China private equity and venture capital

too big to ignore

Private market insights

© 2021 Mercer LLC. All rights reserved.

At a glance

China's private equity and venture capital (China PE/VC) market is large and growing, and currently represents the second largest PE/VC market in the world. We believe an allocation to China PE/VC can add value within a broader global PE/VC portfolio by enhancing returns and diversification. In addition, it provides exposures in high-growth companies that are not fully accessible via Chinese public equity or other asset classes.[1]

The fundamental drivers behind the growth in the China PE/VC market lie in the country's rising consumption power and its focus on innovation. China's private consumption is forecast to more than double to about $14 trillion by 2030, matching the current size of US private consumption.[2] Furthermore, China has a developed ecosystem of talent and capital resources that supports research and innovation as the country transitions from 'the world's factory' to a 'high-tech innovator.' This represents a favorable backdrop for PE/VC managers to fund companies that capitalize on China's evolving consumption trends and opportunities across industries to enhance productivity and innovation.

Investing in China PE/VC is more complicated than investing in developed markets PE/VC. On top of being a dynamic market with frequent new manager spin-outs, investors also need to consider geopolitical, regulatory and other risks, which present both opportunities and threats. Building a successful China PE/VC program requires deep local market expertise and access to quality managers.

China is 'too big to ignore', but most investors remain under-allocated

Relative to the US PE/VC industry, which has more than 40 years of active history, China's PE/VC market only started in the early 2000s. The growth of China PE/VC has been driven by a series of regulatory changes and capital market reforms that attracted capital (see Figure 1).

China's PE/VC activities in the past five years (2016–2020) have doubled compared to the prior five years (2010–2015). The market is expected to grow further, helped by policy support as the Chinese government recognizes the importance of PE/VC capital for early-stage and small and medium enterprises (SMEs), which are the key drivers of China's strategic shift from 'Made in China' to 'Invented in China.'

---

[1] For more details on opportunities in Chinese onshore and offshore public equities and the current view on Chinese onshore bonds, visit Mercer's China hub: www.mercer.com/our-thinking/wealth/investing-in-china.html

[2] IMT, World Bank, National Statistical Agencies, Haver, February 28, 2020.

© 2021 Mercer LLC. All rights reserved.

China is currently number two in terms of contribution to global GDP and aggregate size of PE/VC opportunities (see Figure 2).[3] However, PE/VC penetration in China continues to be low, accounting for only 0.8% of GDP versus 1.7% in North America.[4] This represents significant growth potential for the PE/VC market as China's share of global GDP is expected to grow to 30% by 2030, overtaking both the US and Europe.[5]

A recent industry report projects that global PE/VC assets under management (AUM) will grow at a 15.6% compound annual growth rate (CAGR) from $4.4 trillion in 2020 to $9.1 trillion in 2025E. In line with the overall Asia Pacific (APAC) alternatives AUM growth, APAC PE/VC is also expected to outgrow the global CAGR at 25% and increase its share of global PE/VC AUM from 28% in 2020E to approximately 40% by 2025E.[6] This would put the region on par with the US and above Europe. China currently accounts for about 60% of APAC's PE/VC AUM, and Mercer expects it to grow steadily in line with APAC growth.

While investors in China are over-allocated to China — for the most part due to capital controls — investors outside China tend to be under-allocated to China, relative to the size of its economy, capital markets and PE/VC market. Without any action, this under-allocation will only compound as Chinese businesses are not only growing domestically but also expanding into Southeast Asia, Central Asia and Africa, among other markets.

---

[3] China accounted for 17% of global GDP and 13% of PE investment activities, compared to the US (24% GDP/48% PE). Source: World development indicators, Preqin (as of April 2021), GDP as of 2019, PE investment activities as of 2018–2020.

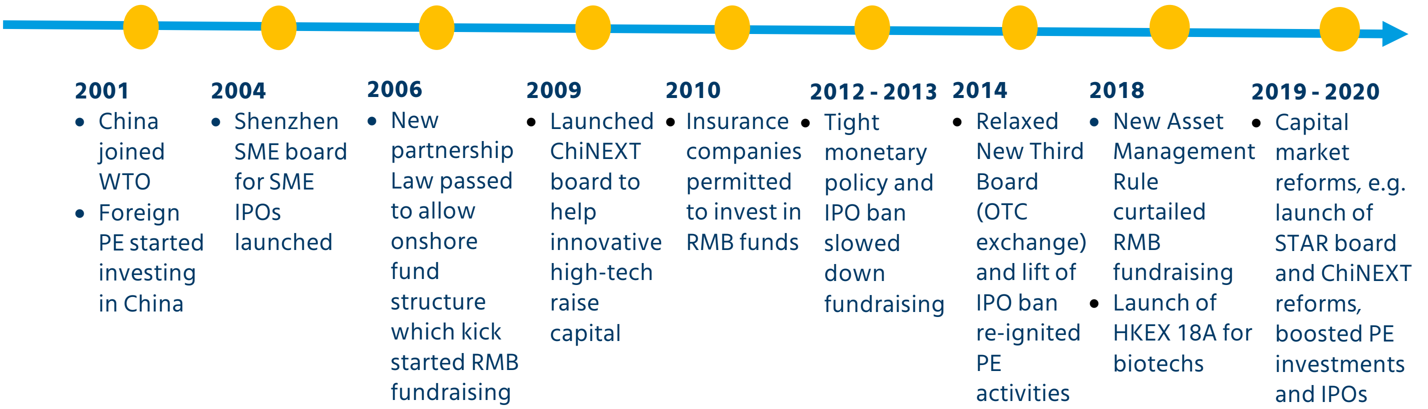
[4] PE penetration calculated by average PE investment (2017–2019)/2019 GDP.

[5] Tonby O, Woetzel J, Choi W et al. 'Asia's Future Is Now,' McKinsey.com, July 2019, available at www.mckinsey.com/featured-insights/asia-pacific/asias-future-is-now.

[6] Preqin. 'The Future of Alternatives: 2025,' February 2021.
AUM = dry powder (uncalled capital) + unrealized value

© 2021 Mercer LLC. All rights reserved.

