ALTERNATIVES MARKET RESEARCH

China Venture Capital Market and Exit Environment

Originally appeared in the Wilshire Private Markets Quarterly Newsletter Q2 2021

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Spotlight on China Venture Capital

The China venture capital (VC) industry has drawn significant attention from international investors since it began to take off in the early 2010s. However, a lack of exit has remained a key concern since those early days, and today, the recent regulatory actions in the region remind investors of the geopolitical risk inherent to China. Yet, with proper management, Wilshire observes the return potential in China to be tremendous and the diversification benefits real, as the exit environment for China VC funds has significantly improved in recent years. With China's venture and technology ecosystem reaching a mature stage of development, the world has witnessed the rise of many disruptive and transformational Chinese technology juggernauts (e.g., Tencent, Alibaba, ByteDance, etc.); many of which are now market leaders in their respective industries and have developed sophisticated business models that cater to the needs of Chinese consumers. As such success stories in China continue, so does the increasing appetite from both public and private market investors toward Chinese technology and new economy companies. Adding to the appeal of the China VC market are the recent public market reforms in China and Hong Kong that are expected to significantly broaden the exit paths for China VC funds. In this article, we focus on these recent public market reforms that have brought positive developments to China's VC ecosystem. We will also discuss the newly emerged risks of China VC and Wilshire's investment approach in the ever-evolving Chinese VC market.

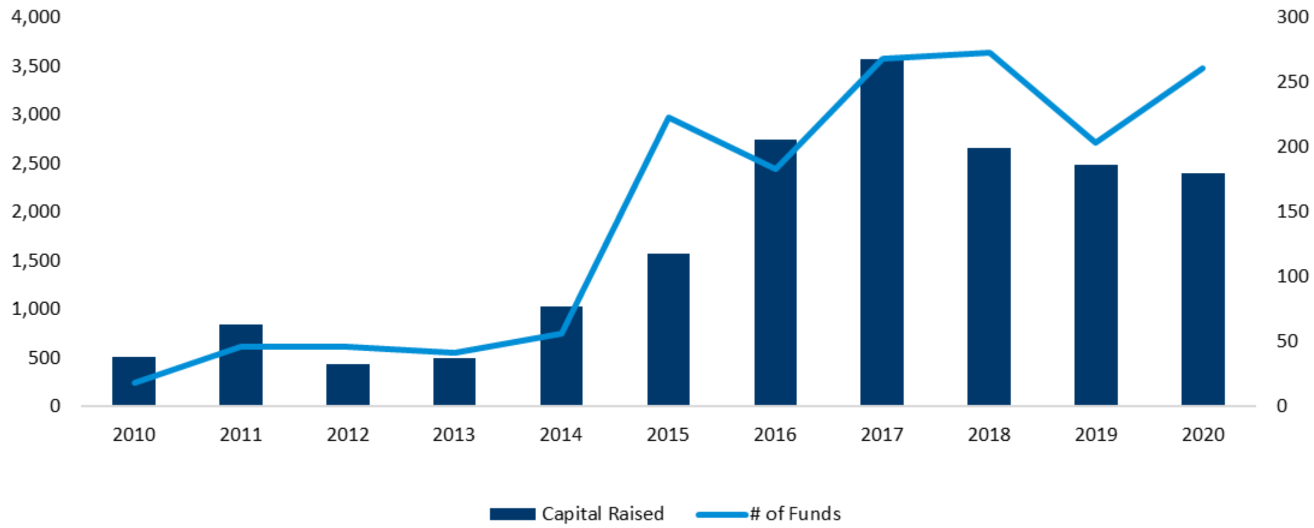
China's Maturing Venture Ecosystem

China VC is attractive and well-positioned in today's post-COVID-19 environment. Notably, China's GDP growth rebounded strongly from a negative 6.8% in the first quarter of 2020, during the height of the pandemic, to a positive 3.2% in the second quarter and continued the uptrend through the rest of the year, with full-year GDP growth of 2.3%[1]. China is the only major economy that reported positive growth in 2020, with GDP growth expected to be 8.4% in FY2021, surpassing most other major economies.[2]

Given the favorable factors of continuous technology advancement, strong entrepreneurial spirit, fast adoption of new technology, and being one large unified market, the China VC market has started to draw increased attention from both domestic and international investors, accompanied by a gradual increase in fundraising activities, particularly after the penetration of mobile-internet, a key enabler, reached critical mass in the early-2010s (Exhibit 1). As shown in Exhibits 2 and 3, China's private markets fundraising breakdown by strategy demonstrates early-stage VC is one of the overarching strategies that contributes more than 45% of total fundraising by fund count and more than 25% of capital raised for China private markets in 2020.

