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INSEAD – LGT Capital Partners Study

Private Equity Exits in China and India



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We would also like to thank AVCJ, whose database and insights provided the foundation for large parts of this report.

For further information on the INSEAD Global Private Equity Initiative, please visit **www.insead.edu/gpei**

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1 Executive Summary

This report takes a closer look at a crucial aspect of private equity (PE), namely the ability of PE firms to exit from their investments in a manner that crystallizes the value created over the period of their ownership. Specifically, it considers exits from private equity¹ investments in Asia's two largest emerging markets, China and India.

The aim is to increase the transparency of this asset class by providing an overview of the market and trends over time, highlighting differences between China and India, and delving deeper into a sample of detailed data provided by INSEAD's inaugural panel of limited partners (LPs).

The report highlights the large number of exits in both markets, we observed about 1250² in this study, and how the speed of established exits (IPOs, M&As) continues to accelerate, thereby boosting investor confidence in Asia's two largest emerging markets, and fuelling the growth of the asset class through fund raising and investing. We show a divergence between the exit channels favoured in China (IPOs) and India (M&As), and how this has impacted overall exit size, as well as the influence of public market cycles on exit timing.

As far as possible – given the limitations of a database relying on public data – we attempt to provide some indication of the broader performance of PE exits benchmarked against relevant public market indices. In both China and India we find a lower-than-expected correlation between PE returns and public market returns, pointing to company- and investment-specific factors as the main drivers of performance in these markets. This analysis is complemented with an in-depth look at realised vs. unrealised returns, drawing upon data from our LP panel.

The report serves as the baseline research for a study that will be updated on an annual basis in the future, offering private equity investors in China and India increasingly valuable insights into the development of a fast-changing asset class.

¹ Throughout the report we use a broad definition of private equity that includes venture capital.

² this refers to the number of PE invested companies from which an exit has occurred and not to the number of exits by PE funds which, given the prevalence of club deals and multiple investment rounds especially in venture capital and growth investing, would have been substantially higher. For a discussion of the difference between company perspective and fund perspective and the practical difficulties in creating a comprehensive data set for the latter please have a look at Chapter 3 "Study Design".

2 Introduction: The need for an exit study on Asian private equity

In recent years, investors have exhibited increasing interest in Asian private equity – more so in view of the region's fast rebound from the global financial crisis which continues to dog Western markets. In line with this, fund raising and investing activity have scaled up dramatically. With PE activity in Japan and Australia still slow, Asia's principal growth capital markets, China and India, are attracting most of the attention, accounting for the bulk of deal volume and fund raising in 2009 and 2010. Despite an increasing supply of domestic capital,³ international investors have their sights firmly set on emerging Asia, with China and India continuing to occupy top slots for investor interest in 2011.⁴

Behind this development are two trends. First, the institutionalisation of the asset class with a larger number of accessible good-quality managers with longer track records; second, improving returns. Indeed some of the biggest long-term investors in Asian PE are seeing returns approach or surpass expected risk-adjusted hurdles, and are mostly looking optimistically to the future.⁵

Yet beyond individual investor portfolios and a number of well-publicised “big wins” (exits returning large multiples of invested capital), there is little in the way of a comprehensive overview on the state of exits in Asian PE. By only focusing on headline-hitting returns without an in-depth understanding of the exit environment a very limited picture emerges of how PE performs. This is a result of the illiquid and non-transparent nature of this asset class which makes it markedly different from public equity. Long capital lock-ups for funds overall and long holding periods for individual deals mean that for extended periods a fund's main value lies in its unrealised investments. Intermediate valuations are calculated using a variety of methods – each with its own strengths and weaknesses – yet the major flaw from an investor perspective lies in the inconsistency of application by different managers (and even, in extreme cases, across investments in the same fund).

For investors in (developing) Asian PE it is even more difficult to cross check underlying value given the sometimes lower quality of reporting by GPs⁶ as well as the greater information asymmetry resulting from the type of investments prevalent in emerging Asia (i.e. minority investments, with no leverage and therefore no third-party documentation, fewer club deals). And while it is exactly this higher level of information asymmetry that provides opportunities for attractive returns and makes PE investing in China and India such an interesting long-term asset class, robust data are rarely available to the broader investor community.

Understanding the performance of Asian private equity as an asset class as well as the performance of individual managers relative to the market thus requires an in-depth look at exits and cash-on-cash returns to LPs. Beyond the initial question of to what extent their reported returns are in fact realised, there are a host of other topics worth exploring regarding the type and “quality” of exits, relationships between the type of investment, geography, holding periods and preferred exit channels over time, as well as the influence of public markets on exit “success”.

This paper attempts to enhance transparency for investors. By providing some benchmarking, we hope that it will contribute to better capital allocations, thereby mitigating some of the unavoidable exuberance of this fast-growing asset class, while remaining optimistic about the strong growth prospects of Asian Private Equity over the coming years.

³ In 2009/ 2010 RMB funds raised overtook USD funds in China in value and in number, see McKinsey (2011)

⁴ Preqin (2010)

⁵ See for more detail INSEAD Study by Prahla and Zeisberger (2010)

⁶ Sometimes made up for by greater informal information flow between GPs and some of their major LPs.

3 Study Design

The report draws mainly upon two data sources; data provided by the Asian Venture Capital Journal (AVCJ)⁷ and INSEAD's inaugural LP panel.⁸

AVCJ Database	INSEAD LP Panel
<ul style="list-style-type: none">• Strives to make available near complete market data• Database contains ~7,500 entries over the observed period, each of which represents either an investment round, a trade sale or an IPO• Good coverage of investments, IPOs and medium-to-large trade sales, yet only in rare cases covers write-offs, trade sales of lower value, and less 'plain vanilla' exit structures (e.g. puts or buybacks)• Reliance on public data introduces incomplete or not accurately disclosed transaction data (mainly relating to amounts and stakes) and makes estimation of investment success susceptible to error• Typically takes company perspective (i.e. investment rounds) vs. investor perspective (i.e. USD invested by individual GP)	<ul style="list-style-type: none">• Strives to create a representative sample of the market• Current database contains ~500 PE transactions in China and India in more than 50 funds• Not yet representative as it suffers from (relatively) small sample size and selection bias towards larger/well established GPs• Provides actual investment amounts and realisations as well as unrealised values (with the typical issues around intermediate valuations)• Rare and irregular reporting around timing of exit, including focus on first or final exit• Always takes investor (GP) perspective so that same company can feature in several funds (same round or different investment rounds) yet focus is on individual investments and their success

Figure 1. Overview of data sources employed for the study

We integrated both data sets as far as possible given the different focus and data collected, arriving at about 8,500 data entries representing either an investment round or an exit (typically a M&A transaction or an IPO). We then “cleaned” the database of a range of transactions that did not correspond to our (arguably narrow) definition of private equity. Not included are infrastructure and real estate transactions, cornerstone investments shortly before or upon IPO (e.g. the big four Chinese bank listings in Hong Kong), tiny investment stakes in rather large public companies reducing the investor to an entirely passive role, and transactions between related parties, as far as they could be uncovered (e.g. transactions between two related state-owned companies in China). This left about 6,850 data entries. Hence our data clearly differ from that of other published sources. In addition, different levels of data completeness reduce the data available for more specific analyses.

Furthermore, given the focus of the larger part of the database on “proper” exits there is an imbalance between investments reported and corresponding exits. This holds even if we assume that a large percentage of investments made during the latter part of the decade will still be held in portfolios. So in this paper we do what many practitioners in China and India are all too familiar with – we triangulate a problem for which only imperfect data exists from different sides. It is our goal to revisit this study annually, increasing its coverage both in breadth and depth. In breadth by potentially including other Asian geographies and by capturing an increasing part of the overall market data such as less typical exit structures and little-covered write-offs, and in depth by significantly expanding our LP panel to allow us to investigate other relevant questions for the investor community.