Figure 1. Regulatory and capital market reforms boosted PE/VC activities in China



$180bn
$160bn
$140bn
$120bn
$100bn
$80bn
$60bn
$40bn
$20bn
$0bn

2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020

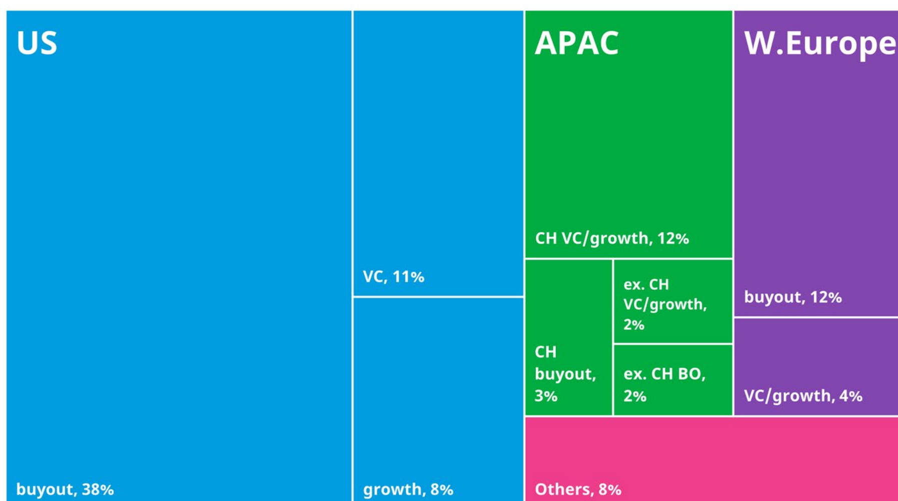
Fundraising Investment Exit
Expon. (Fundraising) Expon. (Investment) Expon. (Exit)

Source: AVCJ database (as of April 2021); fundraising numbers only includes China-country funds; Expon. = exponential trend line that illustrates growth in PE fundraising, investment and exit activities

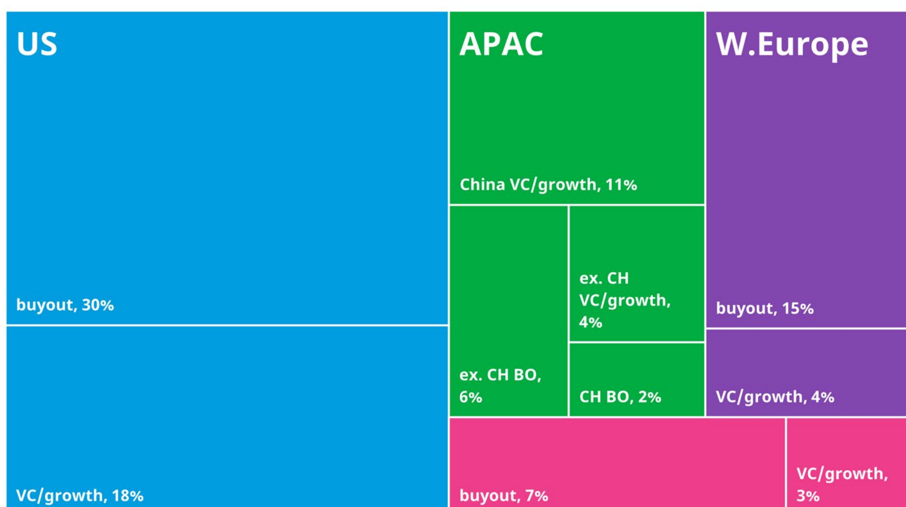
© 2021 Mercer LLC. All rights reserved.

Figure 2. Global PE/VC fundraising and investment breakdown

Global PE/VC fundraising breakdown (2018 – 2020)



Global PE/VC investment breakdown (2018 – 2020)



Source: Preqin (as of April 2021). CH = China, BO = buyout; fundraising numbers for China only include China-country funds

© 2021 Mercer LLC. All rights reserved.

Potential benefits of a China PE/VC allocation

Possible enhanced return

Mercer believes an allocation to China PE/VC can add value within a broader global PE portfolio by enhancing returns and diversifying away from developed markets. Benchmarked against the US and Europe PE's top quartile funds, China has also shown outperformance across vintage years. Although high historical returns are likely to come down due to higher deal valuation as the market becomes more competitive, China PE/VC is nevertheless still expected to offer attractive returns relative to more mature PE/VC markets such as Europe. In terms of performance relative to public equities, China PE/VC has outperformed the MSCI Emerging Markets on a public market equivalent (PME[7]) basis across 5-, 10- and 20-year horizons, as illustrated by Figure 3.

Exposure to high-growth sectors

China PE/VC provides investors with access to high-growth companies at the earlier stage of their development, with the potential to invest in future leaders long before they list on public exchanges. Complementing sector exposures within typical public equity allocations to China, China PE/VC offers additional breadth in some sectors, as well as access to under-represented high-growth segments of technology and healthcare (see Figure 4). Similar to US high-growth companies, many Chinese companies, particularly those in the new economy sector, are also staying private for longer before their initial public offering (IPO), as they can easily obtain PE/VC funding without going public.[8] Investors can potentially capture growth in this segment by participating in private equity. A PE/VC allocation to China is therefore an important complement to a public equity allocation, as it facilitates broader and more representative exposure to the full suite of attractive growth opportunities in China.

Direct exposure in a growing domestic market

Alongside GDP growth, domestic Chinese businesses have grown in scale over the decades. For the first time in 2020, China has more Fortune 500 companies than the US. These Chinese businesses derive the majority of their growth from business activities within China. Compared to the 2000s, when investors could get access to China through global multinationals, it is becoming harder to gain portfolio exposure to China's domestic market without investing directly in onshore China equities.[9] The same dynamic holds true for private companies; for instance, China now accounts for a quarter of the world's unicorns, second only to the US.[10] These unicorns provide direct access to important economic growth drivers in China, exposure that may not be achievable via private companies outside China.

---

[7] PME is a metric that compares PE fund performance to public equity indices, accounting for the irregular and fluctuating cashflows in PE to give investors a more like-for-like comparison.