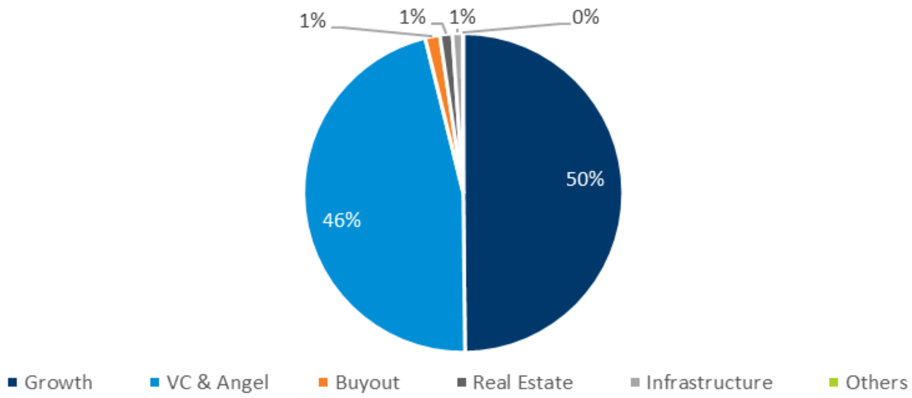
[1] National Bureau of Statistics of China
[2] IMF World Economic Outlook, April 2021

Exhibit 1 –China Private Markets Fundraising by Year



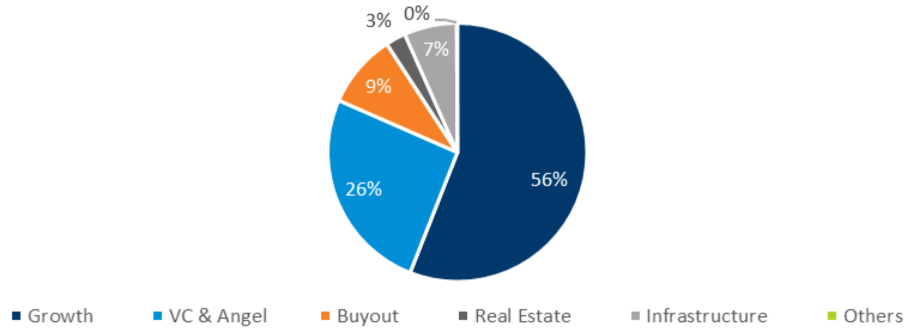
Source: Zero2IPO, March 2021.

Exhibit 2 – 2020 China Private Markets Fundraising by Number of Funds



Source: Zero2IPO, March 2021.

Exhibit 3 – 2020 China Private Markets Fundraising by Capital Raised



As China's technology ecosystem has evolved over the years, it has nurtured numerous publicly listed technology giants (e.g., Baidu, Alibaba, Tencent, JD.com etc.), privately held mega-unicorns (valuation above $10 billion, e.g., ByteDance) and unicorns (valuation above $1 billion, e.g., Guoquan). According to Credit Suisse, China is currently the second largest source of unicorn companies with a total number of 112 unicorns and an aggregate valuation of $400 billion, accounting for 25% and 30% of global volume, respectively.3 Wilshire observes that these successful technology powerhouses have and will continue to be a valuable source of talent for both Chinese VC firms and startups. Further, these technology companies are playing an increasingly important role as an active participant in startup fundraising and a viable M&A exit option for China VC funds. On the manager side, Wilshire notes that there is an increasing sophistication in the VC manager universe in China. Particularly, there is a growing number of high-quality managers emerging focused on each stage of venture capital (early, mid and late-stage), with some covering the entire investment chain while others specialize in a specific stage or sector. As the VC ecosystem in China matures, the manager universe is changing from a market dominated by global VC managers to also include an increasing number of top-tier local players, along with a rising trend of sophisticated spin-out managers. These continuous developments help strengthen the China VC ecosystem.

