China Private Equity in 2017 and Beyond

China presents a challenge for financial investors. On the one hand, it is now the world’s second-largest economy by some measure. It continues to grow at rates well in excess of those in Europe, Japan and the U.S. It is undeniably a country on the move, one that is exciting to watch and, in our opinion, one in which investors should participate.

On the other hand, worries about the Chinese economy seem to have received more than adequate attention from the world’s financial press. There is certainly plenty to be concerned about: slowing macroeconomic growth, increasing levels of debt, a possible bubble in residential property prices, volatile public equity markets and, most recently, a depreciating currency and capital outflows.

There are good reasons to believe that the Chinese leadership will be able to manage these issues without suffering serious crisis, for reasons we discuss in this paper. In addition, we are convinced that thoughtful private equity investors can achieve attractive, risk-adjusted returns while participating in the continuing development of what is anticipated to become the world’s largest economy.

Slowing growth

Reports of the slowing rate of macroeconomic growth in China must be placed in context. While the rate of growth has indeed slowed from unsustainably rapid levels, it is quite robust by global standards and is likely to remain so. Indeed, as illustrated in figure 1, China is expected to account for nearly a third of all real global GDP growth in 2017.

While a country’s macroeconomic growth alone cannot produce good private equity investment performance, it certainly helps. This is especially true in China, where most of the growth is coming from private companies unable to borrow from banks or access public debt and equity financing to the same degree as in other countries.

Figure 1
2017 Real Global GDP Growth (%)

As of January 2017. HQ Capital makes no guarantee of future outcomes and/or targets. Note: Other Emerging Markets are all emerging markets as defined by IMF excluding China. Other includes residual countries not picked up by the other three categories, namely Advanced Economics defined by IMF ex-U.S. Source: IMF, World Economics Outlook October 2016.
Moreover, although the overall rate of growth has slowed from the torrid pace of the early years of market-oriented reforms, most of the slowdown is due to the actual decline of certain sectors dominated by state-owned enterprises ("SOEs"), which themselves account for the lion’s share of bank borrowings and public market financing.

Massive overcapacity in certain sectors dominated by the state, such as steel and cement production, is proving to be a major drag on Chinese growth. The fact that most economists predict 2017 to see growth in the range of 5–6.5% suggests that the privately-owned businesses in which our fund managers invest, such as healthcare and financial services, education and new technologies, are growing much more rapidly than the overall rate indicates.

Growing debt
China’s SOEs are a problem for the country’s economy in more ways than one. Notably, they account for a meaningful proportion of the increased level of societal debt that, having reached roughly 260% of GDP -- up from 154% in 2008 -- has caused some anxiety among international investors.

The Chinese government is also concerned about that phenomenon. Its agencies are now actively employing a number of measures aimed to control and reduce debt generally and in particular SOE borrowings, including a substantial and continuing program of swapping debt for equity. Controls on the growth of private credit in the non-bank financial sector are also being implemented. Whether such measures prove efficacious in the slow process of reforming the SOEs remains to be seen, but it is clear that the Central Government is committed to bringing the overall rate of growth in debt under control.

Some commentators have likened the growth in private credit, which has fueled a rise in real estate prices, to the situation that prevailed in the U.S. during the years immediately prior to the financial crisis of 2008. While it is true that a large percentage of China’s societal debt -- which as a percentage of GDP is still only half that of Japan’s -- is held by households who have borrowed principally to purchase the residential properties they occupy, there are important differences from the U.S. experience.

Most mortgagees in China have a substantial amount of equity tied up in their property, with loan to value ratios much lower than in the U.S. both before and after that country’s housing crisis. Moreover, there are no non-recourse mortgages in China. With unlimited personal liability, Chinese borrowers tend not only to be more prudent but also more prone to refrain from selling even during a prolonged period of suffering negative equity.

It is important to note also that the majority of China’s debt is domestic. As the major domestic lenders are well-capitalized state-owned banks incented by regulation to write off bad loans, and as the finances of the ultimate owner of China’s SOEs – the Central Government -- are healthy, astute and well-informed observers such as Shan Weijian of PAG do not believe there will be a financial crisis in China or even an economic hard landing.

That is not to say there are no problems in the economy generally or the financial system in particular. Nor do we think that the resolution of such problems will be easy. But there are strong grounds to conclude that China’s debt is not going to be the problem that some observers have claimed it could be and that the Chinese economy is fundamentally stable. Stability does not produce good private equity returns by itself, of course, but when coupled with growth it certainly helps.

Exciting sectors
Turning to opportunities, it is clear that growth in the sectors in which our investment partners are currently most active -- including education, financial services, and healthcare -- is strong and likely to remain so for some time. This growth is due to the rise of China’s middle class, members of which have increasing amounts of income to spend and invest.

