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Secondary Private Equity Funds in China

Dan Zuo[1,a,*]

[1] *City University of Hong Kong, Hong Kong, China*
a. danzuo2-c@my.cityu.edu.hk
**corresponding author*

Abstract: Combining the latest era background, this paper mainly focuses on the growth of secondary private equity funds in China's capital market. Starting with the current macro form and development status, it will provide an overview of the private equity market and secondary funds, followed by an introduction to the development and status of S funds in the global capital market. Following that, author will go over the history and current state of S funds in China's capital market. Analyze the advantages and characteristics of the S fund based on its theoretical essence and actual business. Finally, watch for the development of secondary private equity funds in China. As one of the few articles on secondary private equity funds and transactions, the discussion in this paper enriches the content and literature of secondary private equity investment.

Keywords: secondary funds, private equity, venture capital, Chinese capital market

1. Introduction

The new crown pneumonia epidemic and the conflict between Russia and Ukraine have added new uncertainties to the global macro situation, which have continued to have a significant impact on employment, oil and natural gas, and other fields, as well as have far-reaching and extensive joint effects on the global investment market. Investors' assumptions about the fundamental market face significant challenges in the context of an unstable circumstance and increasing uncertainty. Tracking the trends of the invested companies, as well as anticipating and preparing for possible abnormal scenarios, has become increasingly important in private equity. At the same time, many capitals have gradually withdrawn from primary private equity for the purpose of hedging, promoting the expansion of the secondary trading market of private equity.

After ten years of rapid development, the management scale of stock equity assets in China's PE market has surpassed 600 billion US dollars, with annual incremental funds of approximately 100 billion US dollars [1]. According to the usual investment period "5+3 model", Chinese private equity will usher in the first concentrated departure tide in history during the following two years. On the one hand, a large number of companies are planning and waiting for IPO, on the other hand, the fund is approaching the end of its closing term, and PE is experiencing "liquidity anxiety." It has been discovered that the current situation is pretty comparable to that of the more mature European and American private marketplaces. The rise of the private equity secondary market has effectively smoothed out the potential volatility in this market. When the stock accumulates to a particular scale, the second-hand trade market will arise as the times urge. The scale of current private equity fund management in China had reached RMB 18.99 trillion as of the end of July 2021 [2]. With such a

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huge number of assets, there must be a plethora of transaction requirements, such as liquidity, asset optimization, and exit requirements.

2. Private Equity Market and Secondary Funds

Private equity funds are frequently utilized in the private equity market to generate investment portfolios or vehicles that are backed by private equity. The full name of secondary fund is private equity secondary market fund, which is a fund product that transfers investment shares or assets of existing private equity funds and specializes in acquiring alternative asset fund shares, investment portfolios, or investment commitments from investors. Secondary transaction is a transaction in the secondary market of private equity that refers to a transaction used to transfer the main market share already held by investors or the equity interests of the invested company. The cornerstone of S fund transactions is asset succession rather than pure asset sales.