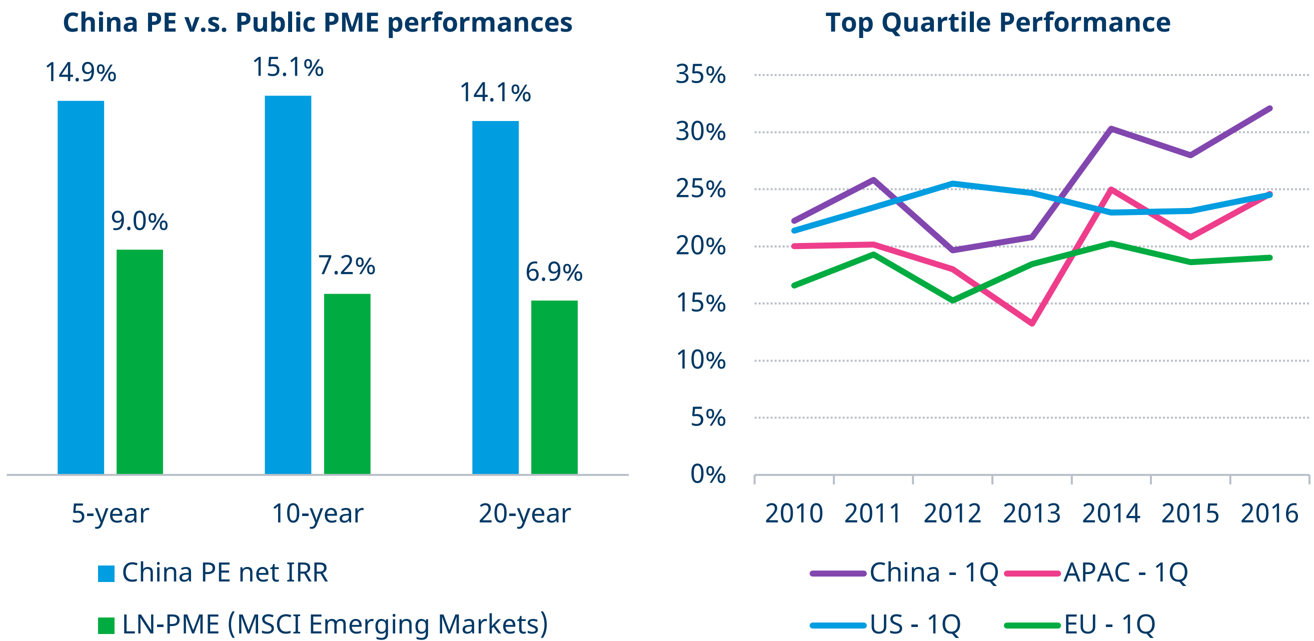
[8] For more details on public and private markets in transformation, visit Mercer's Strategic Research Community.

[9] Mercer. *Positioning your portfolio for the future of Emerging Markets – The case for a dedicated China equity allocation*, 2021, available at www.mercer.com/content/dam/mercer/attachments/global/gl-2021-long-em-and-china.pdf.

[10] Unicorns = private companies with valuations above $1 billion. The number of unicorns in China grew from 37 in 2016 to 138 in mid-2021. Source: Fortune 500, CBINsight April 2021 Unicorn list.

© 2021 Mercer LLC. All rights reserved.

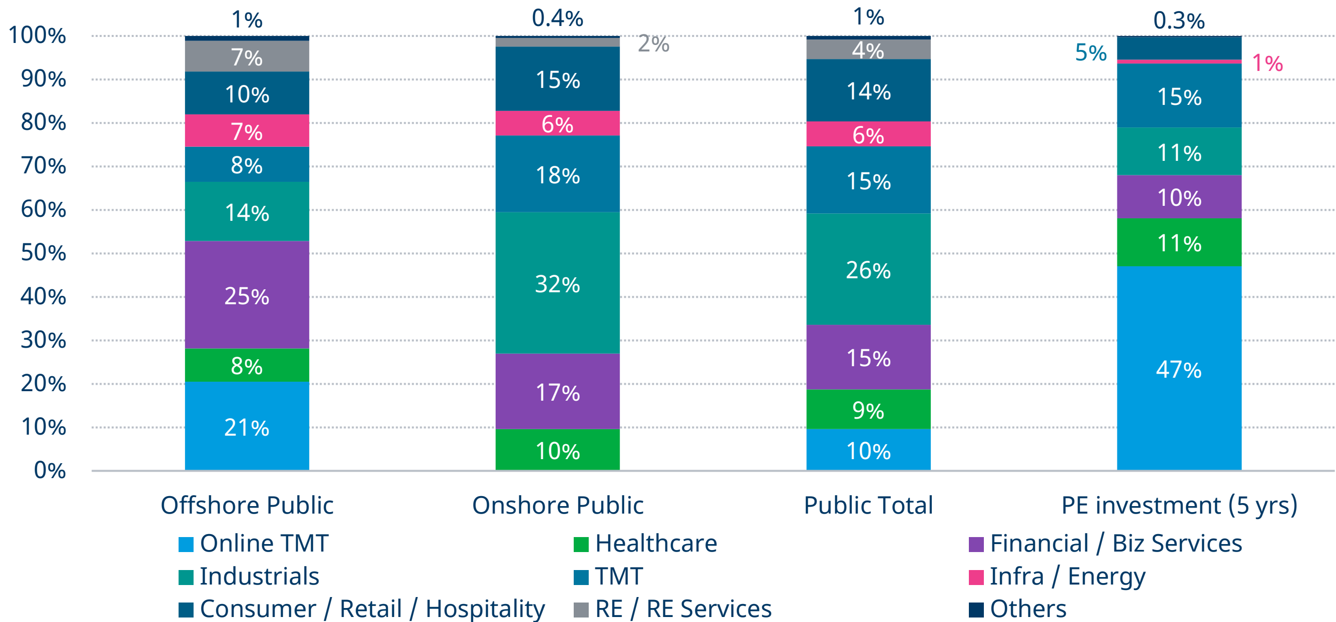
Figure 3. Outperformance against PME and private benchmarks



Source: Burgiss; data as of September 30, 2020 include all China Private Equity funds vintage 2010–2019. Top quartile performance chart excludes vintages 2017-2020 as they are still portfolios under investment period. LN-PME (Long-Nickels PME) is the public market performance measure of the public market index (MSCI Emerging Markets, which is the closest benchmark available), based on the net cash contribution and distribution of the private market funds; past performance is not indicative of future performance.

