAVs, so we decided to explore larger vehicles," he said. ►



“Everyone is monitoring this market closely. The Olympics will be the technology’s first major showcase”

– Fei Peng

“Indeed, many companies have come to realise that the UAV market is now mature, and since 2015, they’ve been looking at advanced air mobility.”

There are three main branches of eVTOL technology. The most common one is an electric version of the traditional helicopter that relies on several distributed electric rotors rather than a single internal combustion rotor. It is regarded as a safety-first option: if one engine fails, others continue to function.

The second approach involves using two sets of rotors, one for lift-off and the other for propulsion. The advantages are greater speed and the ability to hover like a helicopter, but only a single set of rotors is used at any one time, which means the other becomes dead weight.

Finally, there is the tilt-rotor option, widely seen as the most energy-efficient solution. Multiple rotors are mounted on tilting nacelles (a form of aerodynamic housing), which can move from vertical to horizontal orientation after take-off. The same hovering capabilities are available.

Tilt-rotor technology is favoured by the military, favoured by TH Capital, and increasingly favoured by Chinese eVTOL start-ups. For example, United Aircraft, which has raised CNY 3.2bn (USD 444m) across two rounds in the past three months, has moved from UAVs to tilt-rotor vehicles.

Following extensive research, TH Capital identified three Chinese tilt-rotor start-ups it found attractive: Tcab, Zero Gravity, and Aerofugia. The latter claims the distinction of being the only Chinese company to complete a test flight of a tilt-rotor aircraft carrying more than 2 tons. It aspires to become the first domestic player to achieve a domestic tilt-rotor certification.

The company can also tap into Geely’s industrial supply chain across batteries and key electric components, ensuring high-quality, stable and cost-effective supply. Moreover, there is the possibility of collaboration with Caocao and StarRides – Geely-backed platforms in ride-hailing and premium chauffeur services – to create usage scenarios.

TH Capital reached out to Aerofugia last August through the founder of Tengdun, a UAV portfolio company. Aerofugia was hesitant about raising external capital, but eventually invited TH Capital to lead the round because of Sino Jet, another portfolio company. It is the largest business jet

operator in Asia Pacific and is expected to give Aerofugia access to a first batch of business clients.

The new funding will go towards the development and commercialisation of the AE200, an in-house developed tilt-rotor vehicle that seats six and can travel up to 200 kilometres.

Complex back story

Aerofugia is not a straightforward story. Geely acquired Boston-founded Terrafugia in 2017 and supported the development of a flying car, which received pilot certification from US regulators in 2021. However, getting a license to operate on roads proved difficult. Geely pulled the plug later in 2021, bidding farewell to the flying car business model. Attention duly switched to eVTOL.

At around the same time, a group of engineers from Terrafugia’s China operation spun out and established eVTOL-focused Tcab Tech. The Terrafugia personnel that remained became what is now Aerofugia following a merger with Aossco, a local drone manufacturer acquired by Geely.

Peng noted that flying cars are conceptually challenging. Technical requirements for cars and planes can be very different, making it hard to design a vehicle that performs effectively across both functions. “For example, a car’s suspension system is designed to provide a soft ride for passengers. In contrast, an aeroplane’s suspension often generates a strong vibration during landing for safety reasons,” he observed.

Calls for a new regulatory framework covering air and road transportation will only become louder as the global “urban air traffic” industry grows. Morgan Stanley projected in a 2021 that it will be worth USD 1.5trn by 2040, with China accounting for a 29% market share. Many investors have been drawn in by the idea that electrification of the skies will follow electrification of the roads.

“If electric cars are the first half of the electrification process, then we believe that electric aviation is the second half. With the popularisation of electric motors, batteries, distributed engines and other technologies, the achievability of electric aviation has increased significantly, therefore putting low altitude resources into practical usage,” said Yuanfeng Li, a partner at TH Capital. ■

Q&A:

Soul Capital's Herry Han

Lightspeed China spinout Soul Capital is pursuing an early-stage dual-currency strategy in China. Herry Han, the firm's founding partner and CEO, explains how and why he's staying relevant

Q: You formed Soul Capital last year through a spinout from Lightspeed China Partners. Wasn't this a difficult time to launch a new firm?

