Post-investment Management in Chinese Private Equity Funds
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1. Background of the strategic study and its current situations

1.1 Background of Study
The origin of Private Equity (PE) can be traced back to the Industrial Revolution but the genuine private equity of today was developed after the advent of two venture capital companies in 1946: The American Research and Development Corporation (ARDC) and J.H. Whitney & Company.

Owing to the short time period of development, private equity in China is comparatively a young business venture and it faces two distinctive problems. Firstly, the interactions between the private equity company (the investor) and the start-up company (the investee) are inadequate and limited. This invariably leads to the investee start-up company’s under-utilization of the expertise and value of the investor company. Secondly, a more conspicuous feature is the homogeneity of the private equity company’s investment pattern. Driven by the objective of quick profit, the private equity company habitually neglects and overlooks the value of its role of not only as a simple provider of capital funding but also to interact with the investee company in providing professional consultancy and assistance on management and various other post-investment services to further enhance the value and the investment return.

This study will first systemize the various research results both from Chinese and foreign researchers to compare the development of private equity in China and abroad. It will then analyze the various problems facing China’s private equity funds and uncover the importance of post-investment management. It will further incorporate the various successful case studies of Chinese and foreign private equity to derive at the appropriate post-investment management plan.

Through these post-investment case studies and analysis of the operations of post-investment management operations, i.e., the pre-investment due diligence investigation would have a ‘diagnostic’ effect, the post-investment management control of the investee company as an actual “remedial action” implemented by the investor. This will further the positive interaction of the venture capital company with the investee company to enhance the margin of profitability, growth potential and shaping the competitive prowess for the investee company to continually strengthen its corporate value.

The significance of this study is that by investigating the theories and operations
of venture capital investments and analyzing the current situation of the private equity industry, a more conclusive and appropriate post-investment management method could be configured to provide a reference and experience for the development of venture and risk capital investments in China.

1.2 Current researches from home and abroad

1.2.1 Current researches from abroad

The in-depth study on venture capital investments took place much earlier from abroad. The studies and researches were often conducted by the questionnaire method and statistical surveys. In accessing the interaction between venture capital companies and their corresponding portfolio companies, the following points are noted:

The research by Fried and Hisrich (1995) demonstrated a representative view that apart from providing the necessary capital funding, the venture capitalist also participates and monitors in the provision of social interaction networks, moral supports, commercial expertise and industrial regulatory guidelines. All these would have a direct impact on the portfolio investee company’s performance. The study also opined that venture capital investors should have an executive seat on the board of directors in order to co-create a better investment efficacy. Gorman and Sahlman’s study (1989), based on the investment activity of 49 responding venture capitalists, showed the results as follows (in the order of importance by the investment entities):

1. Set up investment teams to help the investee enterprises to raise additional funds
2. Participate in the management team
3. Review and audit in order to help in the formulation of business strategies
4. To contribute and assist in the setting up of feasibility plans.
5. To assist in the bringing in of potential customers

In the event of additional input of capital or funding, or that the management team of the investee enterprises reveal technical deficiencies, the involvement in participation by the venture capitalist would be further intensified.

1.2.2 Current researches in China

Current Chinese researches and studies on private equity funding invariably focus on the practical aspects and operational principles with scant regard toward the development process and exploration of certain pertinent questions on private equity. These studies lack a systematic and overall view toward the subject concerned. There are at present two leading new books on the subject of private equity funding. One is by Li Bin, Feng Bing et al, entitled Private
Equity Funding-The Chinese Opportunity published in June 2007. This book is a practical and pragmatic attempt to discuss the opportunities arising as a result of the China International Private Equity Forum held in Tianjin, the basic principles and operations of private equity funding and some of its successful case studies. Two thirds of its contents focus its discussion on the case studies of listing, finance raising and the laws of mergers and acquisitions. It lacks depth in the theoretical researches and also weak in policy guidance. Another book co-written by the Wang Yanan Economical Research Institute of Xiamen University, the Chinese Capital Market Research Centre of the Singapore Management University together with Power Capital Co., Ltd, published in August 2007 entitled A Report on the Research on China’s Private Equity Funds focuses mainly on the theoretical aspect of research. Some of its contents are repetitive and lacks a systematic approach in the research.