© 2021 Mercer LLC. All rights reserved.

Figure 4. Complement public equity exposure with PE/VC allocation



Source: Public equity data sourced from Bloomberg (as of July 30, 2021); private equity data sourced from AVCJ database (as of March 31, 2021); Mercer analysis[11]

Challenges and considerations

As attractive as investing in China PE/VC is, investing in China comes with its own risk profile. Below we outline some of the key China-oriented risks investors should consider.

Heightened regulatory risk

As a state-controlled economy, regulatory risk has always been prominent in China. Recent regulations show that the Chinese government is increasingly focused on the quality of growth and other social goals such as 'common prosperity'[12] over the quantity of economic growth. Starting in

---

[11] 'Offshore public' represents the market capitalization distribution of equities domiciled in China and Hong Kong (HK) that are listed in HK or the US. Duplications of equities listed both in the US and HK (through secondary listing) are excluded. 'Onshore public' represents the market capitalization distribution of equities domiciled and listed in China. The duplications from companies that have issued both A-shares and B-shares are excluded.
'Public total' represents the aggregate of 'Offshore public' and 'Onshore public' data. The duplications of equities listed both as A-shares (listed in China) and H-shares (listed in Hong Kong) are excluded (based on the information provided at http://data.10jqka.com.cn/market/ahgbj).

[12] On August 18, 2021, at the Communist Party's Central Committee for Financial and Economic Affairs, China's President Xi Jinping laid out China's goal to reach 'common prosperity' where people share in the opportunity to be wealthy as the main objective for the next stage of its development. The plan called for better governance and more balance in the economy, focusing on grassroots consumption as key economic multiplier rather than capital-intensive investments. The announcement has further affected the share prices of large internet companies as many expect more regulations to be put in place to 'redistribute' the wealth, such as a rollback of tax incentives for internet companies in favor of hard tech research and development.

© 2021 Mercer LLC. All rights reserved.

Q3 2020, a number of new policies have heightened regulatory risk in some sectors, particularly for large consumer internet platforms and the education sector:

i) A more stringent anti-monopoly law to address unfair market competition, with internet giants fined for violating rules. This is in line with the shift in approach in developed markets, including the US and the European Union, with steps taken to address concerns about monopolistic power and data security.

ii) New data security law requiring any Chinese companies that hold the personal information of one million users or more to seek a government cybersecurity review before listing abroad. Related to this is the Chinese Securities Regulatory Commission (CSRC) is also considering requiring Chinese companies that use a variable interest entity (VIE) structure to seek approval before going public in foreign markets. The stricter oversight on overseas IPOs is seen as a response to the increasing pressure in recent years from the US to require additional information disclosures from US-listed Chinese companies. Companies that are most affected are the ones deemed to hold sensitive personal or key infrastructure data.

iii) Crackdown on education industry to restrict the scope of after-school tutoring. The motivation behind the regulation is to promote social equality and elevate the nation's birth rates by addressing increased living cost and education spending.

The speed, overall number and severity of some of these regulations shocked many investors and raised fears about the potential for additional regulatory actions over the coming months. Although most of these regulatory developments were foreshadowed by the Chinese Government's previous statements about policy priorities and also in some cases by earlier regulatory actions, some have argued that the communication and implementation of these latest developments could have been managed in a way that better signaled the underlying objectives and scope and reduced the uncertainty and negative market impact.[13]

[13] For example, the policy priorities to contain the over-heated real estate market, to regulate the after-school tutoring sector and to restructure the healthcare sector and focus on innovation. Since 2018, there have been regulations on implementation of private education and off-campus tutoring content, and since early 2020 the government has been making amendments to the anti-monopoly law to target the internet sector.

© 2021 Mercer LLC. All rights reserved.

Following the negative public equity market reaction in early July 2021, the CSRC held a meeting with major international banks to provide assurances about the intent and scope of regulatory actions. Nevertheless, market sentiment has been affected, and it also raised concerns over the legitimacy of the offshore VIE entities.[14] In mid-August, the US Securities and Exchange Commission directed staff to 'take a pause' from listing Chinese companies under the VIE structure and advised that all China-based operating companies would need to make certain disclosures before they could go public in the US. As such, overall listings, in particular those of consumer tech companies, are expected to slow down for the next 6–12 months as fund managers reevaluate exit strategies. Though the eventual verdict on the VIE structure currently uncertain, based on our discussions with fund managers, a requirement for VIE structures to seek approval prior to listing may actually be a step forward for the Chinese government in acknowledging the legitimacy of the structure, which has always been in a grey area as it has never been endorsed before. Navigating the evolving regulatory framework presents alpha opportunities for managers with local knowledge and the ability to judge the potential opportunities and risks emanating from the regulatory regime.