⁷ Asian Venture Capital Journal, www.avcj.com

⁸ INSEAD's LP panel consists of a group of LPs in Asian PE that share some of their fund data with INSEAD for research purposes. The goal is to increase transparency and enable evaluations of investment strategies with INSEAD as an academic institution performing the function of a neutral depository and research organisation. All data is kept strictly confidential and only used for publications in a highly aggregated and anonymised form. **If you are interested in participating in INSEAD's Asian LP panel, please contact the authors of the report.**

4 Exit environment in China and India

4.1 Overview

Based on an analysis of deal volume, the development of the PE markets in China and India can be divided into three phases:

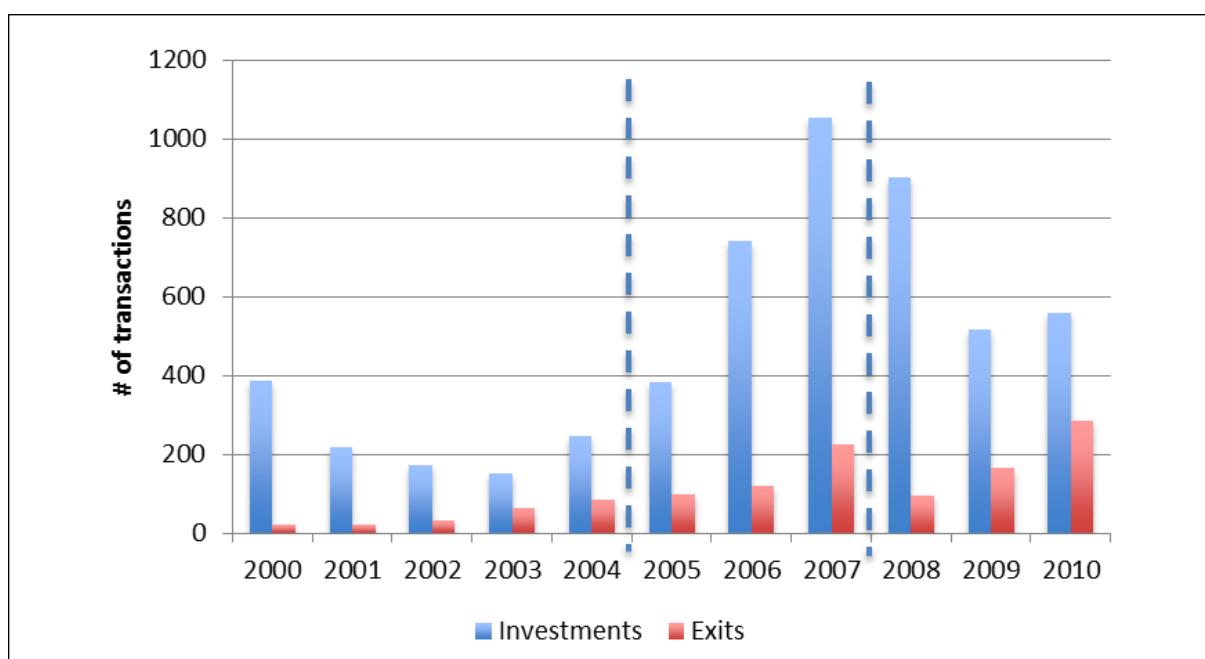


Figure 2. Investments and exits in China and India, 2000-2010

1. The “early days” (2000-2004): a phase characterized by:
 - a limited number of transactions (excluding the tail end of the tech bubble in 2000)
 - modest growth in investment, exit volume and deal size in both countries
 - longer (three years or more) investment cycles
 - M&A route typical exit format in both countries (and work-out of dotcom overhang).
2. The “boom years” (2005-2007): a phase where plenty of money entered the industry and deal activity grew exponentially year over year. During this phase we observed:
 - a sharp increase in the volume of transactions
 - steep growth in average PE investment size in China and India
 - shortening (less than 2.5 years) investment cycles
 - differentiation of exit routes, with a preference for IPOs in China and trade sales in India.
3. The “crisis and post-crisis days” (2008-2010): following the market collapse in 2008, investment activity slowed down substantially (though less so than in the West), exit markets closed briefly (again, less so than in the West) and funds had to spend more time managing existing investments. This phase is characterised by:
 - a ~50% investment volume drop in 2009 vs. 2007
 - recovery in exits to pre-crisis levels in both countries (by 2009 in China and 2010 in India)
 - continuing increase in the number of IPOs in China
 - With IPOs in China now open to smaller companies, average PE-backed public offerings become smaller than in the pre-crisis years.

As the industry grew, so did the interest of investors (LPs or limited partners).

While a small number of institutional investors had been active in Asian private equity in the early to mid-90s, there was little focus on China (after the Tiananmen Square incident) or India (with the economic liberalisation process only starting in 1991). Instead, investments centred on the tiger economies and South East Asia (Hong Kong, Taiwan, Korea, the Philippines, Thailand and Indonesia). Many of these early investors incurred heavy losses as a result of the Asian financial crisis of 1997/98, leading them (at least temporarily) to reduce their focus on the region.

However, by the early 2000s many larger institutional LPs had started to (re)establish a presence in Asia, extending the pool of capital available to the industry away from local financing sources, family enterprises and bank principal investment strategies. Yet, in a delicate balancing act between demand (GPs) and supply (LPs), asset allocations to China and India only started to grow substantially from 2004-2005 onwards.

Factors that made LPs more comfortable with investing in China and India included:

- overall strong economic growth and macroeconomic stability, providing a stream of investment opportunities
- increase in investment and fund size, providing for more meaningful allocations
- more experienced management teams (although still with shorter track records compared to their counterparts in developed markets)
- a first wave of exits (in some cases big wins), providing confirmation of the ability of funds to return money to investors.

Yet, in true entrepreneurial fashion, a lot of these earlier allocations were more driven by anecdotal evidence and a sense of wanting to participate in Asia's PE growth story rather than by hard economic facts. While these decisions mostly came to be justified in the ensuing years, it is only now – as a number of funds reach maturity and exits have become easier and profitable – that a better understanding of the fundamental attractiveness of the PE industry in China and India is possible.

Institutional investor market entry case study

LGT Capital Partners is a leading alternative assets and fund of funds manager with a strong focus on private equity and USD21bn in total commitments under management. While it started investing in Asia in 1999 it did so initially through global relationships and pan regional funds.

Post SARS, in 2003, real private equity ecosystems began to emerge in China and India. A fly-in, fly-out investment strategy no longer made sense as advantage increasingly shifted to local, domestic firms based in Asia's two largest emerging markets. By 2005, there was increasing evidence of proof of concept, as leading domestic firms had demonstrated an ability to return significant amounts of cash to LPs and serial entrepreneurs began to emerge in China and India. From a top down perspective, it was clear that the real opportunity was in emerging Asia. From a bottoms up perspective, there were well in excess of 1,500 PE firms in Asia and having a local presence was critical to performing diligence on managers and as well as on secondary and co-investment opportunities.

While the LGT Group had been present in Hong Kong since 1986, LGT Capital Partners began to build its Asian presence in 1999 and now has 18 people in Asia, based in Hong Kong and Japan, with a Beijing office scheduled to open in the second half of 2011. To date, LGT CP has committed close to USD1 billion in Asia, sits on twenty two PE fund advisory boards in the region and has closed nine secondary transactions in Asia since 2007.

Mini Case 1: Institutional LP entry into Asian PE

China

The strong rise of PE activity in China over the last decade is well documented.

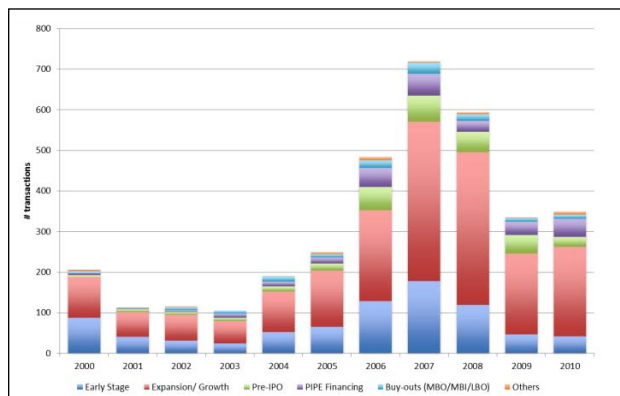


Figure 3. PE investments in China, 2000-2010

Starting from a low level of investment activity after the dot-com bubble of just over 100 transactions per year until 2003, by 2007 PE investments had surged almost seven fold to 719 reported deals.

This growth was driven by expansion/ growth capital⁹ as well as resurgence in early-stage investing, and complemented from mid-decade onwards by capital market-linked transactions such as pre-IPO investments and PIPEs.¹⁰ While control deals /buy-outs grew in number, they still do not play a major role in the PE ecosystem in China.

The global financial crisis halved PE investments in China and dramatically reduced early-stage activity. Total investment dropped from 719 to 335 deals in 2009, while early-stage deals dropped from 178 to a mere 42 in 2010, or only 12% of deals, the lowest ratio recorded in the last ten years.

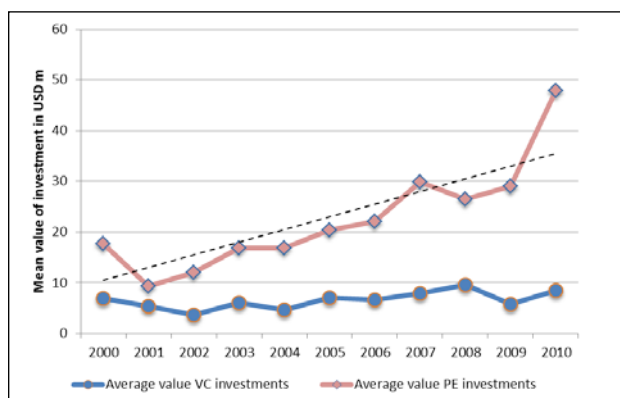


Figure 4. Average investment size in China, 2000-2010

Over the last decade, the average size of both early- and late-stage investments (all the above categories except early-stage) showed a clear growth trend.¹¹

Average investment size for venture capital (VC), stemming from the loftier valuations and larger investment rounds of 2000, hovered for a while around USD4-5 million before a growth spurt from 2005 onwards brought it up to USD9.6 million in 2008. Subsequently it dipped, but bounced back to USD8.5 million last year.