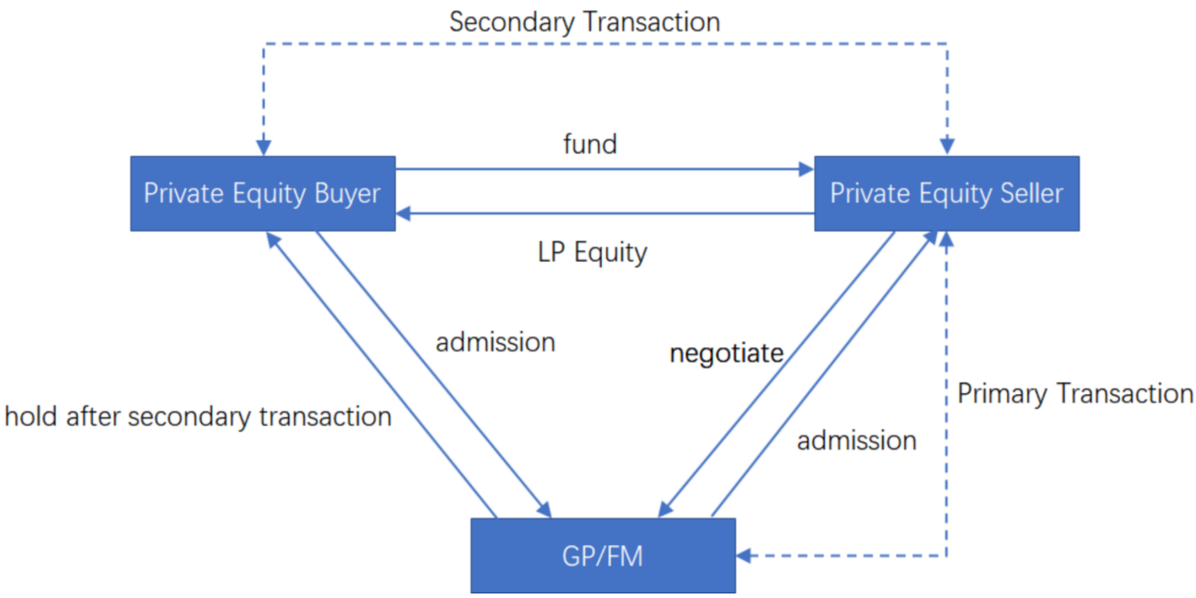

Figure 1: Secondary private equity transaction subjects and process.

S funds and S transactions enable private equity investment funds satisfy their liquidity needs, and are an important way for fund shareholders to withdraw before liquidation. There is no doubt that the expansion of the private equity market to a certain point has resulted in the birth of this emerging investment type. The original mechanism and source is that it can provide liquidity to LPs with limited capital. Since secondary trading occurs when the J-curve of equities direct investment funds bottoms out and rises, it accelerates the speed at which LPs receive returns. On the other hand, this is a niche market with few buyers and considerable seller pressure, resulting in large price discounts. Transaction method covers subscribed capital contribution, transfer of paid-in capital contribution, fund continuance and restructuring, and so forth.

3. Development and Current Situation of S Fund

3.1. On the Global Capital Market

The S fund is known as the "jewel in the crown" of the private equity market in the global capital market. VCFAG Group, founded in 1982, was the first organization to participate in private equity secondary market transactions [3]. After the Internet bubble burst in 2000, the secondary market for private equity began to emerge at a rapid pace. The volume of private equity transfer S-fund transactions was $7 billion in 2004, $27.5 billion in 2013, $42 billion in 2014, and $40 billion in 2015. The PE secondary market grown dramatically in 2017-2018, with the highest transaction value exceeding US$72 billion [4]. Over the last ten years, the total trading volume of worldwide S funds has increased year after year.

Since the debut of the S fund, the market has embraced this product. This is caused by a variety of factors. S-funds have an unique price advantage and can obtain private equity at a reduced cost. Furthermore, the payback is relatively short, and the S fund, which is mainly allocated to fund shares in the later stages of investing, will generate returns as early as the first year of investment, with more than half of the cost returned on average by the fifth year. Many market participants have high expectations for S funds [5]. S funds have matured as an investment strategy in the worldwide market, with approximately 30% of European and American private equity funds exiting through share transfer [6]. Pension funds, sovereign wealth funds, endowments, and foundations, to name a few, are becoming more diversified and complicated as new entrants to the secondary market. The influx of new competitors has increased competition in the entire market, lowering the discounted benefits of transactions. The advisory company role in secondary transactions has also expanded dramatically, with the advising firm now providing pricing reporting and decision-making, discovering and connecting buyers and sellers, arranging and structuring transactions, and managing databases and confidentiality. Agreements, quotation collecting, and negotiation are also aspects of services.