High valuations and growing dry powder

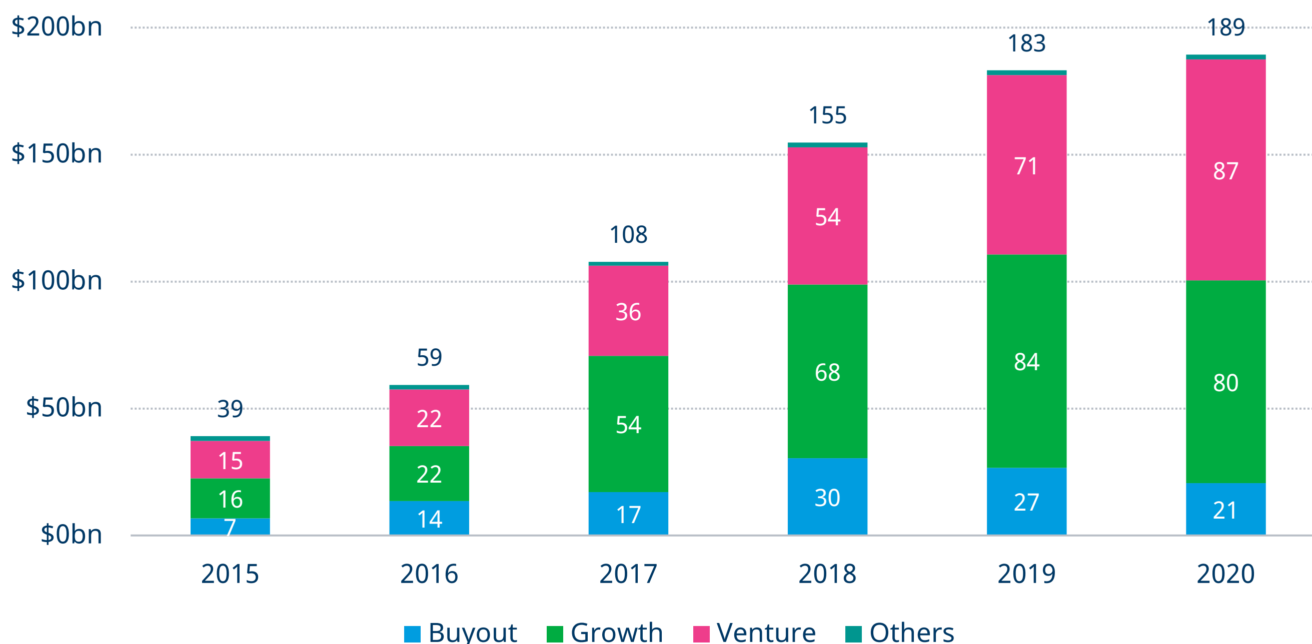
Dry powder (unspent capital) has been building up since 2017 with a strong fundraising environment (see Figure 5). This has raised concerns on whether a high level of dry powder would drive up valuations and erode discipline in the industry. Indeed, high valuations are one of fund managers' top concerns. Regardless of the market turmoil in July 2021 caused by new regulations, valuations have yet to change significantly — good deals continue to face intense competition. As such, managers can no longer achieve the desired returns by relying on overall market beta, but need to focus on generating alpha through differentiated sourcing and value-creation strategies. This makes manager selection and access to the right funds even more critical for investors.

---

[14] In a number of sectors in China, such as the internet sector, companies are not allowed to have foreign ownership and cannot directly list on exchanges outside of China. Given China exchanges have stringent requirements on company profitability, many companies with fast revenue growth but which are unprofitable have chosen to list on exchanges like NASDAQ. To raise money on such foreign exchange, companies are structured as VIEs. VIE is an arrangement where a China-based operating company, typically in an offshore shell company in the Cayman Islands, issues stocks to public shareholders. That shell company enters into service and other contracts with the China-based operating company, then issues shares on a foreign exchange. Though the shell company has no equity ownership in the China-based operating company, for accounting purposes the shell company is able to consolidate the operating company into its financial statements. Pioneered by Sina Corp during a 2000 IPO and used by numerous tech giants like Alibaba and Tencent, the VIE framework has never been formally endorsed by Beijing. The CSRC is seeking to amend rules that require firms using VIEs to seek CSRC approval before going public in Hong Kong or the US.

© 2021 Mercer LLC. All rights reserved.

Figure 5. Dry powder in China (US$ billion)



Source: Preqin (as of June 2021).

Geopolitical risk

In past years, relations between China and the US, the UK, Australia and India have deteriorated over trade, border disputes, technology supremacy and the origins of COVID-19 as well as differences over political, social and religious issues, which China sees as interference with its internal affairs. Although the Biden administration employs a less confrontational style than the Trump administration, most foreign affairs experts do not expect to see a significant improvement in China's relationship with the US and most of its allies in the near term. Ongoing tension could lead to further adverse impact for investors with exposure in sensitive sectors, such as companies holding key personal data or ones that provide products/services to the Chinese military.

To date, the geopolitical tension has affected China PE/VC activities, in terms of reduced cross-border transactions and consideration for IPO listing channels, but the impact on fundraising has been limited. Investors continue to be attracted by the high prospective returns that China offers.

ESG and other considerations

China is predominantly a minority growth (that is, non-buyout) market where fund managers have less influence in companies. Though many fund managers may have an ESG policy in place and there may be some effort to promote ESG, particularly for the governance of portfolio companies, the results are not effectively measured.

© 2021 Mercer LLC. All rights reserved.

In addition to the aforementioned challenges, issues such as lack of transparency in information and reliable data, weaker legal enforceability and corporate governance, and reliance on *guanxi* (that is, a system of influential social networks that facilitate business) are also more prominent in China than in the US and Europe. Hence, fund managers' ability to align their interests with company management is critical.

Investment themes and opportunities

The aforementioned risks should be considered but can be managed by skilled managers, and we believe that investors are compensated for taking these risks due to the abundant opportunities in Chinese private markets.[15] The fundamental driver behind growth in the China PE/VC market lies in China's i) continuous growth from a large GDP base; ii) sizeable population of millennials and middle class that are key drivers of private consumption; and iii) strong focus on R&D and large talent pool — China has established itself as an innovation center. In accordance with the central government's long-term national planning for 2021–2025, as outlined recently in the 14th Five-Year Plan, investment opportunities will revolve around the major themes of domestic demand, digitalization, technology localization, healthcare and clean tech.

Long-term growth in consumption and the rise of homegrown Chinese labels
China's private consumption is expected to drive global consumption; it is projected to grow at an 8.7% CAGR from $6 trillion to $14 trillion between 2020 and 2030.[16] This growth is not just fueled by income growth, an emerging middle class and urbanization, but also by a declining savings rate and increasing availability of consumer credit. Global investors have been attracted to Chinese consumers' resilience during the pandemic and the growing buying power of younger generations represented by the millennials and Gen Z.[17]

The younger generation have more discretionary cash to spend on products and services that embrace elements of experience, entertainment, uniqueness and personalization. Growing up in the era of China's rise as a global power, strong nationalist sentiment is driving the *guochao* trend, or a surge in consumer interest in domestic brands and products that incorporate traditional Chinese style and culture. As the geopolitical conflict has worsened, western brands, especially when taking political stances to please a western consumer base, have found it more challenging to appeal to Chinese consumers. The preference for domestic over foreign brands is now evident across various product categories, such as mobile phones, home appliances, apparel and cosmetics/skincare, among others. Domestic brands are also perceived as having improved quality and offering good value for money. Geopolitical dynamics, especially US restrictions on technology exports to China, have also accelerated the need for domestic substitution. China's huge and fast-growing consumer market is becoming more insulated from the world in some respects, which increases the importance of direct portfolio exposure to Chinese companies.