Late-stage investing, on the other hand, showed a consistent upward trend towards larger deal sizes. This was not only due to the growth within each investment type (e.g. average growth capital investment growing from ca. USD10 million in the early 2000s to about USD20 million by 2009 and surging to USD40 million last year) but also to an increased proportion of larger later stage transactions such as pre-IPO, PIPEs and control/buy-out deals. The latter, while still small in number, broke through the USD100 million average in 2007, and, after two slower intervening years, reached about USD120 million last year.

⁹ Expansion and growth investments include both venture capital investments and later stage investments

¹⁰ PIPE or private investment in public equities is often structured transactions (convertibles, different share class) in which the PE firm takes a minority position.

¹¹ Average deal size calculation is based on transactions with reported amount.

So while VC investments in China exhibit a strong volatility in numbers, the amount perceived to be required to get a venture off the ground seems to grow only moderately. Therefore later stage investing now clearly dominates the investing landscape both in terms of numbers and given the growing deal size, and even more so by USD invested.

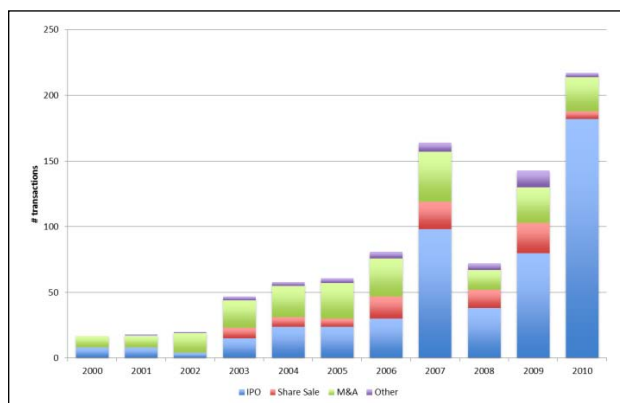


Figure 5. Exits in China, 2000-2010

Exits¹² for PE investments in China were limited until 2003. Between 2003 and 2005 exit activity rose steadily as exits from the first wave of investments were reported. It then surged, taking advantage of general bull market conditions, to reach a first peak in 2007. In that year 164 exits were reported – six and a half times as many as the average of 2000-2003. IPOs became the prevalent exit channel, constituting 60% of exits compared to 37% before 2007.

Exits were badly hit by the global financial crisis, with activity dropping to 72 deals in 2008, down 56% year on year. However, activity quickly resumed and in 2009 IPOs and trade sales were almost at pre-crisis levels, while 2010 saw a real “IPO boom” with 182 sponsor-backed IPOs reported (reaching an uncommonly high proportion of >80% of all PE exits).

Overall we counted 898 exits from PE invested companies in China over this period of which two thirds happened in the last four years. Observing the largest exits with PE involvement¹³ confirms the “late” arrival of large PE exits. With few exceptions, significant transactions took place only from 2006 onwards. Also noticeable is how the largest deals belong to the financial services industry.¹⁴

China M&A exits				China PE backed IPOs			
Shenzhen Development Bank	2200	2010		China Minsheng Banking	4010	2009	
Ping An Insurance	1040	2005		China Pacific Insurance	3100	2009	
Jushi Group	430	2010		China Merchants Bank	2415	2006	
Taobao.com/Tao Bao Holding	360	2005		Huatai Securities	2296	2010	
CGEN Digital Media Network	350	2007		Industrial Bank	2005	2007	
HNA Airport Holding (Group)	322	2010		Beijing Bank	1995	2007	
He Jian Technology	285	2009		SMIC	1803	2004	
Photonic Bridges	200	2006		Rongsheng Heavy Industries	1798	2010	
Foodstar Holdings	165	2010		Changsha Zoomlion	1680	2010	
Soufun Holdings	154	2006		Alibaba.com Corp.	1500	2007	

Figure 6. Largest PE Exits in China, 2000-2010

¹² We group exits into four categories, namely M&A (trade sale or financial investor), IPO, Share Placement and Other (which includes as the largest group Write-offs, but also Buy-backs and Puts back to seller or company).

¹³ For the largest transactions we looked at money raised for IPO which had PE investors as backers independent of whether and how much they sold on IPO. We did not include subsequent open market transactions in this list. Similarly, for M&A transactions we took the gross transaction value reported and did not split out how much accrued to the financial investor.

¹⁴ This holds even after we deliberately exclude the cornerstone investments in the big bank privatisations that have no shared characteristics with “regular” PE investments.

Looking at the development of average size of exit events, it is important to understand that funds raised in an IPO cannot be compared to the value of M&A transactions.¹⁵

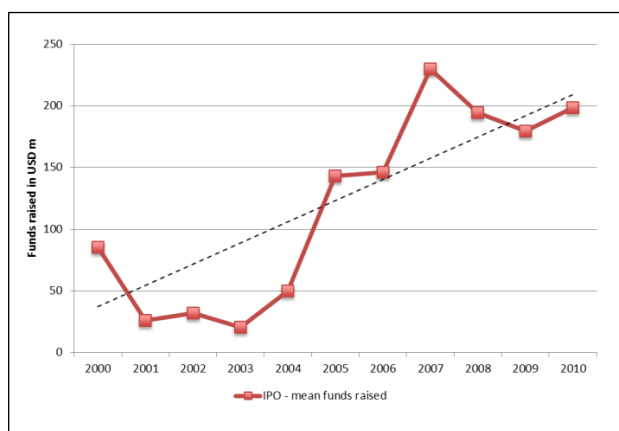


Figure 7. Mean size of funds raised in IPO China, 2000-2010

Growth capital with exit to HK IPO

In 2005, Morgan Stanley PE and CDH invested in Belle, a vertically integrated women's shoe retailer

Having only recently taken control of its distribution, the company grew to more than 4,000 outlets by the time of its IPO in 2007.

The company raised USD 1.1 billion in its float, making it the largest mainland China consumer company to go public in HK. The share price has since more than doubled leading to a >10x return for the PE investors.

Mini Case 2: IPO China

While IPOs were still small from 2001 to 2003, with an average of USD26 million raised, they grew tremendously over the next few years, with investees succeeding in raising on average USD230 million by 2007. This steep upward trend was subsequently moderated by the financial crisis, when public offering sizes shrank, and by the wider range of IPO options available with (smaller) mainland IPOs (Shanghai & Shenzhen) gaining share vs. (typically larger) Hong Kong and US IPOs.

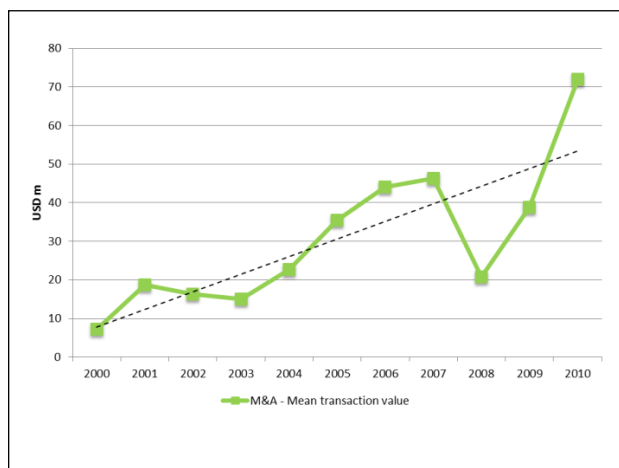


Figure 8. Average size of M&A exits in China, 2000-2010

Growth capital with exit to domestic trade buyer

In 2007, Hony Capital invested USD74.69 million for an 18.5% stake, in a mix of primary and secondary shares, in Jushi Group, a Chinese manufacturer and seller of glass fibre and related products. Between 2007 and 2010, Jushi internationalised aggressively boosted by Hony Capital's investment. Subsidiaries were founded in India, Singapore, Italy, Spain, France, Hong Kong, and South Africa.

In 2010, Shanghai-listed China Fiberglass entered an agreement to acquire 49% stake in Jushi from China National Building Material, Zhenshi Holding, Hony Capital and Surest Finance in exchange for shares. The total consideration was CNY 2.94bn which gives Hony's investment a book value of about USD164m.

Mini Case 3: Trade Sale China

Average size of M&A exits has (albeit from a far lower level) risen even faster (26% CAGR from 2000-2010). There were two jumbo transactions during this period, left out of the graph as it aims to show "typical" M&A exits (see Figure 6 for Shenzhen Development Bank and Ping An). Including them would have produced two peaks at USD78 million in 2005 and USD 170 million in 2010.

¹⁵ Exit sizes of IPOs and M&A cannot be compared. The former refers to the amounts raised by the IPO without allocating proceeds to company or PE investors and does not take any residual value of the shareholding into account, whereas the latter typically refers to the value of the transaction accrued to the investor. (Where it is instead linked to enterprise value we attempted to deduct any net debt position).

India

India was a smaller target for PE investment than China throughout the decade. From 2000 to 2010, about 1,900 investment deals in India were reported, compared to just less than 3,500 in China.

