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Emergence of Large Funds May Exacerbate Matthew Effect in VC/PE Market

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VC/PE funds with the scale of over RMB1.00B emerge more frequently on the horizon. According to news report, CPEChina Fund, L.P., a USD fund launched by CITIC PE, announced the closing of over US $990.00M; Tiantu Capital has set up its fifth PE fund-Tianjin Tiantu Xinghua Equity Investment Partnership Co., Ltd. (limited partnership); Tencent injected RMB450.00M in Huayi Brothers Media Corporation from its RMB5.00B Tencent Industry Win-win Fund launched in early 2011.

Since the beginning of 2011, according to reports published in PEdaily.cn alone, 3 USD funds raised USD1.00B respectively and 8 RMB funds collected over RMB1.00B each. Some funds outstripped their expected raising objectives, with larger scale than previous funds.

When it comes to the fund management teams with brand effect, PE-oriented VC or large-scale PE has become a common occurrence. Top 20% of institutions outperformed their industry peers in fundraising, and the enlargement of fund scale and the shortening of fundraising time render us a feeling that we are ushered in an era of sufficient funding.

However, this is only one side of the story. According to statistics of Zero2IPO Research Center, 127 funds were scaled under US $100.00M in China's VC market in 2010, representing 80.4% of the total funds, and nearly 60% of newly raised funds were ranged between US $10.00M and US $50.00M. Evidently, PE funds have much smaller scale. In 2009, funds sized below US $200.00M accounted for 66.7% of the total, which hit 74.4% in 2010.

Also in 2010, domestic and overseas VC firms raised 158 funds or US $11.17B totally, representing an increase of 68.1% and 90.7% respectively from those recorded in 2009. Furthermore, 82 PE funds which were available for investment in Chinese mainland raised US $27.62B in 2010, 2.73 and 2.13 times respectively of the number of funds and fundraising amount in 2009.

With more and more capital ventures in, the VC/PE industry is growing and thriving, attracting more new players whose participation in VC/PE contributes to the improvement both in number and scale of funds, which also leads to the small scale of new funds. Given that, the VC/PE industry has undergone a rapid industrial development on the one hand, and witnessed the widening polarization on the other.

Soaring Capital behind Large Funds

Baring Private Equity Asia closed its latest fund on US $2.46B in February, with an oversubscription of nearly 40% over its planned scale of US $1.75B. The overall scale of KKR China Growth Fund is US $1.00B, but its designed target last year was US $800.00M. In April, IDG-Accel raised two China funds -

IDG-Accel China Growth Fund III and China Capital Fund II, at US $550.00M and US $750.00M in scale separately. Previously, on June 28, 2007, IDG-Accel Chinese Growth Fund II was closed only on US $510.00M, and in June 2008, IDG-Accel Chinese Capital Fund raised a total amount of US$600.00M.

Similar scene could be found in the raising of RMB funds. Oriental Fortune Capital closed the third RMB fund at RMB2.50B, far higher than the target of RMB1.00B to RMB1.50B. Shenzhen Fortune Venture Capital will raise at least RMB3.50B for its 10th RMB funds, but the total size of its previous nine RMB funds was only RMB6.50B. Tianjin CDH Investment has raised the LP contribution threshold from RMB20.00M of fund I to RMB30.00M in raising its second RMB fund, with a much stricter assessment on LP qualification. The fund which is projected at no more than RMB8.00B has already gained RMB3.00B investment from Social Security Fund.

For some VC/PEs, the capital in the fund raising market appears rather adequate, so that when being asked about the monetary contraction by media, most of investors respond with "no impact felt".

With regard to capital supply, the macro backdrop of China is truly sufficient funding. According to Zhou Qiren, a Member on the Monetary Policy Committee of the PBOC, China's M2 money supply hit RMB13.46 trillion as of the end of 2000, and RMB60.62 trillion by the end of 2009, representing an increase of RMB47.16 trillion. The GDP growth of the same period posted RMB24.50 trillion, while the increase in investment and consumption expenditure was RMB23.60 trillion. Meanwhile, the additional amount of China's cash and bank deposit was RMB23.00-24.00 trillion more than the abovementioned two figures. In this sense, monetary growth outperforms economic growth.

However, since the onset of the financial crisis, rounds of quantitative easing monetary policies of the US Fed worsened the overflow liquidity worldwide, and huge amount of capital is entering emerging markets. According to Jing Ulrich, Managing Director of JPMorgan Chase, US $5.70B worth capital flowed into emerging markets from April 4 to 8 2011, the largest weekly inflow since October 2010.

Against the backdrop of monetary flow, both Chinese and foreign governments have released great liquidity to tackle the financial crisis, which become the solid pillar for the increases both in the number and size of funds in VC/PE market since 2010. The wealth effect of ChiNext and the long-term cultivation of market by VC/PE constitute two wings for rapid development of the industry. China's economy, largely driven by indirect financing, couldn't meet the financing expectation of mass enterprises. The urgent need for an in-depth integration between finance and the real economy has become the root course for where the VC/PE industry is standing at the moment.

Another key factor is that after over two decades of exploration and development in China, the VC/PE industry has been accepted by state-owned and private capital over time.