---

[15] Besides, most of these risks also apply to varying degrees in public markets.

[16] IMT, World Bank, National Statistical Agencies, Haver as at February 28, 2020.

[17] Millennials are people born between 1981 and 1996, and Gen Z are people born between 1996 and the mid-2000s.

© 2021 Mercer LLC. All rights reserved.

Digitalization across industries

Even before the pandemic, China was a leader in the consumer-facing or business-to-consumer (B2C) digital economy, as demonstrated by the scale of the prevailing super apps and a high e-commerce retail penetration of 45% versus 12%–15% in Western Europe and US.[18] COVID-19 has supercharged the digital adoption rate ahead of schedule for not only the B2C applications, but also in the traditionally less digitized parts of the economy, such as areas requiring heavy physical interactions (for example, education, medical consultation, property viewing) and business-to-business (B2B) processes.

The adoption of 5G technology, the Internet of Things and artificial intelligence (AI) will unlock a broad range of opportunities across industries, including the optimization of service delivery, factory automation and end-user experience. In the next decade, investment opportunities will center on enterprise software and cloud computing, led by smaller businesses than the super apps in the B2C space. It is expected that the next wave of large unicorns will come from both the upstream supply chain (B2B and industrial-facing), last-mile delivery (B2C and consumer-facing) and software solutions that make the information or goods flow more efficient. Fund managers that can spot and fund such opportunities early on in the process will likely benefit from these emerging trends.

Localization of deep tech (semiconductors)

As AI, big data, electric vehicles and 5G become more prevalent, demand for semiconductors and software become critical. Because of the decoupling between the US and China within the technology space, and the difficulty in sourcing international semiconductors and telecom equipment, the 14th Five-Year Plan pinpoints development of key technology as a national priority, with a specific objective of building a self-sufficient chip ecosystem that is independent from the US. China has been setting up government guidance funds, both at the national and provincial levels, pouring billions of dollars into creating a Chinese chip ecosystem. At the PE/VC level, fund managers are also shifting more focus to the deep-tech/hard-tech space, and the opportunities arising from the geopolitically driven 'silicon curtain.'[19] Different from the focus on consumer tech, this will require managers with more technical and industry background, increasing the importance of careful manager selection.

Healthcare opportunities

The pandemic has raised awareness of healthcare. In the short term, vaccines, antiviral drugs, medical protection and online medical analysis will be the market hot spots. However, the outbreak has also exposed the huge gap in disease prevention and control and the insufficiency of basic medical care capacity. As such, in the long term, Mercer expects to see positive structural changes that will create opportunities for private equity investors in sectors across biotech, medical devices and diagnostics, and hospital services.

---

[18] Source: eMarketer

[19] Silicon curtain = legal barrier to technology transfer and sale of advanced computer equipment between China and the West.

© 2021 Mercer LLC. All rights reserved.

At a macro level, China is an attractive market for healthcare sector investments, with increasing longevity, low penetration of healthcare services and growth in the middle-class population looking for better quality healthcare. Structural healthcare reforms will further drive improvements in healthcare services, drug distribution and insurance, as well as innovation and increasing healthcare expenditure. Healthcare expenditure accounted for around 6.5% of China's GDP in 2020E,[20] which is significantly behind that of developed countries like the US and Germany.[21]

Green tech

China has announced a carbon-peak target by 2030 and a carbon-neutrality target by 2060. To achieve these goals, the country is ramping up green investment in areas like renewable power, electric vehicles, battery storage and technology that will reduce carbon emissions from factories and allow China to reduce its reliance on imported energy. Historically, PE/VC managers had limited focus in this area, but from 2021 Mercer has seen more fund managers raising dedicated green funds or discussing inclusion of green tech as a key investment area.

China PE/VC activities overview

Investment

China PE/VC investments has grown at a 13% CAGR since 2010 to over $100 billion in 2020 (see Figure 6). Despite the pandemic, YoY deal activities were up by 51%, driven by online Technology, Media, Telecom (TMT) and healthcare. Compared to the US and Europe, where VC/growth deals accounted for less than 40% of transactions, China's VC/growth deals account for 85% of transactions. The VC market in particular has enjoyed tremendous growth given China's unique characteristic: it is one of only two countries with a population of more than one billion, and the only one of these two with unified language, culture and customs and a centralized government.

The VC segment is broadly segmented into early-stage (financing round series A and B) and late-stage/early-growth (series C and beyond) deals. The late-stage/early-growth deals are investments into high-growth, pre-profit companies that have reached a growth inflection point with low technology risk, which are often targeting an IPO within two years. This segment is currently characterized by intense competition and high valuations. As such, we advise investors to be selective in gaining exposure to this segment. On the other hand, early-stage VC is less competitive and therefore considered a more attractive segment. Fund managers can demonstrate the ability to generate alpha through identifying and investing in high-growth companies at a lower valuation.

Control and joint-control investments have also increased to 15% of invested capital. Going forward, control deals are further driven by i) China's maturing economy; ii) the competitive operating environment; and iii) generation succession, which increases entrepreneurs' willingness to engage with PE investors. The number of control-focused funds in China is currently limited, but Mercer

---

[20] Source: BMI Research, August 2017

[21] Source: WDI; US and Germany were at 17% and 11% in 2018, respectively

© 2021 Mercer LLC. All rights reserved.

observes that managers who have traditionally operated in the growth stage are also doing more control/joint-control deals.

Fundraising

China accounted for 15% of global fundraising in the past three years. The activity has grown 2.6 times in the past ten years and remained steady at an average of $87 billion (2016–2019) before dipping in 2020 during the pandemic (see Figure 6).

China's fundraising consists of two type of funds: i) domestic vehicles denominated in local currency RMB (RMB funds); and ii) offshore vehicles denominated in USD (USD funds). Given capital controls, onshore investors mostly go into RMB funds and offshore investors go into USD funds, although selected local government schemes such as the Qualified Foreign Limited Partnership (QFLP) program also allow offshore investors to invest in onshore vehicles.[22] Mercer does not currently view the QFLP space as attractive at its current state. In addition, there is currently limited number of quality fund managers with QFLP funds. Most of the top-performing managers have both USD and RMB funds and prefer to keep onshore and offshore investors separate. Compared to the pure RMB fund managers, managers that have managed USD funds (or both USD and RMB funds) are more experienced in meeting the due-diligence and reporting requirements by overseas investors.