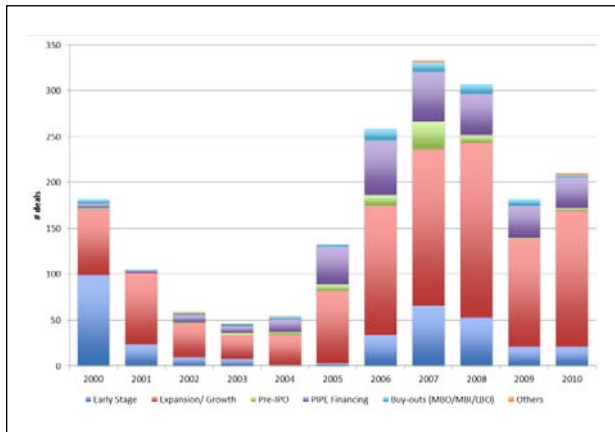


Figure 9. PE Investments in India, 2000-2010

PE investments in India started the decade broadly at the same level as China (287 investments in India in 2000 and 2001 vs. 319 in China). As in China, after a slump, PE investments soared from 2005 to 2007. Again, growth was driven mostly by a strong increase in growth capital deals as well as PIPE investments. The latter category is of far greater importance to Indian PE than to Chinese PE (and the only category where absolute numbers in India are larger than China). However, overall investment growth was less rapid than in China; investments in India in 2007 were 2.9 times the average 2001-2003 level, compared to 6.5 times in China.

On the other hand, the impact of the global financial crisis was slightly milder as the decline in investment between 2007 and 2009 was only 45%, vs. 56% in China, mainly due to resilience in the aforementioned categories. Early-stage activity declined roughly in the same proportion as in China, with R&D, start-up and seed capital investments representing 31% of deals in 2000-2003, but only 20% in 2007 and 10% in 2010.

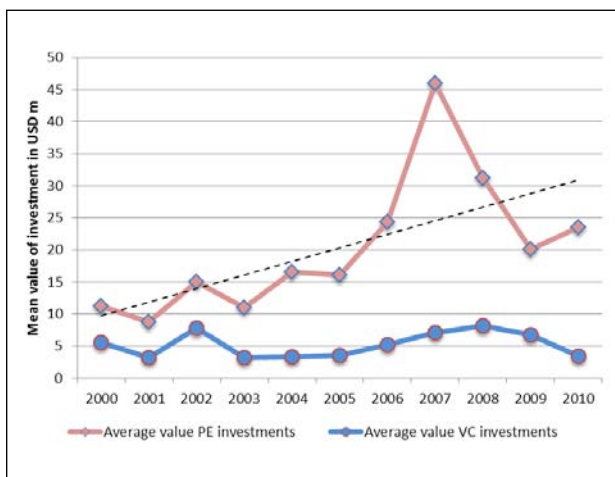


Figure 10. Average investment size in India, 2000-2010

As for developments in the size of investments, different trends can be observed. Unlike China, early-stage deals did not exhibit a clear growth pattern, oscillating for a long time around USD3 million before a short growth spurt, and subsequently falling to levels seen at the beginning of the decade.

PE investments were broadly comparable in size in China and India until 2006. However, investment size rose sharply, driven partly by PIPEs where valuations were typically linked to the then prevalent very high market prices. Accordingly, whereas deal size stalled in China, it dropped in line with public markets in India over the following two years, before a small increase in 2010.

Overall, PE deals in India have somewhat recovered without reaching the levels of 2006/07 or the exceptional size of investment seen in 2007.

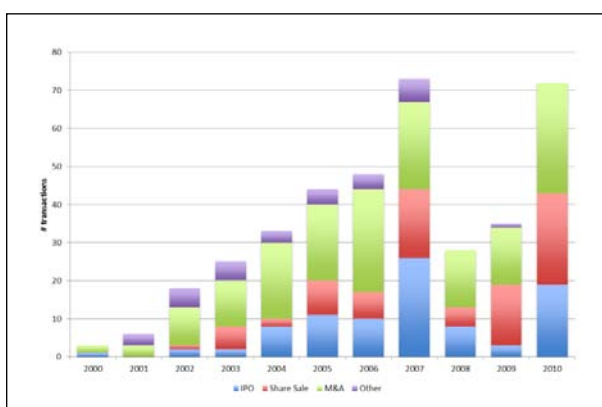


Figure 11. Exits in India, 2000-2010

Exits in India followed a broadly similar trend to China. Growth in exits was slightly smoother between 2002 and 2007, and then came to an even more dramatic halt as exits fell 62% between 2007 and 2008. As in China, activity resumed rather swiftly after the global financial crisis, and by 2010 had almost returned to peak levels.

Although IPOs increased in India over the period observed, overall they remain far less common than in China. Growing steadily since 2000, the percentage of exits via IPO reached 36% in India in 2007, compared to 60% in China in the same year. Also, while in China

IPOs continued after the global financial crisis, in India the trend towards more IPOs was interrupted: in 2009, only 9% of the reported exits were via IPO. Yet following on from the IPOs prior to the financial crisis and the frequent investment in public securities through PIPEs with recovering public markets, there has been a flurry of share sale activity.

Overall we counted 354 exits from PE invested companies in India over this ten year period. Similar to China, almost all major exit transactions belong to the second half of the decade. Yet unlike China, the most notable industries involved are telecommunications and (renewable) energy plays.¹⁶

India M&A exits			India PE backed IPOs		
Bharti TeleVentures	1486	2005	Reliance Petroleum	1807	2006
I-flex Solutions	593	2005	Genpact	568	2007
Mphasis BFL	367	2006	Idea Cellular	555	2007
IL&FS Investsmart	242	2008	Suzlon Energy	332	2005
Dabur Pharma	220	2005	SKS Microfinance	286	2010
Ambuja Cement India	200	2006	Orient Green Power	202	2010
Spice Communications	179	2006	Edelweiss Capital	174	2007
SpiceJet	158	2010	Bharti TeleVentures	174	2002
XCEL Telecom	136	2009	Punj Lloyd	144	2006
Trinethra	132	2006	Hathway Cable and Datacom	143	2010

Figure 12. Largest PE Exits India, 2000-2010

¹⁶ While we generally excluded pure infrastructure investments, we decided to retain Reliance Petroleum, a downstream player in the oil business, conscious that it is somewhat of an outlier in this data set.

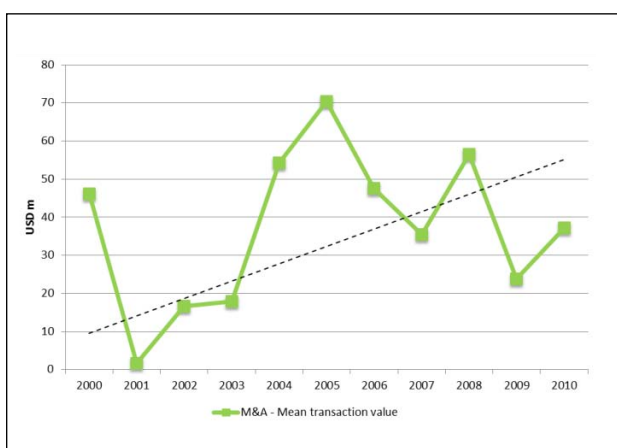


Figure 13. Average size of M&A exits in India, 2000-2010

Growth capital with exit to overseas trade buyer

In 2007, Q Investments invested Rs2 billion (≈USD50 million) to incubate XCEL Telecom, an Indian telecom tower operator.

XCEL Telecom went on to build about 1,700 telecom towers before being sold in 2009 to US-based American Tower for Rs7 billion.

This deal marked the first exit by a PE player in the telecom tower space, which has seen huge investments from PE funds in companies such as Bharti Infratel and Aditya Birla Telecom. Yet as of 2010 the parties are still locked in a dispute over tax liabilities from the transaction.

Mini Case 4: Trade Sale India

As for exit sizes, we do not see a clear upward trend (compared with China). Trade sales had broadly similar average sizes throughout the period, in the range of USD 30-60 million, with the exception of 2005.¹⁷ Over the decade, the average trade sale proceeds in India were USD 37 million, a little higher than China (USD 31 million). While China trended up in the post-crisis era, there has been no clear recovery in average M&A exit deal size in India.

