FrontLine Research Paper

Looking at Chinese venture capital fund distributions

Venture capital (VC) is one of the most ubiquitous private equity investment strategies worldwide. It was also the first to bloom in most countries, along with growth capital. There is no need to have specific fixed income expertise, as required by leveraged buyouts; nor any specific regulation, as required to operate distressed debt investing. Regardless of the geographical region, high potential start-ups require capital to grow. Professional investors can provide this capital, along with expertise, know-how, and network.

Some countries apply capital market controls, limiting VC funds in the sale of their assets.

A few pre-requisites are necessary for VC funds investments. One is a reliable local rule of law and its enforcement. This is necessary so that VC fund managers, who are minority investors, can confidently design and use their investment instruments, such as preferred shares. Another is the existence of vibrant local capital markets, to provide exit paths for VC investments. Ideally, a local dynamic stock exchange would welcome fast growth small capitalisations. As trade sales are the main avenue to exit venture investments, local capital markets should support local and international start-up buyers.

 Copyright © 2019 eFront. All rights reserved.

With respect to establishing favourable capital markets, some geographical regions, such as emerging markets, can present more challenges than others. First, the local rule of law might be more or less adapted to the intervention of minority investors. The protection of their rights can be variable and at times difficult to enforce. For example, some standard clauses of shareholders agreements, such as non-compete clauses, are simply illegal in certain jurisdictions. Second, some countries apply capital controls and have applied specific measures constraining initial public offerings or limiting trade sales, notably to foreign companies. This can result in difficulties for VC funds when disposing of their assets.

One of the largest emerging markets is China. The country has seen the fast development of a professional VC sector over the course of the last two decades. The country applies capital controls and its authorities are actively managing its capital markets. Has this led to any specific consequences in terms of exits and distributions for local VC funds? Thanks to the high-quality data provided by eFront Insight, it is possible to answer this question. To do so, this issue of FrontLine will compare Chinese VC funds with their international, Western European and American, peers. The currencies of reference are respectively the Yuan, US dollar, Euro and US dollar to minimize analytical distortions. The same vintage years have been selected across the board to create comparable samples.

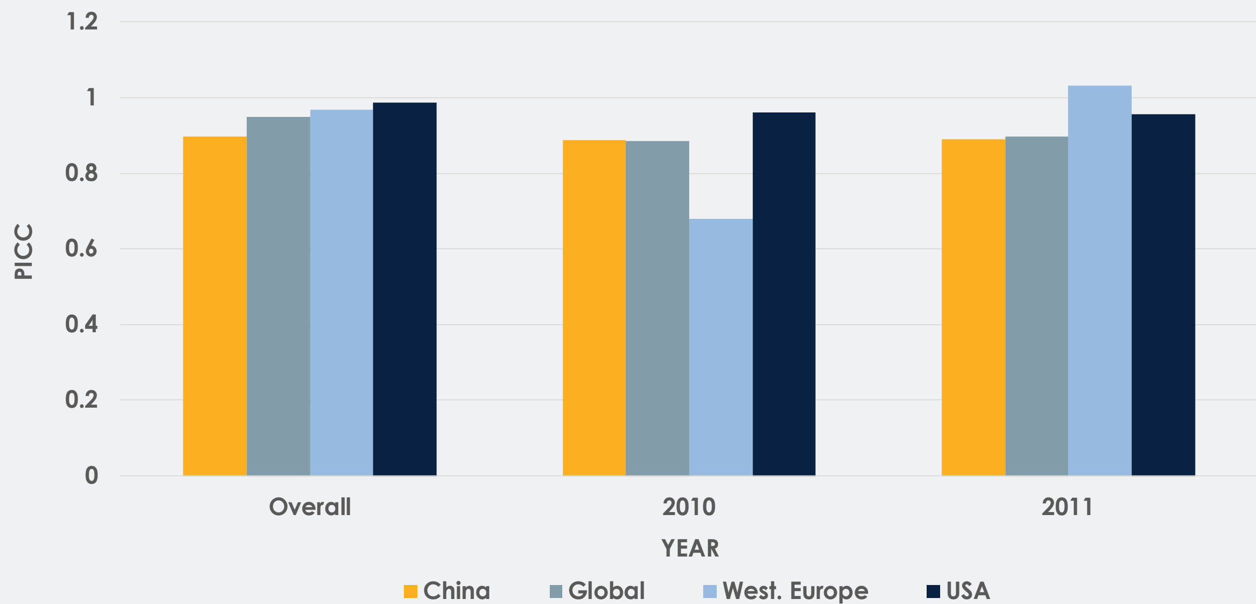
Chinese VC funds seem to use less capital than their peers, but this is due to the higher weight of recent vintage years in the sample.

