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Exits have been unusually strong in the past few months, says Pantheon's **Gong Jie**

By Eudora Wang
14-18 minutes

The aftermarket performance of portfolio firms is increasingly being taken by limited partners (LPs) as an important benchmark to assess their venture capital and private equity backers in an over-heated public market, according to an Asia-focused investor.

"In the past couple of weeks, we have seen some much-needed correction in global public market sentiment, which has removed some froth from certain overheated pockets," said Gong Jie, a Hong Kong-based partner at UK-based investment firm Pantheon Ventures, in a recent interview with DealStreetAsia.

"Despite this correction, for many companies with strong fundamentals, the valuation re-rating between pre-IPO marks and current marks based on the stock prices still amounts to a substantial uplift, not to mention the money multiple, especially for those GPs that invested early," she said.

The aftermarket fluctuation of newly-traded companies gains significance amidst a robust exit market in Asia, especially in mainland China, that is paving the way for investors to cash out profitably through trade sales and more prominently, initial public offerings (IPOs).

Issuers seemed unfazed by the coronavirus pandemic. According to consultancy PwC, there were 118 new listings and 139.3 billion yuan ($20.38 billion) in total funds raised across mainland stock exchanges in Shenzhen and Shanghai in the first half of this year (H1 2020), an increase of 84 per cent and 131 per cent, respectively, from a year-ago period.

With the trading frenzy on its Nasdaq-style STAR Market, the Shanghai Stock Exchange (SSE) topped the global IPO market in H1 2020 with 73 new listings and came second in terms of total funds raised, which stood at 111.7 billion yuan ($16.34 billion).

While the IPO market boom translates to "a strong harvesting season" for institutional investors, Gong said that the exit activity for investors behind Chinese companies reached “a high point” in July, stimulated by interest rate easing and other monetary policies amid a virus-induced economic slump.

In China, Beijing’s IPO market reforms to build a more market-driven, registration-based listing standard have also stoked interest in typically risk-averse investors.

“In a liquidity-fuelled and buoyant IPO environment like this, there is significant quality disparity among company listings. There has been a wide dispersion in aftermarket performance, which is an indication that medium and long-term equity investors are far from indiscriminate. Such aftermarket performance becomes the acid test for company quality,” said Gong.

With $50.7 billion in total assets under management (AUM) by the end of Q1 2020, UK-based Pantheon Ventures invests in private equity, infrastructure & real assets, as well as private debt. The firm has about 340 employees, including 95 investment professionals, across offices in New York, San Francisco, London, Hong Kong, Seoul, Bogotá, Tokyo and Dublin.

Gong Jie is a Hong Kong-based partner at Patheon Ventures and a member of the firm’s Asia Regional Investment Committee and the Global Co-investment Committee, as well as Vice Chairman at the Hong Kong Private Equity and Venture Capital Association (HKVCA). Prior to Patheon Ventures, she was the head of Asia at Morgan Stanley Alternative Investment Partners’ private equity FOF group.

Edited excerpts of the interview with Gong:

How have the first eight months of 2020 been for Asian private equity & venture capital LPs?

The backdrop for Asian PE and VC in the last eight months has been COVID and the US-China tension. In this environment, capital deployment by PE and VC has inevitably been more subdued than usual. At the height of the COVID outbreak in Asia, GPs’ attention pivoted away from new deals towards supporting existing portfolio companies.

Fundraising has also been slower. Not being able to do face-to-face meetings and roadshows have been a factor. A higher level of caution amid global uncertainty has been another. Nonetheless, in our experience, sought-after GPs are still managing to successfully raise capital and reach their hard caps. In uncertain times there tends to be a flight to quality, whether quality is represented by brand name or by outperformance, especially in realized returns. Such GPs have in fact generally benefited and seen the demand for their funds increase.

More unexpected is the fact that exit activity has been unusually strong in the past several months. July marked a high point in recent years for the number of IPOs globally by Chinese companies. There were over 70 IPOs of Chinese firms during the month, significantly up compared to the same time last year.