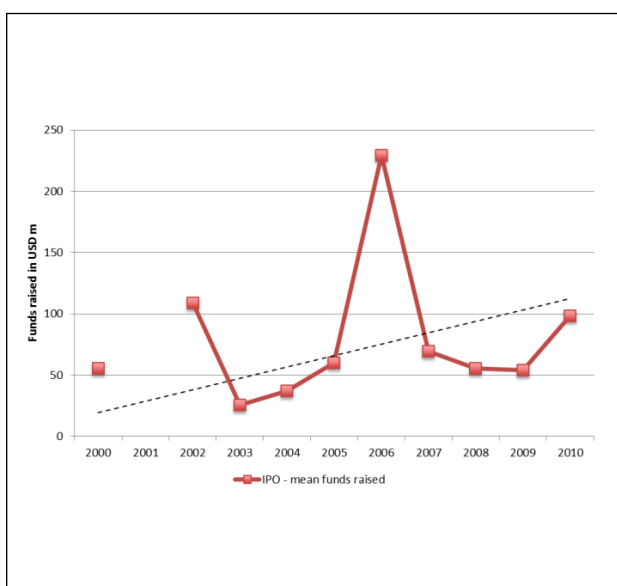


Figure 14. Mean size of funds raised in IPO India, 2000-2010

Growth capital with exit on domestic stock exchange

In 2004, CVCI invested INR1 billion, half in debt and half in equity, for an undisclosed stake in Suzlon Energy, an India-headquartered manufacturer of wind turbines founded in 1995.

CVCI's capital allowed Suzlon Energy to expand internationally, integrate horizontally by incorporating other divisions, and hit the 1GW installation mark. By 2006, Suzlon had a 50% market share in India and was ranked the fifth largest wind turbine producer worldwide.

Prior to the IPO in 2005, Suzlon received further financing from ChrysCapital and DEG Germany. The company was listed on the NSE in September 2005, raising INR15 billion. With its debt already returned prior to the IPO, CVCI realised INR1.85 billion from the listing and INR8 billion from a subsequent sale in 2006. Hony's investment a book value of about USD164m.

Mini Case 5: IPO India

Likewise, Indian IPOs exhibited no clear trend towards bigger sizes and the amount of funds raised varied greatly across companies.¹⁸ Over the last ten years, PE backed IPOs in India raised on average USD79 million, substantially less than the USD119 million in China. Hence IPOs were often less attractive than M&A exits after taking execution risks and lock-up periods for IPOs into account.

¹⁷ As before, we excluded the most prominent transaction of 2005 (BhartiTeleventures to Vodafone, worth USD1.5 billion). If we include it, the average deal size goes up to USD150 million for that year.

¹⁸ The 2006 spike is caused by the USD 1.8 billion IPO of Reliance Petroleum, in which ICICI Ventures held a very small stake.

4.2 Exit strategy

How do China and India compare in terms of exit strategies over the last decade? Here we focus on two strategic decisions, namely when to exit (holding time) and how to exit (exit channel).

Exit channel preference

If we look at exits by channel, focusing on IPO and M&A activity (as for write-offs and buyback structures there is typically little to no choice for the PE investor), the difference between China and India is obvious. While IPOs are the prevalent exit channel in China, M&As have been dominant in India. While there is no difference in India for venture and later-stage investments, a slightly higher proportion of PE deals (and the majority of the small number of buy-outs) went for an M&A in China.

China	VC	PE	Buy-out	India	VC	PE	Buy-out
# of companies with entry and exit details	476	212	14	# of companies with entry and exit details	160	123	7
->IPO	72%	63%	21%	->IPO	34%	33%	14%
->M&A	28%	37%	79%	->M&A	66%	67%	86%

Figure 15. Exit channels, China & India, 2000-2010

Possible explanations for these different patterns are:

- **China has grown to be the biggest IPO market in the world.** For the last four years, China, with its domestic stock exchanges in Shanghai and Shenzhen and its international financial hub Hong Kong, has been the biggest IPO market in the world. In the last two years, China accounted for an astonishing 45% of all global IPO proceeds (e.g. in 2010 USD 129.8 billion of USD 284.6 billion), dwarfing the Indian capital markets as an IPO location (where last year USD8.4 billion was raised). Hong Kong alone has been the world's largest exchange for IPOs for the past two years, with about 20% of all global IPO proceeds raised (USD21.9 billion in 2009 and USD57.4 billion in 2010).¹⁹
- **PE investment gives a company a better chance to “jump the queue”.** In China an investment by a reputable PE firm creates multiple benefits if the owner's/company goal is a public listing (including the signalling effect, a seal of good corporate governance relative to the broader market, better investment banks willing to work with company etc.). Based on the imbalance between Chinese firms willing to list and listing slots available, the category of “pre-IPO” investments has developed whereby the role of the financial investor is mainly limited to smoothing the path to IPO. While limited, it can potentially be very rewarding, yielding large multiple arbitrage opportunities between private and public companies.²⁰ This category does not exist in the same form in India, where there are comparatively few barriers to listing.²¹
- **In China, state control over regulators and the judicial system may discourage private sale agreements.** Political and regulatory hurdles for foreign strategic investors (especially full takeovers and larger investment targets²²) make a trade sale in many cases an uncertain prospect. In contrast, the IPO channel provides a structured framework and access to more independent and efficient foreign business environments (e.g. Hong Kong, the U.S.). In fact, out of 523 reported PE-backed exits via an IPO process, only 217 companies were floated in Shenzhen/Shanghai, 173 in Hong Kong, and the remainder in international markets, mainly on the New York Stock Exchange, NASDAQ and in Singapore. This contrasts with India, where 90 out of 94 reported exits via IPO took place on domestic stock exchanges. It will be interesting to see how the China IPO market develops in the next one to two years, as we see signs that local IPO markets in Shanghai and Shenzhen will become more important going forward.

¹⁹ Ernst & Young (2010)

²⁰ Of course, in exchange for this return potential the PE firm carries the risk of markets temporarily closing, regulatory changes (both making it harder or easier to list) and a change of public valuations.

²¹ This positive signalling effect is not just limited to later stage pre-IPO investments but is equally observable in early-stage venture investments where companies have a much higher level of credibility when they go to list overseas on the NYSE or NASDAQ if they have top-tier Chinese or international VCs on their shareholder roster.

²² For an example see the decision by Chinese regulatory authorities to block the acquisition of Huiyuan Juice by Coca Cola on antitrust grounds. Financial Times (2009).

- **Key ingredients for M&A exits are missing.** Obtaining controlling stakes in larger Chinese firms is notoriously difficult, yet this is a frequent requirement for strategic buyers and reduces the number of trade sale opportunities. For secondary sales (i.e. from one financial investor to another), until recently there has not been enough differentiation between PE firms, reducing sales opportunities to financial investors higher up the value chain.²³

Exit timing

A major driver of returns is getting the exit timing right, hence we studied how many exits took place in each phase of the economic cycle. To analyse the pattern of exits against market behaviour we studied a subset of 793 deals for which data on investment/exit timing and amount were available.²⁴

In China, exits overall were somewhat correlated with the market cycle. IPOs followed the bull-bear market cycles,²⁵ more closely than trade sales. They were concentrated in 2007, when the index was extremely bullish, continued at a much slower pace in the first six months of the 2008-2009 bear market, then resumed heavily in the last months of 2009. Trade sales were scattered across the observation period, with less correlation to the index. They also dominated the smaller size bracket, as these companies are often too small to consider a public listing.²⁶ The chart also shows that 2007 marked the beginning of PE sponsored “mega-IPOs” – with funds raised in excess of USD 1 billion – and that IPOs with funds raised between USD 100 million and 1 billion resumed massively after the financial crisis.

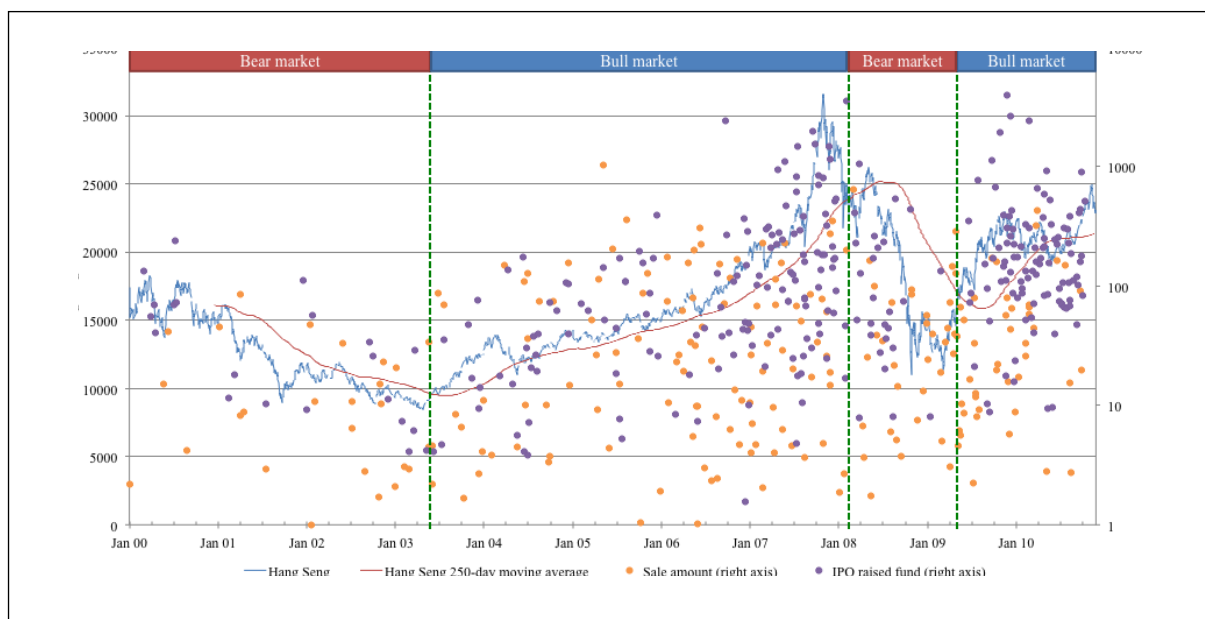


Figure 16. Timing of China exits, 2000-2010 (subset of fully documented exits)

²³ For a discussion on difficulties in executing M&A exits see: Lange & Ellis (2004)

²⁴ This subset covers 67% of exits in the AVCJ data set.