After ten years of consistent expansion, the amount of funds to be invested in the global capital market will hit a record high of US$3.4 trillion in 2021. Acquisitions and exits set new records, totaling US$1.1 trillion and US$957 billion, respectively [7]. The last time such a large-scale privatization transaction occurred on the worldwide market was in 2006-2007, before to the financial crisis. With the gradual rise in the acquisition price of various businesses, the emphasis of investment is shifting to specialization, particularly in the field of technology. Tracks that can achieve outstanding performance through professional technology empowerment, such as fintech, healthcare, and business services, etc.

The worldwide private equity investment market will exhibit three significant trends by 2022. The first is that investment places a greater emphasis on the ESG measurement system. More investors will consider corporate ESG factors while making investment decisions. Most private equity players have developed unique ESG investing criteria that have a substantial impact on the valuation of private equity assets, in whole or in part. If a company has ESG issues, the likelihood and amount of investment will be greatly reduced. The second point to mention is that investing in software is getting increasingly popular. In 2021, private equity deals in technology exceeded $284 billion, with 90% focused on software, providing excellent returns. Investors are predicted to favor the B2B software and technology business in the future. While technological companies are rapidly growing, they are also posing greater threats. Enterprise software companies that are mature or developing, on the other hand, have reduced risks and volatility and will become the primary investment targets of private equity. Software investments outperformed other industries, with over 60% of investments achieving 2.5x or higher returns and fewer bankruptcy liquidations than other industries. The third is to account for inflation. In various countries, inflation have occurred in 2021-2022, with the United States reaching a 40-year high [7]. The responses of the Federal Reserve and other central banks will have a significant impact on current and future transactions. In order to protect profits and future earnings, extensive research has been conducted on how to combat inflation.

In terms of private equity exits and financings, the overall value of exits has more than doubled since 2020. Special purpose acquisition companies (SPACs) were the standout performers, with deal value increasing 325% over the previous year to $158 billion. The year before, the global private equity industry raised a total of US$1.2 trillion, with buyout funds raising US$387 billion [7]. Private

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equity investors continued to generate huge gains in 2022. Buyout funds provide investors an above-market average rate of return (IRR) while minimizing volatility. According to a survey of worldwide alternative asset sector statistics, 95% of the limited partners polled met or exceeded their private equity investment returns in the previous year. In 2022, nearly 90% of respondents said they will raise or maintain the proportion of private equity investment, and up to 95% stated that they will keep this trend for a long period of time [8]. To offer liquidity to existing limited partners (LPs), more general partners (GPs) are turning to secondary partners. This allows investors in early-stage private equity firms to exit existing investments in order to meet yield and liquidity targets. This adjustment will help to attract more investors with varying time horizons, and extra time and capital will also provide additional value for investors. This new type of trading is becoming an increasingly important part of the secondary market.

3.2. In Chinese Capital Market

To acquire relatively high premiums, private equity fund managers in China have traditionally exited through IPOs or mergers and acquisitions. The primary concern of managers regarding the PE secondary market is that unjustified prices will harm the fund's investment income as well as the private fund manager's image and reputation. However, since 2017, China's IPOs have gotten increasingly restrictive, traditional exit methods have become more competitive, and A-share stock prices have declined. Because VC/PE private funds have encountered great difficulties in both raising and exiting, S funds have steadily gained the attention of the capital market. Although China has established a number of trading platforms for second-hand shares of private funds, such as the Beijing Financial Assets Exchange and the Shanghai Equity Exchange, the most important role these platforms currently play is to broaden the channels for transaction information disclosure and has not yet been implemented. The actual completion of the share transaction and the final realization of investment income are both direct driving factors. The positions and roles of professional investment institutions and intermediaries are still vitally needed. It is also an inevitable trend for China to implement the S fund model to assist private equity fund managers in exiting.