Five years ago, the number of middle class urban households in China -- defined by McKinsey & Co as enjoying annual income of between $9,000 and $34,000 -- reached 174 million. As figure 2 illustrates, five years from now that number is forecasted to rise by nearly 100 million households, with the percentage in the upper middle class rising nearly three times.
The consumption power of China’s middle class households is already very sizeable and is projected to grow rapidly in the coming half decade. Another forecast, presented graphically in figure 3, gives a sense of the scale of this consumption, with the incremental growth projected for the period 2015-2020 being roughly equivalent to total consumption in Germany and larger than in the U.K.

As Chinese households have grown in wealth, they have sought the same goods and services as people in other countries. At present, we are seeing strong appetite for better quality consumer products, including safer and healthier food; increased expenditure on leisure pursuits and experiences, including travel; strong demand for supplementary education at the pre-school level as well as vocational and language training; and an insistence on more and better healthcare products and services. Some of these powerful trends are illustrated in figures 4, 5 and 6.

### Figure 3

**By 2020, Chinese consumption is expected to grow by $2.3 trillion even if GDP growth slows to 5.5%**.

Nominal private consumption, 2020 (in Strillions)

![Graph showing consumption growth forecast and private consumption, 2015-2020.](image)

As of January 2017. HQ Capital makes no guarantee of future outcomes and/or targets.  
Notes: Assumes annual GDP growth rate of 5.5%. Because of rounding, not all numbers add up to the totals shown.  
Source: Economist Intelligence Unit; BCG analysis, December 2015

### Figure 4

**China healthcare expenditure (in RMB billions)**

![Graph showing China healthcare expenditure.](image)

As of January 2017. Past performance is not necessarily indicative of future results. HQ Capital makes no guarantees of future outcomes and/or targets.  
Source: McKinsey Report, NHPPC, SBOVC, HQ Capital Analysis

### Figure 5

**Investment in China’s education industry (in RMB billions)**

![Graph showing investment in China’s education industry.](image)

As of January 2017. Past performance is not necessarily indicative of future results.  
Source: Zero2IPO, IT Juzi, Deloitte Analysis, HQ Capital Analysis
In addition, the middle classes and the affluent in China are looking for ways to manage their finances better, protect themselves from loss and improve returns on their savings. As figure 7 shows, household financial assets in China remain overwhelmingly in cash and deposits. This can be expected to change rapidly and China is already seeing new forms of financial services developed by non-traditional players, such as internet giant, Tencent, and private equity-backed Ant Financial.

In many cases, the goods and services being sought by the increasingly affluent Chinese are not supplied at all by SOEs, or are supplied badly, with private enterprises filling the breach. Such enterprises often find it difficult or impossible to obtain finance for growth from traditional sources and therefore are the principal users of private equity capital. We look for managers who understand these trends and others, such as the growth of new industrial models and materials, and who have developed the expertise to be value-adding partners with their portfolio companies.

Challenges and opportunities, old and new

One challenge for private equity investments in China remains exits.

Many China-focused growth capital funds invested during the past decade remain unable to divest and return capital to their investors. We believe this was due in large part to inexperience and an overly optimistic sense of their ability to access public equity markets. While the public equity markets have steadied since China’s stock market bubble and crash of 2015 and initial public offerings (“IPOs”) have resumed, the road to a domestic IPO remains long and hard for most private companies.

It is essential that private equity managers in China have the discipline and skills to find other avenues to exit their investments. Fortunately, the growth of domestic mergers and acquisitions as well as dividend recapitalizations have presented some new liquidity solutions. At the same time, troubles for existing portfolios can produce attractive opportunities for secondary investors having the requisite contacts and expertise.
International expansion for larger Chinese companies is natural. Doing so successfully, however, whether by acquisition or through joint ventures, presents challenges that many such companies do not yet possess the human resources to meet. One way for such companies to address such challenges is to work with private equity firms, such as Hony, PAG Asia and Primavera, adept at helping to bridge gaps in skills and experience.

In summary
Global investors understand that China’s role in the world economy is already huge and destined to grow larger. It is also clear that it is not easy for financial investors to participate in this exciting but complex market. What should become increasingly clear is that one way for investors to allocate capital is through the thoughtful use of private equity, which as figure 8 makes plain has significantly outperformed public equity investing in China over a meaningful period of time.

We believe that there continues to be excellent opportunities in China available for granular, bottom-up investors with adequate resources on the ground and experience of the market. Volatility elsewhere in the world and an overly simplistic approach to debt and slowing macroeconomic growth in China have obscured those opportunities for many investors. We believe this has made the environment all the more attractive for those able to see past headlines and exploit the opportunities presented by inefficient and relatively opaque capital markets in the region.

Of course, the key to successful private equity investing in China, as elsewhere, is to work with local partners who have relevant expertise and experience and whose interests are properly aligned with those of their investors.
HQ Capital has a well-established presence in Asia, with two offices in China and a seasoned local team. Through our various investment programs, we seek to help investors build well-constructed private equity portfolios through a combination of primary commitments to funds and the acquisition of interests in the secondary market, managed by partners having the qualities we believe essential for success.

For further information about our programs, please contact us.

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