KEYNOTE INTERVIEW

China's rebound creates domestic PE opportunities

China and Hong Kong may have been the first to be hit by covid-19, but they are also rebounding quickest. Despite US-China trade tensions, there are plenty of domestic opportunities emerging, say Tracy Wut and Derek Poon of Baker McKenzie

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Q What has been covid-19's impact on PE firms and portfolio companies in China?

Derek Poon: China and Hong Kong were the first markets to be hit by covid-19 back in February, but China was also one of the first economies to come out of lockdown and rebound from the pandemic. Initially, deal activity was down and financial sponsors that were looking at selling assets pulled processes or put those on hold because of travel restrictions and the challenges around deal-making and due diligence.

The initial focus was on triage for portfolio companies, particularly focused on those in the travel, hospitality and retail sectors. GPs ensured those companies had sufficient liquidity and were quantifying short-term liabilities and existing debt positions. We also saw GPs liaising with existing lenders to draw down on working capital facilities or roll over repayment and, if necessary, deploy capital to inject into businesses.

Tracy Wut: China has rebounded strongly and got back to normal quicker than Hong Kong, Singapore and the rest of the world, particularly where local domestic consumption has increased in tier-one cities such as Beijing and Shanghai.

GPs are now helping portfolio companies prioritise operational expenditure over capital expenditure as China enters a period of slower growth. There has been a slowdown in sales processes and a lot of assets are now not coming to market until Q4 2020 or even Q1 2021, given the poor financial performance earlier in the year.

Q What has been the impact on deal activity?

DP: When covid-19 first hit China and Hong Kong, a few clients put a freeze on new money investments to concentrate on portfolio companies. Others invested in opportunistic transactions, distressed assets, real estate private equity or new asset classes, such as digital infrastructure. We saw flash crashes in

Hong Kong and China-listed entities, which presented opportunities for financial sponsors to bridge and refinance controlling shareholders who may have had margin loans. Because valuations were low, we also saw privatisation offers from sponsors, with management or other investors as part of consortiums. Covid-19 accelerated an increase in PIPE opportunities, with investors looking at strategic investments in listed companies that needed liquidity alongside institutional investors.

TW: In terms of sectors, we saw activity in logistics, e-commerce and technology, particularly fintech and online gaming, which both attracted a lot of investment. In the last 12 months, we have also seen a lot of interest in healthcare and biotechnology.

Q How are US-China trade tensions impacting private equity in China?

DP: US-China trade tensions are creating uncertainty and have affected outbound transactions from China. Transactions that trigger a CFIUS review are taking longer to process given the increase in questions and draft and enacted legislations – including the PRC Unreliable Entity List, Draft Export Control Law, HK Autonomy Act and HK National Security Law – which have added to increased scrutiny and uncertainty for dealmakers.

But with China recovering quickly, new domestic opportunities are emerging. Many multinationals are continuing to rethink their China strategy, with some embarking on divestments of their China operations. We are seeing private equity sponsors and local PRC champions – sometimes working together – watching the domestic market to see if they can acquire assets and use them to scale domestically or regionally.

TW: China has become more attractive as a listing option in the last few months. The Chinese and Hong Kong arms of global, regional and China-focused private equity firms are leading take-privates of PRC companies listed in the US, with a view to relisting those in the PRC and Hong Kong. Others are seeking a secondary listing in Hong Kong, potentially as a precursor to a take-private.

Q What role might PE play in China's recovery?

DP: PE continues to be important. Several global, pan-Asia and Chinese sponsors raised record funds dedicated to Asia last year, so dry powder is still at record levels and there is a lot of competition for quality assets. As well as targeting new local champions, regional and Chinese private equity firms are keen on supporting local businesses looking to expand and push deeper in tier three and tier four cities in China.

We are seeing a lot of investment in digital infrastructure, such as hyperscale data centres, and in logistics and real estate. Given the rise in e-commerce and technology generally, these can be either private equity, infrastructure or real estate plays. There is a saying that data is the new oil, and investments are being made in both greenfield and brownfield data centre platforms, particularly in China, with several assets achieving or seeking capital markets listings. There are also opportunities in the retail and consumer sectors for private equity to fund digital transformation and help investee companies build out e-commerce platforms post-covid.

TW: We have seen some acquisitive Chinese conglomerates make overseas acquisitions that now need to be divested, or are potentially in distress. Alongside multinationals restructuring their businesses in China, often to bring in local champions as partners, we see opportunities for strategics backed by private equity.

We are also seeing opportunities for private equity in commercial real estate, given depressed valuations and the potential for a rebound. In China, when some of the first-tier cities came out of quarantine there was an instant rebound in valuations for residential real estate.

Q How do you see Hong Kong's future as a private equity hub for the region?

DP: Since the pandemic we have seen some Hong Kong-based PRC-focused private equity professionals relocating to the mainland to counter travel restrictions. But Hong Kong will continue to be a private equity hub, given the concentration of GPs in the city with close proximity to the mainland, the city's involvement in the Greater Bay Area initiative and its low tax regime and established financial infrastructure.

The Hong Kong government has implemented a new limited partnership regime for investment funds, with the Limited Partnership Fund Ordinance coming into effect in August. The intention is to encourage GPs to establish and raise funds in Hong Kong rather than the Cayman Islands or Singapore, by streamlining the licensing processes and providing a more facilitative tax environment for funds. We already have clients enquiring about this. The government has also proposed a tax concession for carried interest distributed in respect of private equity funds, historically one reason GPs were discouraged from operating in Hong Kong.

TW: Recognising that many businesses are looking to expand their presence in the Greater Bay Area, to unlock the opportunities of a region that has a GDP of US$1.3 trillion and a population of about 67 million, we have enhanced our capabilities in southern China through our joint operation partner, FenXun Partners, which has a new office in Shenzhen. That office is FenXun's fourth in the PRC (after Beijing, Shanghai and Hainan) and complements Baker McKenzie's offices in Hong Kong, Mainland China and globally. ■

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