IPO Market Reforms and China Venture Capital Exits

Public markets are the main exit route for China VC investments (Exhibit 4) and this path has broadened significantly since 2019. Exhibit 5 shows a clear uptrend of China VC-backed IPO exits, with a notable uptick in recent years (2019 – 2020). Despite certain regulatory challenges that arose in the second half of 2020 (discussed in the next section), this uptrend in IPO activity has continued to persist in 2021. Exhibit 6 illustrates the movement of share prices for the top 10 China VC-backed IPOs in 2020 (in terms of IPO fundraising amount) from the date of IPO through the second quarter of 2021. Most companies show healthy share price performance – reflecting the market's generally positive views toward China's new economy companies.

[3] Credit Suisse, May 2020

Exhibit 4 – 2020 Exit Path of China VC Investments

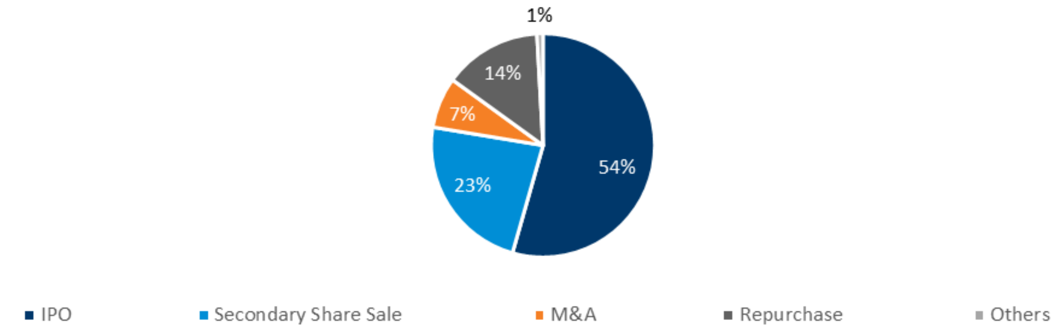


Exhibit 5 – China VC IPO Exit by Year

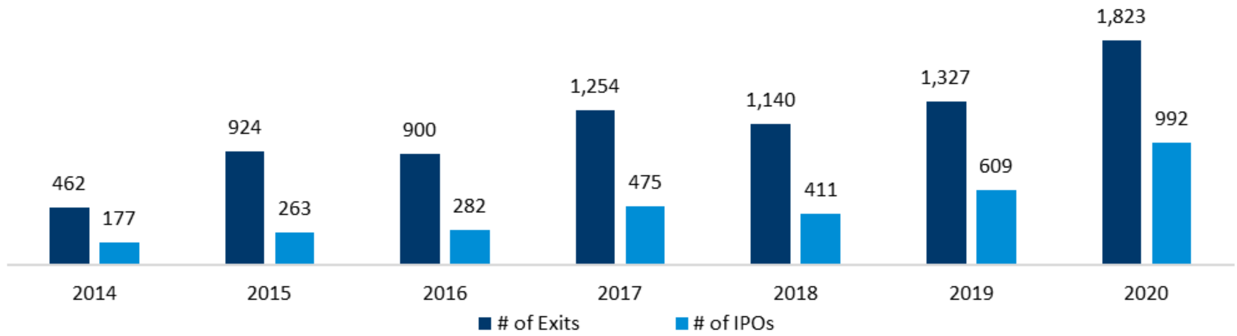


Exhibit 6 – Top 10 China VC-Backed IPOs in Fundraising Amount in 2020 and Post-IPO Share Price Performance