Although the two currency structures pursue the same strategy, they rarely invest in the same deals because the investing deal currency depends on the target company's legal structure and the ultimate IPO listing venue. Companies looking for onshore listings have onshore structures take RMB capital, and companies looking for overseas listings in the US or Hong Kong will typically have offshore structures and take USD capital. The choice of the listing venue preference is often dependent on where the company's market comparables are listed.

At first glance, the data in Figure 5 shows RMB fundraising has outpaced USD funds and accounted for 70% of total fundraising between 2016 and 2020. However, a closer look shows that over 50% of the RMB fundraising is driven by large government-affiliated funds. Excluding government-affiliated funds, RMB fundraising has declined since 2018. The fall-off is primarily due to a new asset management regulation designed to curtail shadow banking and restrict banks from issuing products with mismatched asset-liability durations. As a result, banks and third-party wealth managers that have historically accounted for over 60% of capital raised in RMB funds have pulled back on issuing private market products. The Chinese regulator has also recently announced plan to restructure the RMB private equity fund industry by eliminating fake ones to promote an orderly

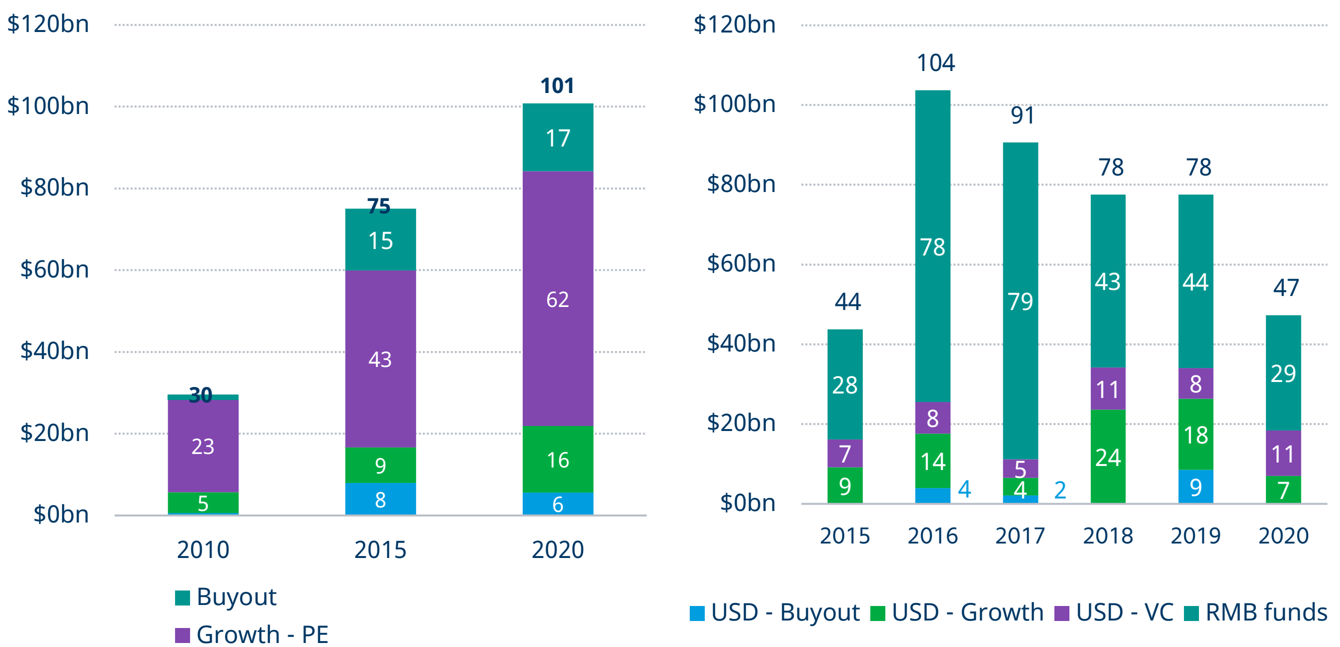
[22] QFLP program is only available in a few number of trial areas such as Shanghai, Beijing, Tianjin, Chongqing, Shenzhen, Qingdao, Guizhou Province, Fujian Province, Zhuhai, Guanzhou, Suzhou, Shenyang and Hainan Province. QFLP enables qualified foreign limited partners to set up a private equity fund with qualified domestic investors (acting as the general partner). An advantage of the QFLP fund is the pre-review of foreign exchange clearance which speeds up foreign exchange settlement. However, QFLP is not as widely used as expected given i) establishment of QFLP is subject to the local requirements, which are relatively high; ii) requirement to invest within more limited scope; and iii) a QFLP fund is deemed as a foreign investor and are still subject to approval for restricted industries and not permitted in prohibited industries.

© 2021 Mercer LLC. All rights reserved.

industry ecosystem.[23] Given the current difficult local fundraising environment, we observe that more managers who have traditionally managed only RMB funds are also tapping offshore investors to raise USD funds.

USD fundraising has stayed more modest at an average of $26 billion (2016–2019) before declining to $18 billion in 2020. In 2020, 22 large funds accounted for roughly half of total fundraising, as investors flocked to managers with an established local name during a time of uncertainty. Nevertheless, 45 medium-sized funds account for a quarter of fundraising.[24] This shows that though proven funds are receiving capital and raising larger funds, there continues to be a good pipeline of new platforms through corporate or team spin-outs.

Figure 6. China PE/VC investment and fundraising



Source: AVCJ database (as of April 2021).

Exits

In 2020, market turbulence and COVID-19 curtailed exits, leaving the number near a 10-year low. Divestments fell 52% as managers waited for better times to sell portfolio companies and paid more attention to portfolio management. Although the numbers have recovered in H1 2021, it is likely to slow down in H2 2021 given regulatory uncertainty for overseas listings (see Figure 7).