²⁵ For the purposes of this paper we assume that the bear market starts when the reference index crosses the 250-day moving average downward, whereas the bull market starts when the index crosses the 250-day moving average upwards, unless a prior bull-bear or bear-bull switch has happened less than 250 days earlier.

²⁶ This is potentially changing after the tremendous momentum of the two Shenzhen boards: the SME board and the ChiNext board. ChiNext only opened in October 2009 and is supposed to focus on small high growth companies akin to NASDAQ in the US. Last year saw them host 205 IPOs for USD30.2bn and 116 IPOs for USD14.1bn respectively. Both boards have seen many PE backed exits mostly by domestic Chinese PE firms. If ChiNext can grow through some of its initial problems with transparency and (related) excessive valuations it will become a valuable addition to the more established IPO venues for the PE industry.

In India the picture looks slightly different, with trade sales spread more evenly across time (accounting for growing economic activity) and exit sizes. IPOs of PE-sponsored firms are clustered towards the end of the last bull market but overall play a significantly reduced role and barely resume after the financial crisis, consolidating the preference for trade sales.



Figure 17. Timing of exits in India, 2000-2010 (subset of fully documented exits)

IPO in New York by Indian e-commerce company

In 2005, SAIF Partners invested USD10 million for a controlling stake in MakeMyTrip, an online travel company in India. Started in 2000, the company had survived the end of the dotcom boom and the travel crisis in Asia caused by SARS. Two further financing rounds in 2006 and 2007 for USD13 million and USD15 million respectively, in which SAIF participated alongside new investors Helion, Sierra Ventures and Tiger, provided the company with funds for its expansion.

In August 2010, MakeMyTrip listed on the NASDAQ in the first U.S. IPO by an Indian company in four years. While priced at a premium to the biggest online travel agencies it nevertheless surged nearly 90% on its first day of trading. The company raised USD70 million on its debut. Yet with the stock surging, market cap reached USD800 million within two days, giving controlling shareholder SAIF Partners a 23x return on paper.

IPO in New York by Chinese Internet company

In 2006, SAIF Partners invested USD8 million for a 31.8% fully diluted ownership (before IPO) in Perfect World, an online game developer in China specializing in 3D multiplayer online role-playing games (MMORPGs). Most notable games include Perfect World, Legend of Martial Arts and Perfect World II.

In July 2007, Perfect World listed on NASDAQ at an IPO price of USD16 per share, raising over USD100 million to fund enhancement and development of its product line. SAIF Partners realized its investment in four tranches, initially at the time of the IPO followed by three parcel sales to the public market over the course of 2008-2009. On a blended basis, SAIF Partners realized a more than 40x return on its investment in Perfect World.

Mini Cases 6 & 7: Overseas IPO of Indian and Chinese Internet Companies

Holding time

To better understand the investment dynamic from entry to exit we performed an analysis of matching investments between 2000 and 2005 with available data on exits. We assume that the majority of exits for these investments should fall within the observation period (2000-2010), while later investments are more likely to be within the holding time window.²⁷

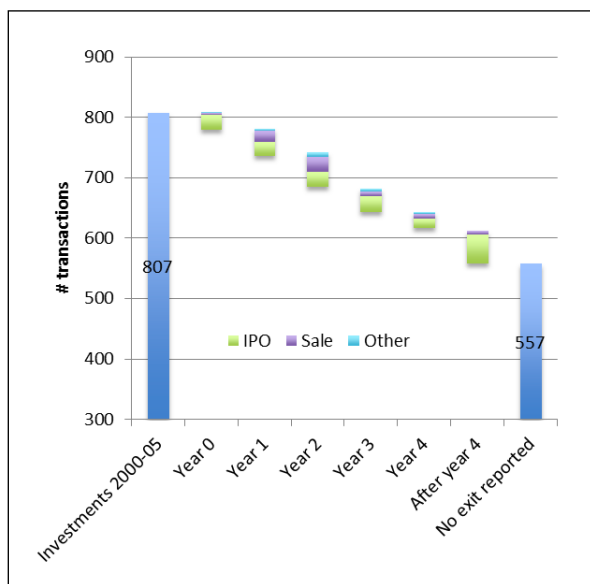


Figure 18. Number of companies exited per year from 2000-2005 vintages, China

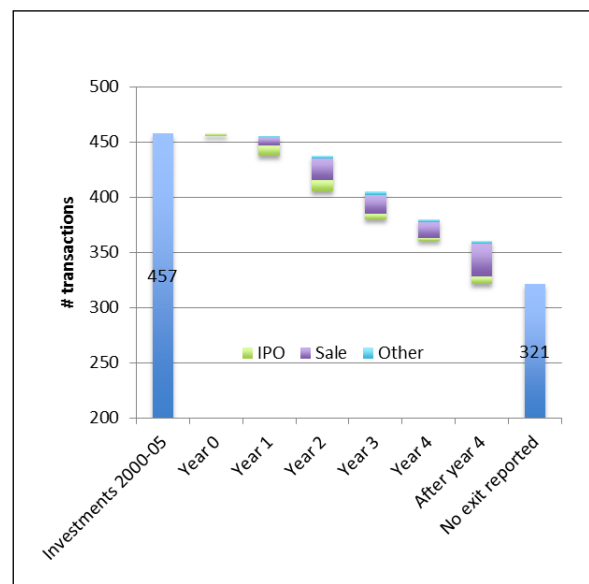


Figure 19. Number of companies exited per year from 2000-2005 vintages, India

As mentioned in the section on methodology, our data focus on IPOs and M&A exits but capture few other exit structures and write-offs. While it is therefore not possible to tell how many and whether investees with no reported exit were indeed exited (including written off) or remain in the funds' portfolio, the data show that in China, PE funds exited at least 31% of the companies they had invested in, while the percentage was at least 30% in India. Of these investments, 24% of the companies in China were exited within four years of the initial investment (i.e. a typical holding period for PE investments in China and India, as discussed in the next section), while the percentage was 21% in India.

Write-off

At the end of 2006, Goldman Sachs, Morgan Stanley and Actis Capital invested USD73 million (USD18 million, USD15 million and USD40 million respectively) for a 31% stake in Taizina, a maker of milk-based health drinks. Actis and Morgan Stanley had previously had great success with their investment in Mengniu Dairy, which they had exited the year before. The investment in Taizina was to be used for expansion of production facilities and distribution. It was also envisaged to list the company in 2007 in Hong Kong or New York.

Yet Taizina expanded too rapidly and was hit hard by China's tainted milk scandal, which hurt dairy sales across the country. Taizina went into provisional liquidation (and later bankruptcy) in April 2010, wiping out the equity and leaving between RMB 2-3 billion in debt. Its founder was arrested in connection with illegal company practices in June.

Mini Case 8: Write-off, China

²⁷ Because every fund can invest in several rounds in the same company and sell its stake in several rounds, to appraise the length of the investment cycle we have to take a "company perspective" instead of a "deal perspective". First, all investment, exit and IPO entries for the same investee are grouped. Then, we examine the first investment deal in every investee and match it with the first reported exit.

Further analysis of the average holding time reveals that exits occur increasingly quickly over time. Yet for this wider data set we are not able to form a view on final exits. Rather, we investigate the time between investment and the first exit event. As we subsequently show, PE firms in China and India tend to hold their public investments (either after IPO or as a result of PIPEs) rather a long time. Yet using the same methodology we can still observe a change over time.

If we ignore the most recent years (as only the quickest exits appear in the data), there is a clear trend for holding periods shortening from above three years to around or less than two years in China.

Year of investment	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
% of companies with at least one reported exit	27%	42%	30%	28%	28%	30%	25%	24%	12%	12%	3%
Avg # of investment rounds	1.6	1.7	1.4	1.5	1.8	1.8	1.6	1.3	1.4	1.1	1.0
Avg time to exit (yrs)	3.7	3.7	3.1	3.1	2.3	2.1	1.5	1.9	1.5	0.7	0.2

Figure 20. Investment rounds and holding time of China investments, 2000-2010

A similar consistent trend can be observed in India, where holding time was three years or more until 2003, then was reduced to just over two years by 2005/06.