	Company	IPO Date	IPO Price	Stock Exchange	Price as of June 30, 2021	Price Change (%)
1	JD Health	Dec-20	94.5	HKSE	112.9	19%
2	KE Holdings	Jan-20	20.0	NYSE	47.7	139%
3	Xpeng	Aug-20	15.0	NYSE	44.4	196%
4	Li Auto	Jul-20	11.5	Nasdaq	34.9	203%
5	Qi An Xin Technology Group	Jul-20	56.1	STAR Board	92.3	65%
6	Cathay Biotech	Aug-20	133.5	STAR Board	104.9	(21%)
7	CanSino Biologics	Aug-20	209.7	STAR Board	412.6	97%
8	Junshi BioPharma	Jul-20	19.4	STAR Board	64.5	233%
9	Beijing Roborock Technology	Feb-20	271.1	STAR Board	1,261.0	365%
10	PerfectDiary	Nov-20	10.5	NYSE	9.4	(11%)

Apart from the maturing of the China VC ecosystem and companies, Wilshire notes that one of the key drivers for the significant improvement in IPO exits are the public market reforms in both mainland China and Hong Kong in recent years. Some of the key reforms include:

- In 2018, the Hong Kong Stock Exchange introduced a new Chapter 18A to the Main Board Listing Rules, which allowed the public listing of high growth but pre-revenue biotech and healthcare companies backed by sophisticated investors. The promulgation of Chapter 18A has significantly helped shorten the holding period and opened new exit paths for many Chinese VC-backed healthcare companies. Notably, six of the world's top 10 biotech IPOs were listed in Hong Kong in 2018, the year that Chapter 18A was officially in effect. In 2020, eight of the 13 China VC sponsored healthcare IPOs in Hong Kong were listed via Chapter 18A, including some reputable names such as Everest (1952.HK) (market-cap of HKD 19.2 billion), RemeGen (9995.HK) (market-cap of HKD 51.2 billion), among others.[4]
- In 2018, the Hong Kong Stock Exchange introduced a new listing regime for companies with a weighted voting rights structure, something previously prohibited in the Hong Kong public market. Since then, the new offering has turned the Hong Kong Stock Exchange into a viable option for offshore-structured Chinese technology companies and has also drawn interest from many high-profile foreign-listed Chinese technology companies to consider filing for IPO in Hong Kong. Some of the notable China VC-backed companies with weighted voting rights that listed in Hong Kong include Xiaomi (Market cap of HKD 692.3 billion), Meituan (Market cap of HKD 1.69 trillion), among others.[5]
- In 2019, the Shanghai Stock Exchange established the Science and Technology Innovation Board ("STAR Board"), the Nasdaq-equivalent public board, a pilot program for a registration-based IPO system. The establishment of STAR Board is part of the Chinese government's efforts to support technological innovation. The listing requirement for STAR Board is registration-based, as opposed to the traditional approval-based procedure for public listing in China. As a result, the listing process is much more efficient than the Main Board of the Shanghai Stock Exchange. Since its establishment, 70 companies with a total market cap of RMB 880 billion were listed on the STAR Board in 2020; that figure further increased to 215 companies and RMB 3.8 trillion total market-cap by the end of 2020.[6]
- In 2020, with the proven success of STAR Board, the Shenzhen Stock Exchange also launched the pilot program of a registration-based IPO system for its already established ChiNext Board (a Nasdaq-style board of the Shenzhen Stock Exchange).

Overall, these public market reforms have helped China VC-backed companies broaden their exit channels and gain access to the public capital markets more efficiently. Exhibit 7 shows the number of Chinese company IPOs (both VC-backed and non-VC-backed) in each of the major stock exchanges in 2020. Interestingly, there is an increasing trend of Chinese VC-backed companies filing for IPO in China and Hong Kong, which in turn indicates a reduced reliance on the U.S. public markets than previously existed. The geographical proximity of the domestic stock exchanges, as well as market familiarity, also contribute to broader market acceptance and greater investor appetite for these IPO companies.