China's S-fund development is relatively late. It only appeared gradually after 2010. At present, China's private equity secondary market is in its early stages of development, with enormous potential for future growth. The S market has had substantial backing from governments at all levels, from the federal to the local. China's private equity market has grown rapidly over the last decade, progressively giving birth to the S market's development potential. Since the end of 2020, the China Securities Regulatory Commission has approved private equity fund share transfer platform pilot projects in Beijing and Shanghai. Many local governments across the country, including Beijing, Shanghai, Hainan, Shenzhen, Jiangsu, Shandong, Shaanxi, and others, have established S funds or implemented a variety of measures to encourage the development of the S market in the last year, creating a superb market for the development and construction of the S market. The support and encouragement offered by regulatory agencies and local governments for the expansion of the S market has created a favorable development environment for the S market. The existing stock structure of China's private equity market, as well as a mismatch in market demand, have also contributed to the S market's investment, which is now a Sex golden opportunity. China's secondary market has become a hot spot for numerous entities engaging in alternative investments over the last two years. The S fund trading market has the potential to significantly boost the vitality of venture capital. Many of China's leading capital firms have gradually begun to invest in second-hand assets other than primary equity, and to collaborate with local guiding funds to support the adoption of S funds. According to the "2022 China Private Equity Secondary Market White Paper," there would be 353 transactions in China's private equity secondary market in 2021, encompassing 337 funds, with a total transaction amount of 66.807

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billion yuan known. In comparison to the transaction amount of 26.445 billion yuan in 2020, there has been a 153% increase, with a compound growth rate of 47% over the last five years [9].

Table 1: Existing S fund institutions in China.

Territory	**S Fund Name**
Beijing	Beijing Xingyao Capital
Beijing	Beijing Vision Relay Venture Capital Fund
Beijing	Datang Yuanyi
Beijing	Hengchang Fortune
Beijing	Hengtian Zhongyan
Beijing	The Jiahao Fund of Funds
Beijing	Junshan Private Equity Fund of Funds
Beijing	Kailian Capital
Beijing	National Social Security Fund
Beijing	Zero2IPO S Fund
Beijing	Pansheng Assets
Beijing	Shanghe Capital
Beijing	Shengshi S Fund
Beijing	CITIC Construction Investment
Fujian	Borun S Multi-Strategy Fund
Fujian	Xiamen Tiandi Investment
Guangdong	Everbright Holdings
Guangdong	Guangzhou (Emerging) Fund
Guangdong	Naxin Capital
Guangdong	Shenzhen Venture Capital
Guangdong	Ying Jia Capital
Guangdong	Yuexiu S Fund
Jiangsu	Newley Capital
Jiangsu	Suzhou Fund
Jiangsu	Taikang Qianheng Equity Fund of Funds
Jiangsu	Star Naher Capital
Jiangsu	Yuan He Chenkun
Shandong	Qixin Industry and Finance S Fund
Shanghai	Pure Stone Capital
Shanghai	Gopher Assets
Shanghai	Hengxu Capital
Shanghai	Shanghai Science and Technology Innovation Fund
Shanghai	Tongji Alumni Fund
Shanghai	Yuanhai Minghua

Resource: https://zhuanlan.zhihu.com/p/501366341

Combined with the current market environment, the following factors contribute to the future development possibilities of S funds in China.

DOI: 10.54254/2754-1169/17/20231056

3.3. The Investment Target is Sufficient

During the 2014-2016 PE boom, China's private equity RMB funds experienced rapid growth. The funds established at the time entered the liquidation and redemption period after eight years of development [9]. The growth rate of stock assets is quite high due to the steeper growth curve. The current market faces structural issues. The issue of funds exiting due to maturity is urgent and serious at the end of the market. A considerable proportion of mature funds have a nearly two-year exit window. Given the large number of mature funds, it is not difficult to infer that the past two years represent a historical window of opportunity for S fund investment. For decades, China's capital and financial markets have lagged behind established global capital markets such as the United States and the United Kingdom. It is foreseeable that with the maturity of development, there will be huge potential for future private equity and secondary market transactions.