Overall, the study and research on Chinese private equity fund mainly focuses on the discussion of the conceptual framework and hardly touching on the realm of post-investment management. With the continuing progress and growth of the private equity industry, the future success of private equity in China will hinge on its ability to provide added value to the investee enterprises. How to adopt a valid and effective post-investment management procedure has become an imminent and urgent problem to be resolved.

2. A comparative study on the development of Private Equity in China and abroad

2.1 Private Equity in the United States
The United States is the earliest country to establish a system for private equity and is also the most matured country in this field. From the development history of US private equity, we are able to notice that the US government’s involvement in private equity has transformed from direct involvement slowly turning to the role of leading and guiding the development and eventually changed into that of an innovator in creating and nurturing to provide favorable opportunities for the PE environment.

The main type of US private equity is in the form of limited partnerships. It consists of independent private equity fund companies, private equity companies affiliated to financial institutions, private equity companies affiliated to industrial enterprises, and independent small investment companies. Of the four categories, independent private equity fund companies are the norm in the realm of US Private Equity.

After a period of more than half a century, the US Private Equity Fund has
developed into a comparatively well structured and scientific operating industry. Its main characteristics are:

1. Its share capital came mainly from funds raised from large institutional investors with pension funds constituting its main source of capital funding followed by endowment funds, banks, and insurance institutions.
2. It is the largest group of private equity funds in the world.
3. It focuses itself more in pioneering industries.
4. Geographical areas of investments are more centralized.
5. Investments are mainly aimed at the investee company’s growth and expansion stage.
6. Exit mechanism is mainly through the sale of shares in NASDAQ.

The US Private Equity Funds function within a self-regulatory framework in the supervision of its operations. This mode of operation creates ample development potential for the industry. The US Securities Act provides only the following regulations: If a private equity fund raise its capital funds through the private sector, it could be exempted from the registration requirements of SEC, other registration requirements remain unchanged. The US National Venture Capital Association (NVCA) was formed to supervise this self-regulatory framework and has a membership of over 300 Private Equity Fund management companies. The NVCA provides its members with professional market data statistics and conducts timely regular market researches. This is playing an important role in the development of US Private Equity.

2.2 The development of China’s private equity funds

Following its rapid development in the Chinese market, the investment magnitude of private equity funds has grown. According to the statistical data provided by CVSource, in 2013, there were 325 commitments of Private Equity Funding in China with a total investment value of 21.59 billion US dollars. Compared to that of 2012 (with 296 commitments of investments and a total investment value of 22.401 billion US dollars), the increase in the number of investments was 9.8% with a decrease in investment value of 3.6% and average individual investment value has decreased by 12.2%.

The activities in the Chinese private equity market were on the decline since 2011. The 2012-2013 private equity investments remained at a low level. Although the number of individual investments was rising at a small scale, the total scale of investment and average individual investment value were sliding downwards. The future of investment is still not optimistic.
According to the data provided by CVSource, there were 11 Private Equity investments in December with a total investment value of 683 million US dollars. The total number of individual investments and total investment values has both shown a decline compared to that of the previous month. After an abrupt rapid development in the last three years, the Chinese venture capital and private equity industry have gone into an unprecedented adjustment period. In both of the venture capital and private equity sector, the value of funds raised and the value of investments are experiencing a notable decline compared to that of the previous year. In the first half of 2013, the trade value and trade volume have both descended to the level at the beginning of 2009. Following the rationale of ‘business appraisals + post-investment added value’ concept to adjust the modus operandi of investments, new VC and PE profitability models are emerging. Post-investment management would become a competitive force for these investment funds.

3 The investment process flowchart of the Chinese private equity industry and the problems it encounters.
3.1 The investment deals flowchart of Chinese private equity

Viewing from the standpoint of project time-scale in general, the post-investment management period requires the longest duration in the whole of the risk-investment deal.

Viewing from the standpoint of importance, the success or failure of the post-investment management would have a strong impact on the performance of the investee enterprise. The investor’s ability to provide value added services to the investee is now an important factor in distinguishing the investor from other investment entities.

3.2 The problems encountered by the developing Chinese private equity

3.2.1 The range of selection of investment deals is usually narrow and restricted.

The venture capital industry in China is experiencing a roller coaster ride of rapid ups and downs. Other than the late starting of these industries, the investment selection strategies of the various venture capital investment entities is often narrow and restricted and is the main reason that hindered the industry’s further development. A lot of investment entities have their funds piled up and not properly utilized and investment mainly made in the expansion stage of the investee enterprises. This has created an unreasonable condition with a skewed development scenario raising the cost of investment.