[4] Market-cap as of July 20, 2021

[5] Market-cap as of July 20, 2021

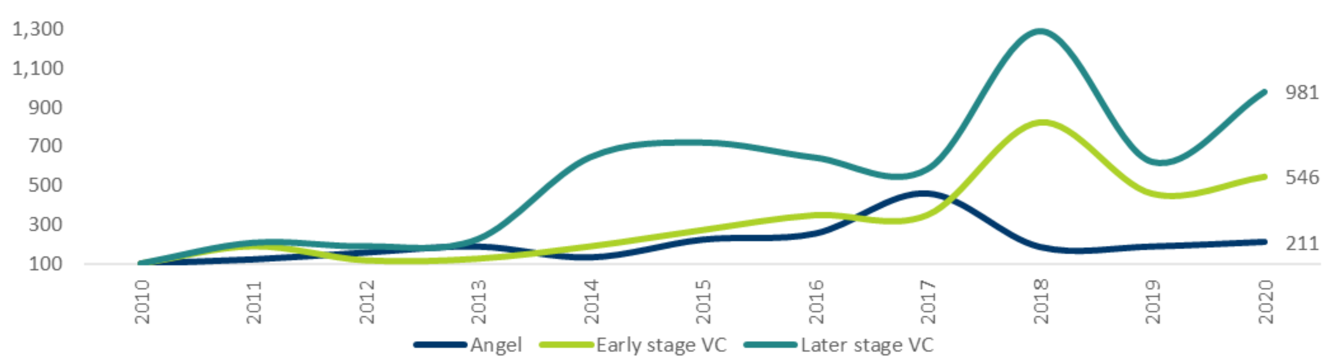
Exhibit 7 – 2020 Chinese Company IPO Exit Venues

Source: Zero2IPO, March 2021.

Newly Emerging Risks and Concerns

While positive and heated market sentiment toward China technology stocks continue, Wilshire has observed an increasingly competitive market that has significantly driven company valuations up in recent years. Exhibit 8 shows the uptick in valuations of the Asia-Pacific VC market, which is largely dominated by China VC activities. For late-stage VCs, there has been a significant influx of new players and many established growth capital and buyout managers have also expanded their coverage to late-stage VC investments. Together, this has resulted in an upsurge of late-stage VC activities in China and in turn, a spike in company valuations. The overcrowded late-stage VC markets and high valuations are deemed somewhat concerning in terms of sustainability. Although, in most cases, late-stage VC/pre-IPO investors have an investment protection clause to set the IPO valuation range no less than their entry valuation (or these late-stage VC / pre-IPO investors would put strong pressure on IPO investees valuation). Consequently, there has been an increasing number of cases of companies going public at unsustainable valuation prices and eventually experiencing a sharp drop in share price, below the IPO price or even below the pre-IPO round valuation soon after listing.

Exhibit 8 – Asia-Pacific Venture Capital Pre-Money Valuation Index (2010 = 100)



Source: Pitchbook, December 2020.

Beyond valuation risk, regulatory uncertainty in the China technology sector is a growing concern.

- In late 2020, Chinese regulators started to challenge the suitability of IPO candidates and the quality of information disclosure of IPO candidates that intended to get listed on the STAR Board. In April 2021, the Chinese regulator officially issued the revision of the STAR Board's listing guideline to reaffirm the STAR Board's focus on promoting the development of innovative deep-tech companies and re-emphasized the negative watchlist that restricts companies in the financial technology, real estate, and investment-related sectors to list on the STAR Board. One widely known case was JD Digital, which is the financial technology arm of JD.com, which eventually had to withdraw its IPO application from the STAR Board after the new listing guideline revision.

- In the second half of 2020, Chinese regulators started to target the leading technology platform companies with the investigation of illegal usage of customer data and market manipulations. Among which, Ant Financial Group is the most notable example that resulted in a last-minute IPO withdrawal, penalized with steep fines and thereafter forced into restructuring. More recently, Chinese regulators announced that they would be applying stricter supervision and a more stringent approval process for Chinese companies that plan to file for offshore public listings. Specifically focusing on the disclosure of sensitive data, national security concerns, insider trading, market manipulation, etc. The Chinese ride-hailing firm, Didi, was significantly impacted by this new rule and resulted in a substantial drop in share price soon after its debut IPO.

- Since 2018, the Chinese government has expressed concerns and warnings regarding the upsurge of the K-12 after school tutoring industry creating social inequality issues. Regulators took action in mid-2021 to crack down on the concerning growth of the online tutoring sector. Under the new regulations, all online K-12 curriculum related tutoring businesses must be in a non-profit business model in order to ensure all students have equal access to educational resources. A number of online tutoring companies have been directly and significantly impacted with their IPO plans being put on hold.