3.4. Economic Swings Create a Fantastic Opportunity for Investing

The global market climate swings dramatically against the background of the current worldwide epidemic, as well as other environmental, social, and regional catastrophes and conflicts, risk aversion is escalating. At the moment, asset price discounts are relatively substantial due to the performance of the main market. As economic growth has slowed, the demand for LP transfers has skyrocketed, and the desire for liquidity has also risen, giving S funds greater wiggle room when investing in fund LP shares. During times of economic instability, there will be more trading chances in the market for low-priced, high-quality shares of private equity funds.

3.5. Investment Opportunities Created by the Government's Withdrawal of State-owned Assets

A high proportion of LPs in China's private equity sector are state funds or government-guided funds. There will be a substantial number of state-owned LPs and government investments in the market that are ready to expire in the coming years, and exits will be considerably hastened. The adoption of the registration system and the removal of restrictions on holdings are at an inflection point in investing, and secondary private equity transactions are extremely cost-effective.

4. Benefits and Characteristics of S Funds

We discovered several intriguing traits and advantages after conducting research and analysis on S funds and S transactions in the global capital market.

4.1. The Investment Target Is Highly Transparent, Which Effectively Reduces the Risk of "Blind Pool"

When private equity funds raise funds, fund investors have a blind spot for the underlying assets that the fund will invest in in the future because the underlying assets have not yet been determined [10]. S funds, on the other hand, are regularly in the late stages of investing when they engage in it, and they typically purchase fund shares that already hold reasonably definite underlying assets. The investment portfolio corresponding to fund shares is clearer and more transparent, and underperforming assets are readily evident. By completing thorough due diligence on the funds or projects to be acquired, the S fund team may more properly price fund shares and underlying assets to achieve the projected returns of LPs.

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4.2. Using a Decentralized Strategy to Allocate Assets, the Entry of Investors Is More Flexible

S funds frequently deploy assets more quickly than direct investment funds. LPs who invest in S funds can effectively incorporate PE assets into their investment portfolios. However, the S fund's acquisition targets are limited, and transactions are only possible when there are fund shares or underlying assets to be sold. S funds' investment strategy is rich with opportunities.

4.3. Avoid the Drawbacks of the "J-curve Effect" and Boost Fund Returns

A direct investment fund's term is typically 8 to 10 years, and its life cycle curve is commonly referred to as the "J curve" [11]. This happens because, within 4 or 5 years of the investor's contribution, the amount of the fund's external investment, management fees, and other expenses is often greater than the income generated by the investment project, resulting in a negative net cash flow, and it takes an average of 3-6 years. This takes years to break even and for LPs to start earning returns, therefore the net cash flow has a "J" shape. S funds generally enter when a company is relatively mature. Because the underlying J curve has frequently bottomed out and begun to rise at these investing points, the return period is shorter.

5. Development Prospects of Secondary Private Equity Funds in China

The IPO is currently the most significant exit route for junior private equity in China, but it has the disadvantages of taking a long time, having limited resources, and being subject to considerable unpredictability. The S fund is playing an increasingly important role as a supplementary exit channel due to its unique advantages. The S fund's primary significance is to improve the liquidity of LPs while simultaneously relieving the pressure on GPs to exit. The private equity secondary fund market has gradually increased in popularity, and general partners have begun to pay greater attention to "secondary." However, because they have a large number of project launch chores and fresh fund raising activity, the management of Chinese VC/PE institutions are still disassociated with S transactions currently. The share transfer of the previous fund is largely the replacement of funds generated by investors themselves, or the requirement for asset allocation adjustment, and there is no new capital increment, therefore lacking subjective initiative to a certain extent.

Based on the barriers to the development of S funds in China. First, the domestic S fund is still in its early stages, the scale is limited, and it has not yet become a mainstream exit method. Second, there is an information imbalance between buyers and sellers of shares, a lengthy process of altering industrial and commercial registration, and the serious shortage of intermediaries. Third, domestic S fund talent is in shortages.