3.2.2 Inadequate interactions between venture capitalists and investee enterprises.

Through shareholdings, venture capitals may enter the investee enterprises’ management to administer some form of supervisory and professional guiding role.
Owing to the investments being usually made at the middle and later stages, the venture capitalist should take a holistic view of the investment mechanism to concentrate more on the interaction with the investee enterprise to assist in expediting growth under appropriate strategies and earn its investment return from this. But, under the current environment of profit oriented drive, this model of investment is difficult to achieve. It can be said that to the investee enterprises which are at the expansion stage or even the profit stage, the venture capitalist is only playing a role of just another avenue of finance fund raising besides the other conventional financial institutions.

3.2.3 The trend of exit routes
Following the continuing readjustment of the secondary market in 2011, the returns made by exits through IPOs continued to plummet. In the first half of the year 2012, there were 75 exits through IPOs and 68 were in the domestic Mainland-China market. Those from the GEM board reported an average exit return of 3.46 times, those from the SME board, 3.52 times, but the average exit return from those of the main board was only 2.48 times. Compared to the exits from overseas, there were five exits in the Main Board in Hong Kong with an average return of 0.93 times. Taking into account the venture capitalists’ other cost of operation in the deal and deducting the investment costs, the net return on investment is comparatively low.

As at November 2013, venture capital and private equity exits at a multitude of ways. Of which, the proportion through mergers and acquisition was 32% and became the leading mode of exit. Other than this, equity transfers, management buyouts, IPOs and buy-backs also became important exit mechanisms.

4 Suggestions for Private Equity post-investment management strategies in China.

4.1 The possible difficulties at various stages facing start-up enterprises and the investor’s countermeasures to deal with them:

<table>
<thead>
<tr>
<th>Stage</th>
<th>Possible difficulties</th>
<th>Investor’s countermeasures</th>
</tr>
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<tbody>
<tr>
<td>Seed Stage</td>
<td>Inadequacy of management, pressure in product development, high risk in capitals.</td>
<td>To assist the investee in finding efficient managers and reorganize the management team. Seek expert help in product development and lower the risk in capitals.</td>
</tr>
<tr>
<td>Start-up Stage</td>
<td>Control on working capital</td>
<td>Financial control and advice on</td>
</tr>
</tbody>
</table>
(too fast and too high consumption), low acceptance of product in market. Slow in floatation or inappropriate timing of listing. investee’s finance operations and utilization. Assist the investee to liaise with downstream enterprises, lead the investee in product R&D and its marketing process.

<table>
<thead>
<tr>
<th>Growth Stage</th>
<th>Management unable to attract skilled managers; requirement of further working capital.</th>
<th>Optimize the work force remunerations and other incentive schemes; assist in the new phase of fund raising.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expansion Stage</td>
<td>Declining competitive advantages; heavier burden on working capital.</td>
<td>Utilizing mergers and acquisitions to extend product lines, increase competitiveness, help in improving the financial structure.</td>
</tr>
<tr>
<td>Mature Stage</td>
<td>Slow reaction time towards external market environment.</td>
<td>Instigate performance appraisal indicators to control the investee’s capability for quick reactions.</td>
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The investor should provide corresponding value added services in different areas of the investee. In the field of finance the investor could assist in helping to find other joint investment partners, helping the investee to procure further funding, and helping the investee to apply for loans from financial institutions. In the area of financial management, the investor could help to improve the financial system, financial diagnosis and financial control and supervision. In human resources, the investor could help in the recommendation of skill managers and to setup the management team, assist in the setting up of proper remuneration and share incentive schemes. In the field of marketing and sales, help the investee to analyze the current development of market trends, assist in product positioning, product marketing plan and appraise and evaluate the marketing plan. In the area of business operations, the investor could participate at board level, formulate critical policies, setting up operating strategies, supervising the operational performances and providing consultancy services on internal control systems. On top of this, the investor could also provide, in the field of production and technology, to facilitate technical cooperation or technology transfers, help in procuring technological patents, copy rights, and help in the planning of investee’s production schemes. In the process of IPO, help in selecting the appropriate equity underwriting institutions and assist the investee in selecting the most appropriate listing location and timing of floatation. Further to these, the investor could also introduce prospective and promising potential suppliers or customers and seek suitable strategic partners to deal with the investee’s crisis management.
4.2 Value added services provided by Private Equity

Private equity, when providing in an all round manner to create value added services to the investee, could approach the objective in four aspects: investee enterprise governance, business development, funding operations and resources management. In the liaison and interaction between the venture capitalist and the investee enterprise, only through the mutual close coordination, cooperation and rectification with each other, would achieve the eventual objective of the investment other than a mere provider of funds. This would then also help to increase the added value of the investee enterprise, coordinating different investment strategies and operation tactics in different challenges and to emanate the investor’s own intrinsic value and competitive edge in this competing industry.

