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Exit Strategy Trends of Private Equity Sponsors Focused on Asia

Overview

In recent years, private equity exits in Asia have increasingly utilized a dual track approach where a portfolio company would prepare for an initial public offering and concurrently pursue a possible trade sale through an M&A process. For Asia-based financial sponsors, the capital markets process typically would involve an IPO on a U.S. stock exchange or the Hong Kong Stock Exchange, although an exit through an A-share offering on a PRC stock exchange increasingly has become a viable alternative. Furthermore, the continued growth of the fund secondaries market in Asia represents a possible additional exit option for financial sponsors.

U.S. Exits

An IPO on a U.S. stock exchange remains one of the favored exit options for financial sponsors, particularly where the portfolio company is in the TMT (technology, media & telecommunications) or biotechnology sectors. Factors favoring the U.S. exit option include the fact that the U.S. capital markets are among the most liquid and deepest markets in the world. In addition, the listing regimes of the New York Stock Exchange and Nasdaq offer significant flexibility for foreign private issuers, both in terms of listing requirements as well as exemptions from certain corporate governance requirements under the so-called “home country practice exemptions”. Moreover, the U.S. investor base often is perceived to have a better understanding of, and as a result offer higher valuations, for technology and other innovative or “new economy” companies.

However, there have been certain headwinds in 2019 which have slowed down, in particular, U.S. listings by Chinese companies. Among other things, there continues to be concerns raised by U.S. regulators as well as politicians over the lack of transparency of certain U.S.-listed Chinese companies and the lack of direct regulatory jurisdiction, such as accounting oversight, as well as whether there is adequate protections available to U.S. investors. Furthermore, unconfirmed media reports that the Trump administration have looked into the possibility of delisting Chinese companies from the U.S. stock markets, albeit likely a drastic and seemingly remote threat, have cast some doubt on the viability of a U.S. exit. Viewed against the backdrop of the current China-U.S. trade tensions, the prospect of further limiting U.S. investor fund flows into China has created a more challenging environment for Chinese companies looking to list in the United States. Heightened regulatory scrutiny and vetting can be expected, particularly over companies with VIE (variable interest entities) structures, and Chinese companies may also be required to take on more onerous financial and other disclosure obligations. The risk of a Chinese company being placed on the BIS entity list has created further headwinds. In 2018, 33 Chinese companies listed in the United States raising total IPO proceeds of approximately US$9.2 billion. In 2019 through the end of November, 18 Chinese companies have listed in the United States, raising total IPO proceeds of approximately US$2.9 billion.

Hong Kong Exits

Despite experiencing significant political turmoil and unrest in the second half of 2019, Hong Kong remains an attractive and competitive listing destination for private equity exits. Compared with a domestic listing in the PRC, Hong Kong has long been a preferred listing venue for Asian private equity as it offers better liquidity than the PRC capital markets and is perceived to have more rigorous accounting, governance and listing standards. In addition, Hong Kong benefits from having a completely open capital account, and the Hong Kong Stock Exchange is seen as a more natural listing venue for companies that have a "China story" (or otherwise have a significant China business) when compared with the U.S. stock exchanges.

On the other hand, historically the Hong Kong capital markets were perceived to favor the more traditional, "asset heavy" companies, and the investor base was seen as less receptive to technology, biotechnology and other new economy companies. Moreover, and unlike the U.S. stock exchanges, until recently the Hong Kong Stock Exchange did not permit dual class share structures, which made it less appealing as a listing venue for many new economy companies. In response to the evolving global regulatory and economic environment, the Hong Kong Stock Exchange adopted new rules in April 2018 that permitted weighted voting rights structures (which are functionally equivalent to a dual class share structure), and also adopted new rules that relaxed certain listing requirements for biotechnology and other emerging technologies companies.[1] As of November 30, 2019, with the US$5.8 billion listing of the Asia-Pacific beer unit of Anheuser-Busch InBev in September 2019, and the US$11.3 billion secondary listing of Alibaba Group in November 2019, the Hong Kong Stock Exchange appears to have regained the top spot as the world's IPO hub in 2019.

China Exits

For financial sponsors in Asia, especially those with portfolio companies that have heavy or exclusive exposure to China, an exit via an initial public offering on a domestic PRC stock exchange remains a tantalizing prospect. The PRC stock exchanges typically offer significantly higher valuations than the U.S. and Hong Kong stock markets, and for businesses that are purely focused on China, a domestic listing often would be the most logical outcome. In addition, the Shanghai-Hong Kong Connect and Shanghai-London Connect programs permit eligible companies listed on each stock exchange to issue, list and trade depositary receipts on the counterpart's stock exchange.

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1 See Debevoise In-depth "New Hong Kong Listing Rules Welcome Emerging and Innovative Companies" published on July 6, 2018.

One of the key disadvantages with pursing a domestic listing in China is that historically there is a long queue of listing applicants with a timeline that is often unpredictable as well as seemingly subject to regulatory discretion. Furthermore, there has been substantial price volatility and regulatory intervention risk as well as foreign exchange controls. The PRC capital markets also have significant restrictions on foreign investors as well as general restrictions on trading activities, and generally is perceived to be less transparent when compared to the U.S. and Hong Kong capital markets.

Recent developments in the PRC stock exchanges that could be of interest to financial sponsors include the launching of the STAR market by the Shanghai Stock Exchange, which is intended to be a Nasdaq-style tech board. Among other things, the STAR market adopts a registration procedure for IPOs and permits greater flexibility to companies in pricing their shares. Another noteworthy development is the announcement by the China Securities Regulatory Commission that it would remove rules requiring companies seeking a ChiNext listing (the Shenzhen Stock Exchange's high tech board) to report profits for two consecutive years, as many Chinese start-ups have struggled to meet the three-year profitability requirements of Shanghai and Shenzhen's main boards.

Fund Secondaries Exits

For Asian financial sponsors, a potentially intriguing development is the significant growth of fund secondary transactions globally. In particular, PE secondary market transactions totaling US$42.1 billion were completed in the first half of 2019, representing a 33% year-on-year increase. While the Asia secondaries market has continued to grow in 2019, it remains less developed compared to Europe and the United States.

As private equity funds mature and approach the end of their fund life, some LPs may wish to leave before the optimal exit window emerges, but GPs may still want to hold on to the portfolio assets for longer. Exits via a secondaries process offer a potentially helpful solution by providing an opportunity for LPs to cash out more quickly, as well as allowing additional time and potentially additional funding for GPs to maximize unrealized portfolio value. As the Asia secondaries market continues to develop and grow, it may become an additional exit option for financial sponsors and their portfolio companies in the region.

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