[23] On August 30, 2021, CSRC announced that it plans to stop “fake” private equity funds that are actually sold to the general public instead of targeted investors and crack down on money managers that illicitly take public deposits, offer loans or embezzle fund assets.

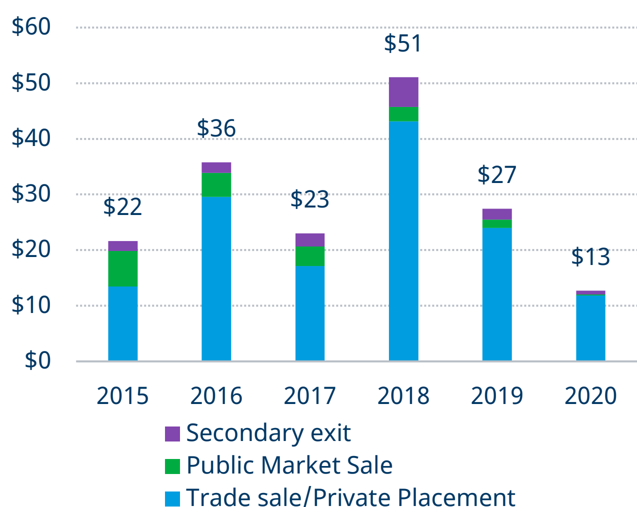
[24] Large fund = fund size >$1.5 billion; medium-sized fund = fund size between $0.5 billion and $1.5 billion

© 2021 Mercer LLC. All rights reserved.

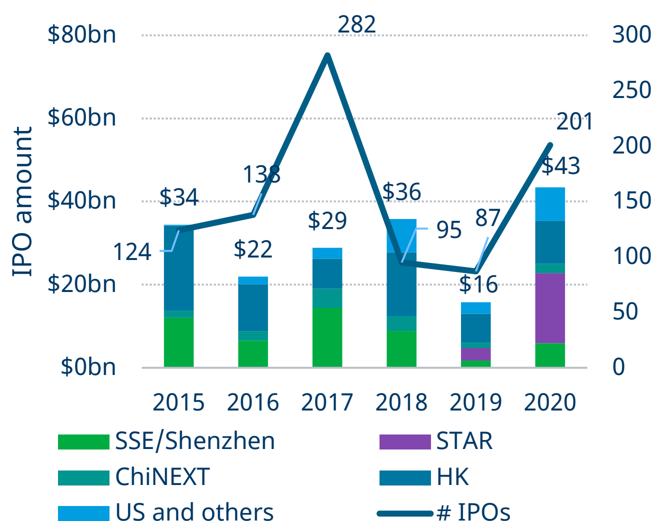
In China, around 90% of exits are dependent on public market sales or private placement post IPO. There has been limited secondary or strategic trade sales as seen in the US and Europe. With a number of financial market reforms that widened the exit channels for high-growth companies, the number of PE-backed IPOs increased significantly in 2020. The STAR board in Shanghai launched in 2019, and the ChiNEXT board in Shenzhen accounted for 56% of the total number of IPOs in 2020. The launch of the Hang Seng biotech index in Hong Kong to allow listing of pre-revenue biotech firms also made Hong Kong the world's second-largest funding hub for biotech after NASDAQ. Going forward, given the ongoing geopolitical tensions, we expect more companies will choose to list through mainland China or Hong Kong exchanges, which China's government is actively encouraging.

Figure 7. China PE/VC exits

China PE/VC exits



PE/VC-backed China IPOs



Source: AVCJ database (as of April 2021)

Conclusion and implementation plan

China PE/VC is a growing asset class that offers diverse opportunities with attractive returns. Mercer believes that private equity portfolios would benefit from allocations to China PE/VC. China PE/VC allocations also complement Chinese public equity allocations in pursuit of broad exposure to China's growth drivers at the total portfolio level.

Given the challenges, a successful investment into China PE/VC requires the same structured and disciplined process as a successful global PE program. To ensure that investors get the full diversification benefit, a consistent, long-term approach to China PE/VC will be better than ad hoc investments. It is therefore important for investors to follow the steps of setting objectives, developing an investment policy, running a cashflow analysis, constructing a portfolio plan, and conducting commercial, operational and legal due diligence.

© 2021 Mercer LLC. All rights reserved.

The most appropriate structure for capturing China PE/VC exposure will depend on investor circumstances. For investors with a limited number of allocations, China exposure could be obtained via pan-Asian funds or a few high-quality China-focused funds. For investors with higher governance budgets, China exposure could be implemented through a dedicated discretionary or non-discretionary China or Asia Separately Managed Account (SMA), in which China would typically account for around 50% of an Asia portfolio.

Mercer has been researching and investing in China for many years. We have a global PE platform with a local Asia PE team that has built strong relationships with key market players with strong track records. The team works with clients across advisory, SMAs and commingled fund of funds, with a flexible governance structure. Reach out to your Mercer contact to further discuss how these options can be customized to fit your investment program.

Mei Ni Yang, CFA
Head of Asia/Pacific Private Equity, Mercer Alternatives

© 2021 Mercer LLC. All rights reserved.

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.
© 2021 Mercer LLC. All rights reserved.
This content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.
Funds of private capital funds are available to sophisticated investors only who are accredited investors and qualified purchasers. Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There may be restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a private placement memorandum (PPM).
This presentation is for sophisticated investors only who are accredited investors or qualified purchasers.
Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.
This does not constitute an offer to purchase or sell any securities.
For Mercer's conflict of interest disclosures, contact your Mercer representative or see
www.mercer.com/conflictsofinterest.
This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary, and actual results may differ materially.
Information contained herein may have been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.
Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.
Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, North Carolina, Oklahoma and Pennsylvania; as "Mercer Investments LLC (Delaware) in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and as "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments LLC is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser.
Mercer Investments' Form ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.
Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.
Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited and Mercer Limited.
Mercer Global Investments Europe Limited and Mercer Limited are regulated by the Central Bank of Ireland under the European Union (Markets in Financial Instruments) Regulation 2017, as an investment firm. Registered officer: Charlotte House, Charlemont Street, Dublin 2, Ireland. Registered in Ireland No. 416688. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.
Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited.
Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.

September 2021

Mercer
A business of Marsh McLennan