5 Conclusion and reflection
5.1 Conclusion of this study

Following the issue of the paper entitled ‘Comments Concerning Further Promoting the Reform of New Stock Issuance System’ by the China Securities Regulatory Commission, venture capital and private equity are supposed to have entered a favorable period. The reform of venture capital and private equity poses an even higher challenge. It is imperative to do well in post-investment management. Only with this can the long term proliferation of VC and PE be established and reflected in the capital market. In future, PE investors’ post-investment management and value added services would be the core in the industry’s continuous profitability.

Value added services provided in pioneering enterprise investments would be the most influential move affecting the successful operations performance of the investee enterprises. The provision of support in strategic operations, human resources management, and post-investment fund raising would immensely affect the pioneering enterprises’ development performance. Support in good network of resources would have a vastly positive influence on the competitiveness of the investee but would not affect much of the potential performance. Production operations support would not have much influence on the growth performance of the pioneering enterprise.

In summary, for private equity to accomplish good post-investment management, it must fully bring forth its edge over others to provide relevant value added services to the deals. Key emphasis should be in areas of development strategies, mergers and acquisition coordination, perfecting the product chain, integration of team efforts, listing and floatation planning and coordination of intermediaries. Particular strategical emphasis should also be that of an advisory and guiding role rather than involving too much and too deeply into the day to day operations. This may inadvertently reverse the management roles and may develop dependence from the investee organization. The important role here is only to place effort to remedy the deficiencies in the investee and not to run the operation for the investee enterprise. The investor should involve at board level to participate in the investee’s strategic planning to protect and guard its future development and growth.

5.2 Related reflections

In view of the future development trends following the intensification of economical innovations, there will emerge in the market new industries which place more importance in the field of intellectual property and value of market potential. Investment enterprises which understand the Chinese macroeconomic market, knowing development and growth economics, possess professional expertise in the relevant fields, will invariably help the rapid growth and
development of the investee enterprises. The investor should then take the forward view of increasing the added value of investee by providing services and guidance in the provision of funds, financial control, human resources, technology and production, marketing and sales, business operating control, and IPOs. This will further promote and accelerate a positive effect and influence in the field of venture capital investments and the pioneering investee enterprises. This will also pave the way to demonstrate to other venture capitalists which are facing investment bottlenecks and provide them with a way to get out of the current predicament.

From an investment point of view the investors should proceed from a single-line cycle of investment towards an industrial-cycle concept of investment i.e. venture capitalists should move away from the current practice in a single-line cycle of merely seeking a deal, investment in deal, then exit deal to seek further deals, toward placing more importance in the continuation of the investment process in nurturing the deal and even to the nurturing of the industry.

From the governmental interactive point of view, this should act as a directional pointer for the industry to positively lead the different investors with different combination of resources to rationalize their investments and optimize the economy and industry structure. The venture capital investment firms should, other than acting as a catalyst to seek market potential, channel-in funds and technology, also be in a position to provide the government with views and industrial data and proofs to participate in the whole economic development and implementation of macro-economical strategies.

Chinese venture capital investment has its own distinctive characteristics in its macro-economical background with its unique investment culture. It can be foreseen that venture capital investments would play a more and more important role in the Chinese market. In the different realms of this economical niche, there will emerge more and more diverse and subdivided industries. Different industrial infrastructures would emanate their own industrial leaders. With the positive operations of these industrial leaders would arise different system of self-motivated and self-optimization mechanisms of operation. The new sectors of venture capital investments, with their domestic and localized specialties and characteristics, would further stimulate the economical development. As a whole, they would accelerate the progress impetus of the industry and provide a new force to be reckoned with.

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[36] Li Changyi: ‘A Comment and Study on Venture Capital Value Added Services’, Economic Perspectives, 2005 (06)