Year of investment	200	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
% of companies with at least one reported exit		28%	18%	39%	31%	43%	27%	17%	9%	4%	4%	0%
Avg # of investment rounds		1.9	2.7	1.5	1.5	1.9	1.6	1.6	1.8	1.1	1.0	1.0
Avg time to exit (yrs)		4.8	3.6	3.6	3.0	2.4	2.3	2.1	1.6	1.6	0.6	0.1

Figure 21. Investment rounds and holding time of India investments, 2000-2010

The transition to a shorter holding time strategy was enabled by the rapid opening up of public markets and the increasing interest of multinationals and international PE firms in Asian companies. Those fast and early exits significantly contributed to the PE industry taking off in China and India.

Growth Capital with exit on domestic stock exchange

In 2007, Goldman Sachs invested USD22.5 million for a 12.5% stake in Shenzhen Hepalink Pharmaceutical, a heparin pharmaceutical producer in China. Founded in 1986, the company focuses on the production of injectable grade heparin products, becoming the only Chinese FDA approved supplier of heparin to many world-renowned pharmaceutical companies.

In May 2010, Hepalink Pharmaceutical listed on the Shenzhen Stock Exchange at an IPO price of CNY 148 per share (73 x 2009 P/E), raising a total of CNY 5.9 billion (~USD864 million) to expand production capacity to supply international clients including Parisbased Sanofi-Aventis SA. Even after a steep fall in its share price in April of 2011, as of May 31st, 2011, the company was trading at CNY 33.37 per share, representing a more than 20x return on paper for Goldman Sachs.

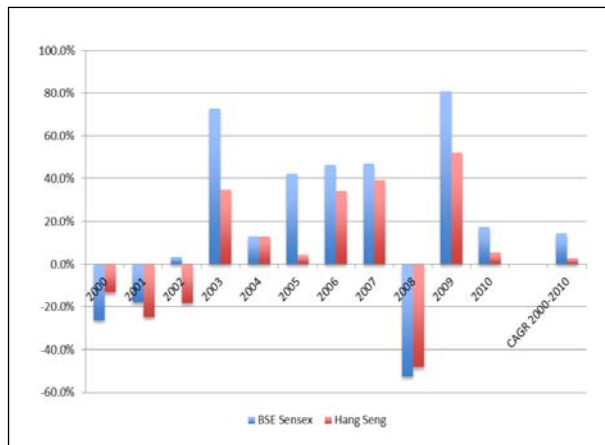
Mini Case 9: IPO China (domestic)

4.3 Performance of VC and PE investments

PE investments have soared in both China and India during the last decade, and specifically since 2005. Was this interest in emerging markets PE matched by performance? While our broad market data do not allow a rigorous risk-return analysis, there are several important elements worth looking at:

- 1 The long-term return of stock markets represents a “hurdle rate” that VC and PE funds hope to surpass. VC and PE exits are compared with market returns to show how many investments actually surpass the hurdle rate and whether the model is based on “consistent hits” or on a “few home runs”.
- 2 A study of entry-exit pairs compared to stock market returns allow us to estimate how much of the return depends on external factors (markets, economic cycle) as opposed to investment-specific factors (company, fund management).

PE returns compared to hurdle rates



For the indiscriminately chosen period of 2000-2010, annual returns on the Mumbai and Hong Kong Stock Exchanges ranged from -52.4% to +81.0%. Mumbai outperformed Hong Kong with a compound annual growth rate (CAGR) of 14.3% vs. 2.9% for the same period, but also exhibited more volatility in annual returns.

As we have seen before, the VC/PE industry in China/India started to gain momentum with more than a one-year lag from the bottom of the previous cycle following the outstanding market performance of 2003.

Figure 22. Annual returns of India and Hong Kong markets, 2000-2010

Share sale into open market

In 2005, General Atlantic Partners, Newbridge Capital and Texas Pacific Group invested USD350 million in preferred shares for a fully converted 10.2% stake in Lenovo, a Chinese manufacturer of computers and peripherals, to help it finance the acquisition of IBM's PC business and strengthen its balance sheet.

After a strong rise in the share price, investors sold a first tranche of their shares for USD360 million in November 2007, within a month of the HK Stock Exchange's all-time high. After waiting for markets and share price to recover, the sell down continued in February 2010 with about USD96 million in proceeds. Finally, the investors fully exited their investment in November 2010 for another USD200 million.

Mini Case 10: Sale of shares in PIPE investment, China

In order to assess the attractiveness of VC and PE investments compared to publicly listed companies, we have analysed all entry-exit pairs for which full entry and exit values were reported (date, amounts and stakes at entry and exit), calculated the entry-to-exit return as the ratio of implied valuations at exit and entry, and plotted them against the return of the respective index (BSE Sensex or Hang Seng) over the same dates.

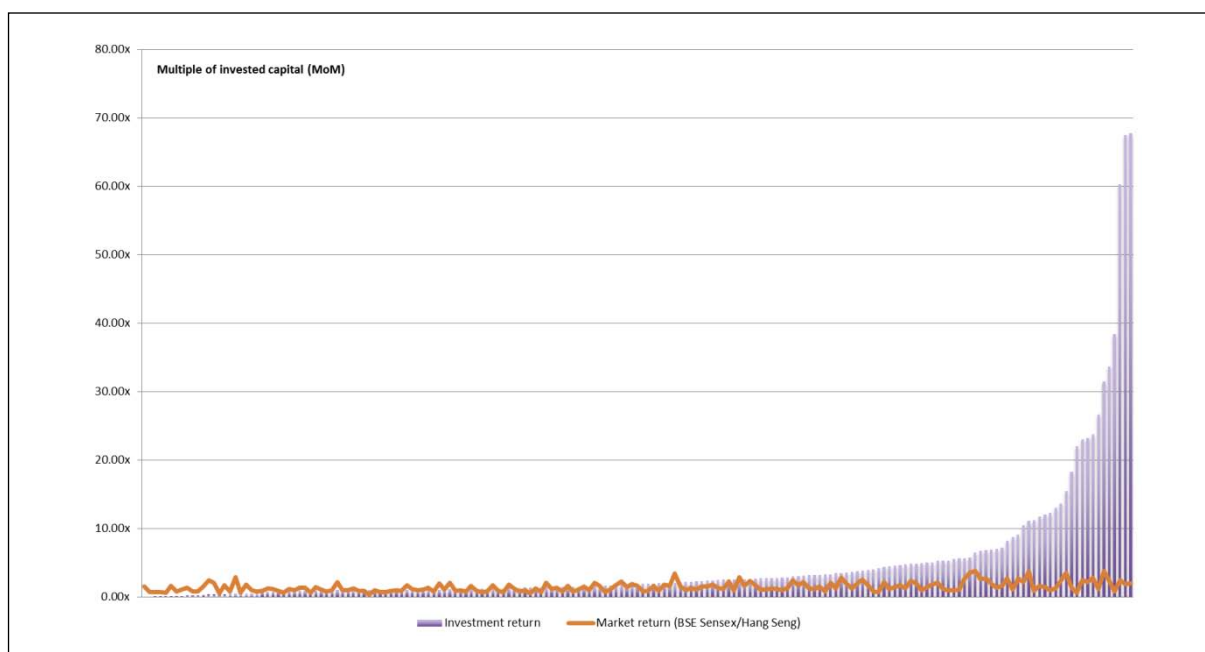


Figure 23. Exit-over-entry returns for a subset of 185 entry-exit pairs, compared to the market return over the same period

In order to assess the attractiveness of VC and PE investments compared to publicly listed companies, we have analysed all entry-exit pairs for which full entry and exit values were reported (date, amounts and stakes at entry and exit), calculated the entry-to-exit return as the ratio of implied valuations at exit and entry, and plotted them against the return of the respective index (BSE Sensex or Hang Seng) over the same dates.

70% of reported exits did beat the markets, and 37% of reported exits achieved at least twice as much as the market return. Because the data mostly capture investments exited through M&A and IPOs and do not properly account for write-offs, the ratio of investments beating the market is to be understood as contingent on an M&A exit or IPO being reported. This was the case for about 20% of the reported investments in the data set, while the remaining 80% contained a few reported write-offs and a large number of companies still in the funds' portfolio and probably a significant number of exited-but-not-reported companies.

Impact of public market performance on PE investments in China/ India

Traditional Western buy-outs are sometimes described by critics as merely leveraged plays on public markets. While this neglects value spotting and value creation by PE firms, it highlights the major importance of public markets for private equity. Is there any difference for PE in China and India where leverage is rarely applied?

A statistical analysis shows that market performance does play a role in PE returns, but far less than might be expected. While there is a positive correlation between market returns and investment returns, market conditions can only explain 15% of the variance of returns.²⁸

Therefore, company-specific and investment-specific factors are the drivers that enable the exceptional returns which appear as “outliers” in the data set. This is not surprising given that even in the midst of the global financial crisis funds were able to exit investments with returns up to 30x. This is likely to be due to the specific economic environment in China and India whereby:

- **Access to good companies is a key success factor in an imperfectly intermediated market:** Funds need an extensive local network and in-depth knowledge of country-specific business practices and regulations to ensure good deal flow and evaluate companies correctly. Yet the opacity of the market also reduces competition which helps to keep down entry valuations.
- Investees evolve in a fast-growth environment and often captive markets where **company-specific factors** like the fit between products and evolving consumer needs, the ability to generate a cost or positioning advantage, and effectiveness in managing fast-growing organisations **play a larger role than in mature markets**.
- In both public markets – but more so in China – IPOs are valued for their growth potential and first-mover advantage. This leads to “**concept**” IPOs, where the first ones in any industry to go public benefit tremendously from the valuation premiums attached to their perceived market position.
- **Scarcity of good acquisition targets** in coveted markets such as India and China leads trade buyers to pay a substantial premium for companies whose business and corporate governance has been “de-risked” under PE ownership.