These IPOs, which took place on stock exchanges domestically, in Hong Kong and in the US, featured companies in smart manufacturing, for example, electric vehicle, biotech and other healthcare sectors, and internet-related companies. Over 70 per cent of the companies were backed by Asian PE and VC firms, so this translated to a strong harvesting season for a number of GPs.

One of the key drivers behind the rise in public market exit activity is the buoyancy of public markets. Interest rate easing and other monetary policy actions across different countries have helped drive both the NASDAQ and S&P 500 to above pre-COVID levels. Other factors include the launch of the Shanghai Stock Exchange's STAR board for technology companies last year, and the Hong Kong Stock Exchange's greenlight for listing early-stage biotech companies. Clearly, the demand for the recent wave of new IPOs of Chinese businesses, which tend to be in the new-economy sectors also reflects investors' search for meaningful growth, which has become more scarce globally.

In a liquidity-fuelled and buoyant IPO environment like this, there is significant quality disparity among the company listings. There has been a wide dispersion in aftermarket performance, which is an indication that medium and long-term equity investors are far from indiscriminate. Such aftermarket performance becomes the acid test for company quality. In the past couple of weeks, we have seen some much-needed correction in global public market sentiment, which has removed some froth from certain overheated pockets. Despite this correction, for many companies with strong fundamentals, the valuation re-rating between pre-IPO marks and current marks based on the stock prices still amounts to a substantial uplift, not to mention the money multiple, especially for those GPs that invested early. All in all, the results at this point are, in my view, a good illustration of the benefits of private market investing.

We have said in the past that many PE and VC exits are through trade sale. In the current environment, trade sale volume is still there but it often comes second as a preferred exit option, as IPO valuation is higher than what strategic buyers are willing to pay. Despite that, trade sales continue to be an important option for the realization of returns.

How has the geopolitical tension played a part in the PE and VC activities in the past eight months?

The US-China relationship has taken a turn for the worse. It is a much-discussed topic in both GP and LP circles. However, up to this point, it does not seem like the geopolitical tension has had much of a dampening effect on the stock market, if you look at the price movement of large Chinese companies listed across the US, Hong Kong and A-share stock exchanges.

In terms of vulnerability towards the export sectors that are directly impacted by tariffs, most Chinese PE and VC have virtually no exposure to such sectors. Neither are they typically in the sensitive technology and critical tech infrastructure companies that are in the crosshairs of the two countries' rivalry. PE and VC's sweet spot has been mostly on the application of existing proven technology, rather than foundational science and frontier technology. Overall, therefore, the US-China tension hasn't caused

GPs to shift course. There continue to be Chinese companies listing on the NASDAQ or NYSE, albeit accounting for a smaller proportion of IPOs than before.

The impact on the export sector certainly translates to the real economy in the form of job losses, a consequence that has been made worse by COVID. Unemployment is the top priority for the government at this moment. What is noteworthy is that such impact is very uneven in where it hits, depending on the industry, social-strata and location within China, and availability of local service sector new openings (for example, food deliveries, car-share driving) to fill the gap. PE and VC need to be more thoughtful than ever in understanding the underlying customer bases and the value proposition of target businesses. It also drives the companies to be much more focused on efficiency and cost containment.

So, who is investing in these highly sensitive technologies and sciences in Asia?

Investment primarily comes from the government's academic, scientific and research institutions. Chinese government funding goes towards the private sector's frontier technology R&D as well, e.g. to drive the development of semiconductor technologies. There are some RMB funds that invest in sensitive technology and frontier science. The exit route is domestic listings or trade sales, but these are outside the scope of GPs managing funds in US dollars.

You spoke earlier about a flight to quality. How fierce is the competition for LPs to invest in the top 10 per cent GPs in Asia?