A: China's VC landscape is undergoing significant change. The economy is entering a new phase and geopolitical issues have presented challenges. As investors based in China, we clearly see that local innovation will diverge from that in the US over the next two decades. Consequently, we believe it is necessary to launch an independent China VC platform to capture opportunities that will emerge. Since IDG Capital entered the country in 1993, US dollar-denominated investors have gradually fostered the local venture capital ecosystem. But the new era will be characterised by a divergence in investment directions and exit channels, the rapid development of domestic capital markets, and yes, the emergence of Chinese VC brands. We want to build a local brand with world-class management and investment standards.

Q: For some China-focused managers, global expansion has meant shifting focus to Southeast Asia or rebranding as pan-regional. Did you consider such courses of action?

A: No. A lot of investors recognised that Southeast Asia is a large market and that web3 is the next big opportunity, but it has since become clear that neither is as significant as previously thought. During COVID, many investors were uncertain about their next steps; there was much discussion of internal circulation and whether China would still connect with the world. After the lockdown was lifted, many of us started travelling again. ►



“We believe it is necessary to launch an independent China VC platform to capture opportunities that will emerge”

Our conclusion was that China and the world need each other, and internal circulation probably would be insufficient. We see the most value in being rooted in China and helping portfolio companies grow globally. China will continue to reform, open up, and encourage innovation. This is clear today; it wasn't that clear last year.

Q: Is it becoming any easier to raise a US dollar fund for China?

A: A lot of US-based LPs can hardly continue investing in China because of the tensions. But the US is diverse and some investors still recognise the US and China are the two biggest PE and VC markets globally and it doesn't make sense to skip China. They started due diligence and are pushing forward. But it is a relatively smaller group than before. We also see capital from other parts of the world playing a more important role. For example, a European LP told us that it finally has the opportunity to access quality assets because US investors are loosening their grip. At the same time, managers with US dollar funds used not to think much of renminbi, but now renminbi and US dollars are entering a period of coexistence.

Q: Yet most of the large deals in China appear to be executed by renminbi funds...

A: US dollar funds mostly draw on capital from the US. They face certain restrictions on investing in certain key assets involving semiconductors, artificial intelligence, and data. Additionally, Chinese companies have not performed well in the US in recent years, so that exit channel is unclear. These factors have led to a freeze in new investments by many US dollar funds. With reduced capital available from market-oriented funds, companies are more willing to accept renminbi. This will not be the case in the long term. US dollar and renminbi funds will co-exist; the exit issue will be solved; and more US dollars will come in from other regions.

Q: Will renminbi funds replace US dollar funds as the dominant force in the market?

A: Ultimately, they will co-exist, but with renminbi

funds playing an increasingly critical role. Over the past two decades, the market has heavily favoured US dollars – this is known for being long money from patient investors who are willing to take risks and don't require guaranteed returns. Whenever entrepreneurs can take US dollars, they do. But geopolitical tensions mean a larger slice of the cake is going to renminbi funds.

Q: Where are the main opportunities for US dollar funds in China?

A: While certain sectors are restricted, there are plenty of exciting opportunities in other areas. I believe electrification is the biggest one in 30 years. The entire human race is shifting to new energy, which will create openings for investment in everything from upstream infrastructure to downstream module suppliers. It's very much hardware-oriented, so not so sensitive and accessible to US dollar investors.

Q: You mentioned that innovation in China is different from the US. How?

A: It might be tempting to classify Chinese innovation as "towards the real," while the US is "towards the virtual." But this is not entirely accurate. Chinese innovation serves China's real-economy development, which is entering a new stage. Previously, the economy largely relied on real estate, but now science and technology is becoming the key driver. At the same time, China is graduating from low value-added production to high value-added, high gross profit, high-tech production. Venture capital investors need to back this trend, although the next generation of successful companies will rely on government support as well. In the US, VCs tend to focus more on software, algorithms, and web3 to make breakthroughs. There is already an abundance of high-tech production, so they have more scope to prioritise virtual aspects to enhance the user experience. This is also reflected in the capital markets, where the US tends to be dominated by enterprise services, infrastructure, databases, and software. China-listed companies are more about domestic substitution, high-end manufacturing, electrification, chips, and new energy. ■

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