M&A with foreign strategic buyer

Baring Private Equity (India) bought 51% of BFL Software, an India listed BPO/software company, in 1998. The company merged in June 2000 with US-based IT consulting company Mphasis in which Baring also held a stake. Subsequently, Baring funds owned about 35% of the combined company.

After several failed sales discussions, including a full sales process with strategic investors and PE firms in 2005, Baring sold the vast majority of its stake to EDS in 2006 (which was in turn subsequently acquired by HP). Turning two-loss making companies into a highly profitable one (with a net profit of USD33 million at the time of EDS acquisition) and delivering control of a fast-growing company in an interesting space to a multinational (EDS acquired in total 52% via tender offer) enabled Baring funds to achieve a significant double digit multiple return on its invested capital.

Baring funds subsequently sold their remaining stake in several steps, partly on the market, partly to EDS. However, in parallel Baring used the depressed share price from September 2008 to March 2009 to increase its stake again (albeit through a different vehicle).

Mini Case 11: M&A transaction with foreign strategic buyer, India

²⁸ We ran a regression on the 185 entry-exit deals – 156 trade sales and 29 IPOs in India and China – in which return on investment is the dependent variable while the independent variables are the following: investment stake, investment amount, vintage, implied valuation at entry, holding time, country (China or India), market return (calculated as exit to entry ratio of BSE Sensex index for India, and a weighted average of Hang Seng, SSE Composite and Shenzhen Composite indexes for China). Return on investment is defined as the ratio between the implied valuation of the company at the time of exit and at the time of investment. The results of the statistical analysis show that market return is the only significant independent variable, yet investment returns are much more dispersed than market returns. Market returns explain only about 15% of the variance of PE and VC returns (P-value significance level: 0.05. Regression results: $R^2 = 0.1486$, p-value < 10^{-4} , p-value of intercept = 0.0867, correlation between market and investment return: = 0.39).

Exited companies from LP panel

A few further observations can be drawn from the data supplied by our LP panel. Overall, we are looking at 233 transactions between 2000 and 2010 that were either fully exited or where there has been a major exit event but value still is locked up. Graphs 24 and 26 depict gross returns measured in multiples of invested capital (MoM). To disguise outliers we have indexed those returns to a maximum of 20x. Unlike the prior analysis, these data contain the full range of exits, including write-offs and buy-backs.²⁹ However, as mentioned before, in only a few cases is the exact timing of proceeds available, making benchmarking against public markets difficult.

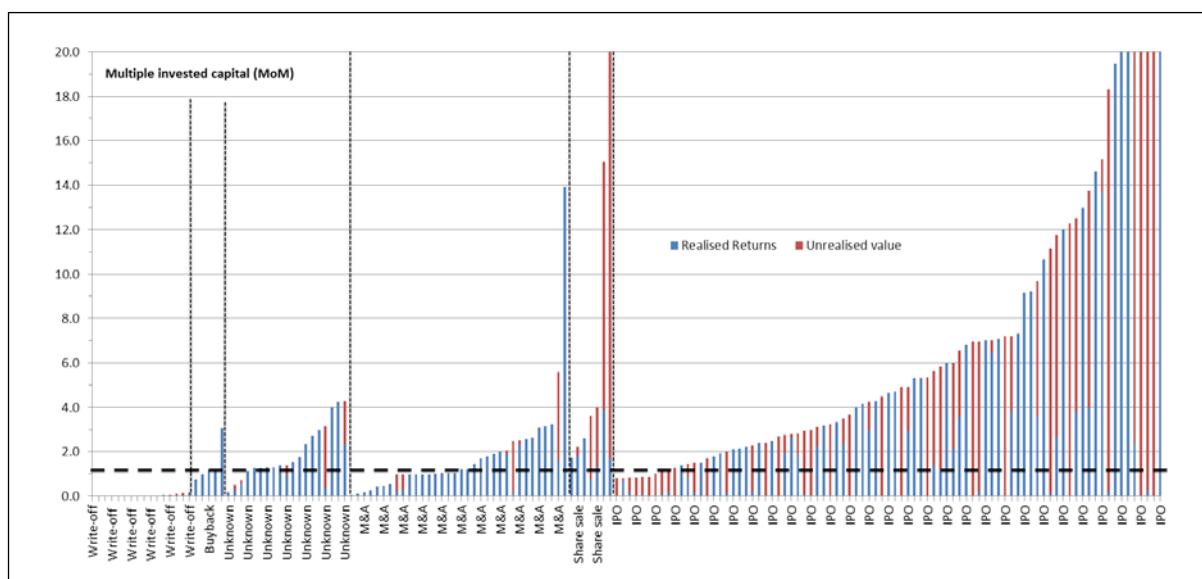


Figure 24. Gross Return (measure in multiple of invested capital) for PE investments, China

The China sample includes 166 exits with a median return of 2.4x invested capital. The dollar-weighted return including unrealised value is 4.9x – no wonder investors are taking notice.³⁰ Excluding unrealised value the gross multiple is 3.1x. As in the wider data set, exits are dominated by IPOs, which make up 51% of all exits. Not surprisingly, IPOs also show by far the highest returns (with some PIPE investments exited through share sales also having spectacular returns).

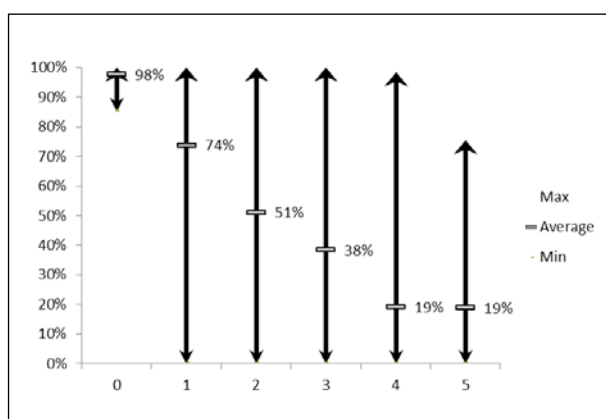


Figure 25. Number of companies exited per year from 2000-2005 vintages, India

Yet the graph also shows the biggest issue with IPOs (which the next graph expands on), namely, the prolonged period required for a PE investor to fully exit through IPO. Graph 25 shows the unrealised value of the investment relative to how many years have passed from the IPO to reporting date (2010). During the year of the IPO (Y0) very little of the investment is realised, probably due to lock-up periods and the sizable stakes that investors often hold relative to funds raised (the majority of which typically goes to the company). Yet even several years after IPO many PE funds continue to hold sizable percentages of their value in stock.

²⁹ Nevertheless GPs are reluctant to completely write off investments as long as a residual value exists. Therefore probably quite a few of these “living dead” are still in the unrealized portion of the portfolio.

³⁰ Keep in mind the current bias of the panel towards brand name GPs. Also returns provided are not on a fund level but across all 166 exits.

5 Conclusions and Outlook

Having delved into the accumulated data, we hope that a clearer picture on the exit history of private equity in India and China has emerged. After a slow start, there have been a large number of exits in the second half of the decade. Many of these have generated large absolute dollar sums, mostly due to a warm reception on stock markets. Besides the landmark exits and with the exception of a very short period during the recent global financial crisis, there has been a consistent level of activity, giving hope that Asian private equity as an attractive asset class is here to stay. In any case, with vibrant capital markets and strong interest in these countries from strategic and financial investors alike, exit risks seem to be a thing of the past. Certainly PE investors will hope so, and they have reason to be optimistic given the strong pipeline for IPOs and M&A exits in their GP's portfolios.

Trends to watch are the increasing practice of public investing, whether in the case of India through PIPEs or in the case of China through late growth/pre-IPO deals, the increasing importance of the onshore RMB market in China, and the expectation that IPOs in Shanghai and Shenzhen will become more important relative to offshore IPOs in Hong Kong and elsewhere. That said, our research to date seems to confirm that while public market performance is certainly a driver for PE returns in China and India, it is much less so than in developed Western markets. This gives some credibility to sponsors who claim to be able to reap company-specific rewards from listed entities. But as not everyone can go public, some of the abandoned IPOs might provide deal opportunities for other PE firms. Will secondaries (i.e. the sale from one PE fund to another) therefore become as commonplace as in developed markets now that more and more differentiated PE firms exist in both markets? And will M&A transactions regain ground over the next cycle in China?

We appear to be right in the middle of a large exit wave from the peak deals of 2006-2008. If PE firms continue to convert these investments into tangible returns, then this asset class in Asia will finally become a 'must have' for global investors.

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