There are two types of GPs that have benefited from the current flight to quality. The first are very large brand-name GPs that are regarded as a safe pair of hands and that set their own record in fund size each time they raise. Given these fund sizes, access is not as difficult as for the other type; smaller GPs with an outstanding track record of realized returns. For these GPs you need to build the relationships early on in their lifecycle. Often the fund size is constrained relative to LP demand, i.e. when they are discovered by more LPs, it can become impossible to get access at all if you do not already have a seat at the table.

You spoke about "brand name" GPs being a draw to many LPs for them to double down on their commitment, leading to such GPs to raise record fund sizes. On the other end of the spectrum, how difficult is it to raise a first-time fund now in Asia?

To generalize, first-time fundraising is difficult. Having said that, not all first-time funds are created equal. There are some that are spin-offs from established firms and that bring with them a strong attributable track record. These first-time funds can be oversubscribed even as they have "Fund I" in their names.

How do you view the pandemic's impact on GPs' performance in China?

The pandemic has been an acid test for PE portfolio companies of their resilience in terms of crisis management, balance sheet strength, business model, etc. Likewise, for GPs it has tested their ability to provide essential support at a time of unprecedented disruption.

Chinese PE and VC capital has overweighed “new economy” sectors owing to the compelling growth prospects. The pandemic has been a transient exogenous shock that has in many ways accelerated the digitalization of the economy just as elsewhere in the world. On the other end of the spectrum, outdoors businesses have largely recovered but they are still hurting from the double whammy of lost market share to online alternatives and the widening valuation wedge between them and online alternatives.

Over a year ago, in your last interaction with us, you had said: “You can think about general outsourcing as a theme for a prolific set of opportunities…This has been an area that has historically been underrepresented in the economy…This is not an area that has been as visible for PE/VC investment. It has a lot of potentials, and is often defensive and acyclical in nature.” Is this still among the biggest opportunities in China?

I was referring to the business services sector. Since we last spoke, there has been a marked pickup in deals done in the sector, noticeably in the SaaS (Software-as-a-Service) area. Software solutions that are “purpose-built” for specific industries have certainly seen increased adoption and demand from companies as a result of COVID’s physical disruption and a stronger emphasis on efficiency and cost management. Many GPs see COVID as an inflection point for the SaaS usage in China.

Another example is a recent uplift in the logistics and supply chain services deals. The vulnerability of supply chain exposed by COVID has drawn attention to the need for reliability and efficiency in that area. Technology-enabled services businesses are embraced by companies for a data-driven and optimized system of supply chain management.

Talking about supply chain, China’s lockdown at the height of COVID also reminded global businesses of their reliance on supply chain in China. The geopolitical tension may add to the incentive of reducing such reliance. Have you seen some sort of supply chain shift?

There have been manufacturing facilities moving from China to Southeast Asia, for example, Vietnam and the Philippines in the past several years, before COVID and before the US-China tension, because the labour cost in China is no longer cheap. Recent developments have been a further catalyst.

I think that the trend is going to continue, but I see it as a balancing act, not as a wholesale shift. For manufacturing of products beyond the low-end light industry sector, the maximization of cost efficiency is achieved through the highest possible level of specialization in a multi-layered and highly-integrated supply chain. This type of ecosystem would be too complex and difficult to replicate as it is predicated on the abundance and breadth of skilled labour, reliability of infrastructure and logistics, etc. To shift manufacturing at the expense of increased cost would not be very palatable in a generally weak economic environment post-COVID.

The second important thing, which is not much talked about, is that China itself is the largest end market in the world, because of its population. It makes sense for global businesses to be in China, to manufacture for the Chinese market.

Big picture, which direction do you think the capital allocations towards Asia will go?

I do not hold a six-month view as there is so much uncertain going on right now. But for the medium and long term, I believe allocations are likely to go up. Given the vast weight of the institutional capital in PE outside of Asia and the natural home bias of these institutional LPs, Asia is under-represented in their PE and VC portfolios compared to the region's economic weight. Private equity valuation tends to be more attractive in this region, and growth levels are higher. The recent trend of the US dollar's mean reversion may continue for some time. These all point to the likelihood of an upward direction in capital allocation to the region.

Important Disclosure

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