China Development Bank announced the establishment of RMB60.00B Guochuang FOF on December 28, 2010, the first-ever national large-scale RMB fund of funds in China. Dai Xianglong, Chairman of National Social Security Fund (NSSF), disclosed at the Boao Forum in April that as of the end of 2011, the total size of NSSF's entrusted PE investment will reach RMB21.00B. According to the public data, four fund management companies have been brought into NSSF's investment, including CITIC Capital, Jinpu Industrial Investment Fund, Guochuang FOF and SAIF Asia Investment Fund.

Among the PE funds launched since early 2011, Liaoning Clean Energy & Low-Carbon PE Fund with a projected size of RMB5.00B and China Xinjiang Equity Fund with a planned size of RMB10.00B have evident government supports; RMB5.00B Shanghai Guohe Modern Service Equity Investment Fund (closed), RMB5.00B Guangdong Culture Industry Investment Fund and COFCO Agriculture Industry Fund with a planned scale of RMB6.00B have state-owned backgrounds. VC drives technical revolution and industrial advancement, while PE promotes the integration of elements and industrial upgrading. The government has piled high hopes on VC/PE's role in China's economic restructuring and the cultivation of strategic emerging industries.

At the gathering of private entrepreneurs in Shenzhen and Zhejiang, VC/PE by means of partnership was much in the talk. Investment firms of different kinds have mushroomed one after another. In particular, after the financial crisis, large credit supply has exacerbated inflation and led to the rapid soaring of capital price. In this setting that enterprises are reluctant to make investment and the traditional pool - real estate market is under strict regulation and control, VC/PE has become one of the choices as trillions of RMB private capital seek for investment destination. To be sure, there are some exceptions. For the leadership of private companies in Erdos, VC/PE is less appealing compared with 25-30% stable annual return of private lending. It's rather difficult to raise a small fund of RMB200.00M in Erdos.

A deep concern behind the exciting landscape is that whether the surging development of the VC/PE industry is a bubble amid capital soaring, or a raise abruptly after years of accumulation, and whether the internal driving force for the industrial development is sufficiently solid behind the capital.

Challenges Posed to Large Funds

Undoubtedly, the VC/PE industry couldn't be immune from the capital surge and every one is deeply involved in the world.

The key for VC/PE players to stand out from the crowd is how to face up to the opportunities and challenges posed by capital surge, clearly recognize themselves and identify a correct direction amongst profound changes.

Gratifyingly, China's VC/PE industry is blessed with an ever mature industrial chain. Incubators, angel investments and traditional VC/PE all have witnessed remarkable progresses. Furthermore, large buyout funds which were rarely seen before are embracing an exciting opportunity.

But challenges couldn't be ignored: for the management teams of brand funds, the expansion of funds under their management means either an increase in the number of investment projects, or an increase in the amount of individual investment; in other words, they need to either make more or larger investment deals.

In case of more investment deals, the requirement for talent cultivation and reserve in this regard will surely be elevated and the corresponding remuneration system and organizational structure of investment institutions will face more challenges. This is a test on internal strength. When it comes to larger investment deals, the auction of Pre-IPO investment has been common and the estimated value of PIPE investment is relatively higher, so the competition for "larger deals" has been very intensive and the investment pressure couldn't be underestimated. Against this backdrop, could investment institutions remain sober-minded and obtain the recognition of enterprises? This is a test on both capability and character.

According to Liu Zhou, Chairman of Shenzhen Fortune Venture Capital Co., Ltd, the coming five to ten years will witness a process of division and reshuffling. He talked about the strategies to combat throat-cutting competition in a media interview: first, replacing high cost with growth potential; second, reducing the participation in the high-competition areas (Beijing, Shanghai, Shenzhen, etc.) over time and tap into the investment opportunities in tier-2 or tier-3 cities. Fortune Venture Capital, which just completed the fundraising of RMB3.50B fund, is planning to set up Chief Representatives at provincial capitals, representing an urgent demand for talents.

Chen Wei, Chairman of Oriental Fortune Capital, once regarded the profit model of domestic PE as "IPO-oriented" in his article, as investment institutions focus more on IPO than the fundamentals of enterprises and the high PE ratio of secondary markets have become the major sources for high return on PE investment. He argued that this mode couldn't be sustained as the PE ratio on the secondary markets will ultimately be reduced to the normal level and PE funds shall return back to the fundamentals of enterprises rather than making fortune through market spread. Beyond that, industrial competition will surely show a clear 2-8 pattern, under which the first echelon stands out with more market resources and poor-performing small institutions will be phased out. Oriental Fortune Capital completed its third RMB fund raising of RMB2.50B and is now aggressively recruiting talents to be stationed in Shenzhen, Beijing and Shanghai.

After closing its latest fund at US$2.46B, Baring Private Equity Asia now manages US $5.00B capital and has a fund management team of only 40-plus talents, which managed US$100.00M capital each. The amount of single investment deal is no less than RMB300.00M. This represents a typical operation mode of foreign funds - high per capita input and high per capita output.

Unlike foreign funds, CITIC PE, which just accomplished the fundraising of US $990.00M, has an over 100 staff management team. Adequate staffs make it be capable to carry out a detailed and professional division of tasks among the investment team. CITIC PE includes four major industries: financial services, consumption, modern manufacturing, and raw materials & energy, under which sub-industries will be formed to carry out researches. It realizes efficient output via meticulous professional division of investment.

It's a marathon and it's unlikely to witness a peerless legend amongst more and more new players at the race course. However, it's more likely to see a widening distance among different echelons. For industrial players, they need to do more than they have done with a view to maintaining a leading advantage, or entering the first echelon, but the winner will outstrip the track record in return.

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