Based on the opportunities for S funds to flourish and exist in China. For starters, it can meet the increased liquidity requirements of existing investors. Primary private equity investment generally lasts 7 to 10 years. The secondary market can shorten the investment return period for some investors who are eager to reach cash. Second, it offers the benefits of both risk and profit. It has been in operation for a long time since its inception for the forthcoming trade aim. The buyer has been able to better understand the state of the fund's projects and actively chose the fund with superior cash flow, which is conducive to diversifying investment and reducing risks. Third, it offers advantages in terms of establishing contacts between buyers and outstanding fund managers, which is conducive to further cooperation expansion. Fourth, as a result of the influence of geopolitics and macroeconomics, many funds established in 2014, 2015, and 2016 are under pressure to exit, due to the demand for LP liquidity and the plentiful supply of sellers. Fifth, an increasing number of roles, including buy-side and various financial institutions, are participating in the entire S fund market. The regional ecology

DOI: 10.54254/2754-1169/17/20231056

has gradually improved, and the establishment of the Shanghai Stock Exchange Center and the Beijing Stock Exchange Center places S funds in a more vital position in terms of supervision and local financing. Sixth, more data suppliers, intermediary providers, legal providers, and evaluations are becoming involved in S fund intermediary services, and the entire industry chain is evolving toward ecological integrity.

S funds typically provide three benefits to general practitioners. First, for GPs, if Institution S becomes a new LP by transferring shares, it reflects market institutions' acknowledgement of the fund's performance, and the manager's reputation will also improve. Second, the new fund's contribution will provide GP with more diverse collaboration opportunities. Most institutions still use a P strategy when purchasing S. That is, to create a fund of funds that invests primarily in new funds from high-quality leading institutions. Through the S fund, GP can communicate with new LP. Third, the listing pressure on GP will be lessened. A After the S buyer enters, they usually hope to continue to extend the life cycle of the fund by keeping it for a period of time and obtaining better returns, which has the function of expanding the fund's extension term. LPs can decrease GPs' workload when making transactions and the energy that GPs must expend, such as supplying due diligence materials, to make secondary transactions more attractive with all subjects. When LPs select S funds for trading, they must keep in mind that each S fund has its unique strategy and cannot cover all sub-sectors. LPs must use caution when transacting with S funds.

The DSG approach is recommended by the asset management business of China's private equity fund of funds for how S funds identify LPs. D represents the direct investment team, S represents the S fund team, and G represents the rich GP resources [12]. The DSG deep synergy system can withstand strong competition and market cycles. This is a complex project, and the strategy calls for the S fund manager not only to have just long-term and continuous access to the market's highest-quality transfer targets. This is frequently tied to the manager's continuous ability to contribute funds and the previous positive relationship with the head GP. At the same time, it can make a swift valuation decision on the target. Finally, the scheme requires the manager to select a good target for the S fund transaction.

S funds place varying emphasis on the needs of various S assets. Different asset packages place different emphasis on distinct indicators and have diverse demands for certain assets. The essence of asset packages differs as well. The variations in many elements make evaluating the quality of the asset package according to a specific criteria problematic. Second, it should be realized that there is no clear price formula for the valuation of S assets, and that matching pricing requires evaluating the expected returns that the assets themselves can accomplish. Each link demands a great deal of trading experience, whether it is asset screening, counterparty selection, transaction structure setting, or risk control.

6. Conclusion

The development of S funds in China faces challenges and requires time and space to flourish. Promoting the growth of investment funds and capital markets is an imperative need for China. S funds have numerous characteristics and advantages, the most prominent is their investment target is more transparent, investor entry is more flexible, and they can avoid the "J-curve effect" withdrawals and boost fund returns. S funds are an indispensable part of the equity ecology. Simultaneously, a large number of private equity funds in China are progressively exiting, and the trend of state-owned funds and policies is bringing benefits. Economic performance is lackluster against a backdrop of COVID-19 and global instability, and risk aversion among investors is increasing. Secondary Private Equity Fund is an inevitable choice to follow the trend in the context of the current enormous number of exit needs.

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