While these re-regulations (or rather, normalization of regulations from the previously relaxed regulatory interference) on China's technology and education sector (as well as what was previously witnessed in the P2P lending sector and healthcare reform, and potentially the gaming sector in the future) are largely focused on enhancing social responsibilities by removing the unfair competitive advantages from monopolies and improving social equality, they are considered reasonably in line with global market practices. Nonetheless, Wilshire is aware that the magnitude and frequency of these regulatory changes are getting higher in recent months, and believes this will bring short-term negative impact to the public and private market sentiments toward China's TMT sector.

Managers that have invested in late stage / pre-IPO rounds at significantly inflated valuations are also expected to be negatively impacted by such sentiments. However, we note that such regulatory changes are in line with the Chinese government's broader long-term economic development focus of shifting from quantity growth to quality growth. These changes are expected to be beneficial in the long run by creating a more levelled playing field that encourages improved competition and supports the continuous development of China's technology ecosystem. Wilshire highlights that these recent incidences demonstrate the importance of having a strong, local network, and a deep knowledge on China's macro trends and regulatory changes to effectively navigate the highly attractive yet complicated Chinese market.

Wilshire's Approach to China Venture Capital

Wilshire continues to be cautiously optimistic on the long-term development and compelling opportunity set in China VC, which has consistently generated attractive returns over an extended time horizon (Exhibit 9).

Exhibit 9 – Global Private Equity Long Term Performance

	Pooled Trailing Period Returns						
	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	Since Inception
US Private Equity	59.5%	24.7%	20.8%	16.6%	13.6%	11.5%	16.4%
- Venture Capital	87.0%	34.2%	23.9%	18.8%	14.3%	9.3%	17.3%
- Expansion Capital	66.4%	25.3%	20.2%	15.4%	12.5%	13.0%	15.7%
- Buyout	46.6%	19.5%	18.6%	15.5%	13.1%	12.7%	15.6%
Europe Private Equity	33.3%	17.8%	17.1%	14.7%	13.4%	13.4%	13.6%
- Venture Capital	52.1%	31.2%	21.1%	17.3%	12.0%	8.9%	9.4%
- Expansion Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A
- Buyout	31.6%	16.7%	16.8%	14.8%	13.6%	14.2%	14.1%
Asia Private Equity	48.9%	20.3%	18.5%	15.1%	15.2%	14.8%	14.0%
- Venture Capital	67.5%	29.9%	24.5%	21.3%	21.1%	19.9%	18.2%
- Expansion Capital	33.3%	13.5%	14.2%	12.8%	13.4%	13.8%	13.8%
- Buyout	26.6%	7.5%	10.7%	10.0%	10.5%	10.8%	10.2%

Source: Burgiss, June 2021.

In acknowledging China's current valuation risks and increased regulatory risks, we highlight the importance of staying disciplined with strong, local intelligence and deep insight into the market. In terms of investment strategy, Wilshire will continue to put emphasis on early-stage VCs in China given the attractive risk-return profile. Early-stage VC has a significantly higher entry barrier and requires specific industry insight and network to identify the new trends and opportunities ahead of others. As such, valuations of early-stage VC investments remain reasonable. In addition, Wilshire puts a strong emphasis on GPs' local network and knowledge, both on the insight of focused industry, as well as the understanding of China's regulatory system and macro development trend. Moreover, Wilshire only looks at VCs that employ a disciplined and cautious investment approach and prefers those that have gone through market cycles. These valuable experiences can help GPs gain a better understanding on how to respond when things don't go as planned. Lastly, Wilshire likes to invest with GPs that have experience in multiple exit channels and prefers those that put exit and distribution to paid-in capital (DPI) as one of their top focuses. Wilshire continues to monitor the development of the secondary market for trading old shares of VC-backed companies and encourages our portfolio GPs to consider the partial sale of old shares in their successful portfolio company prior to IPO to lock in profits.

Overall, although certain risks (e.g., current valuation and geopolitical risks) might be comparatively higher for VC in China / Asia than in the U.S. and Europe, these risks carry commensurate potential excess return. Further, from a portfolio construction standpoint, exposure to Asia, and particularly Asia VC, can provide solid diversification benefits to an investor's portfolio.

Important Information

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