A first glance at funds performance

To compare VC funds, we will look at a sample of vintage years from an overall perspective. Unfortunately, the relative weight of funds and the difference in number could introduce some analytical biases. As an illustration, Chinese VC funds seem to use less capital (as measured to the paid-in to committed capital, or PICC) than their peers (Fig. 1). This could be due to the fact that the Chinese sample gives more weight to recent vintage years than for more mature markets. We will further explore this assumption below.

 Copyright © 2019 eFront. All rights reserved.

Figure 1 – Use of capital by venture capital funds, by region



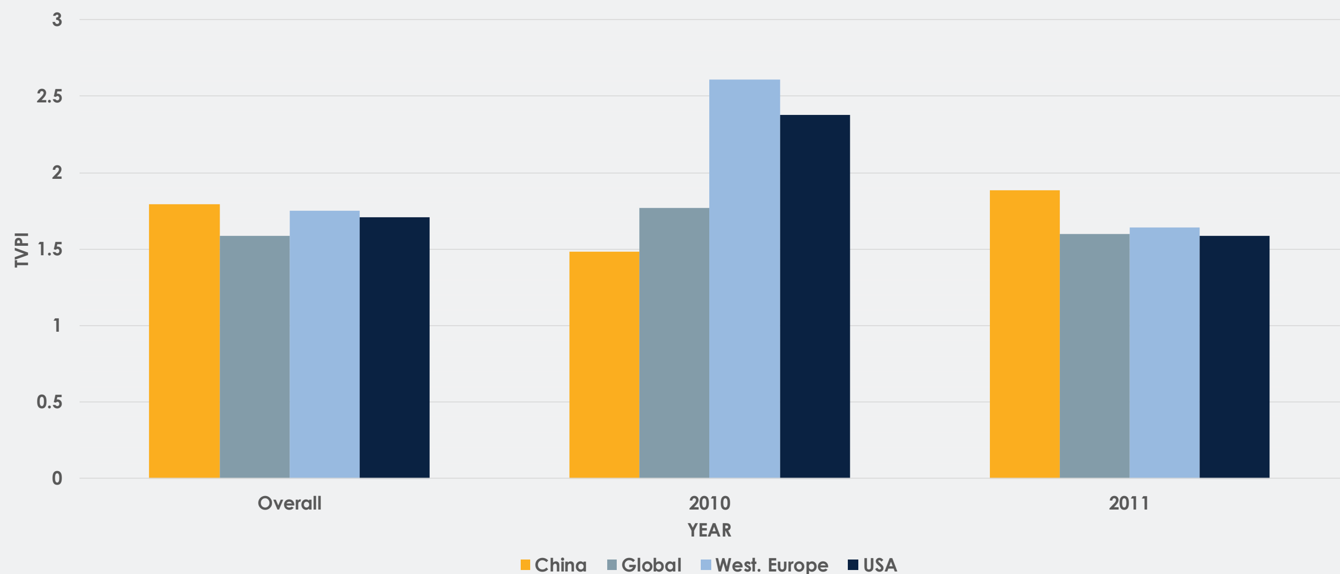
Source: eFront Insight, as of Q3, 2018.

Therefore, we have selected two recent but rather mature vintage years as a support for further analysis: 2010 and 2011. Along these lines, Chinese VC funds seem to operate at par with international funds. The "Overall" figures are thus skewed by younger Chinese VC funds. However, the vintage year analysis shows that VC funds based in the US deploy systematically more capital than in any other region. On average, they invest more than 95% of fund sizes. This means that some funds in the sample invest more than 100% of the fund size. The explanation for such a level of investment is that early distributions from some US VC funds are recycled during the investment period. This would be confirmed by faster time-to-liquidity in the US than anywhere else. We will further explore this assumption below.

A detailed vintage year analysis also shows that Western European VC funds are an outlier. While funds of the vintage year (VY) 2010 deployed only 68% of their fund size, those of VY 2011 deployed 103%, therefore recycling significant early distributions. We should, therefore, apply caution when drawing conclusions from our vintage year analysis in Western Europe. This is particularly true with performance figures (Fig. 2), as Western European TVPI looks particularly high. Overall, the total value to paid-in (TVPI) of Chinese funds in local currency appears as fairly similar (1.79x) to American (1.70x) and Western European (1.75x) funds.

Copyright © 2019 eFront. All rights reserved.

Figure 2 – Multiple of venture capital funds, by region



Source: eFront Insight, as of Q3, 2018.

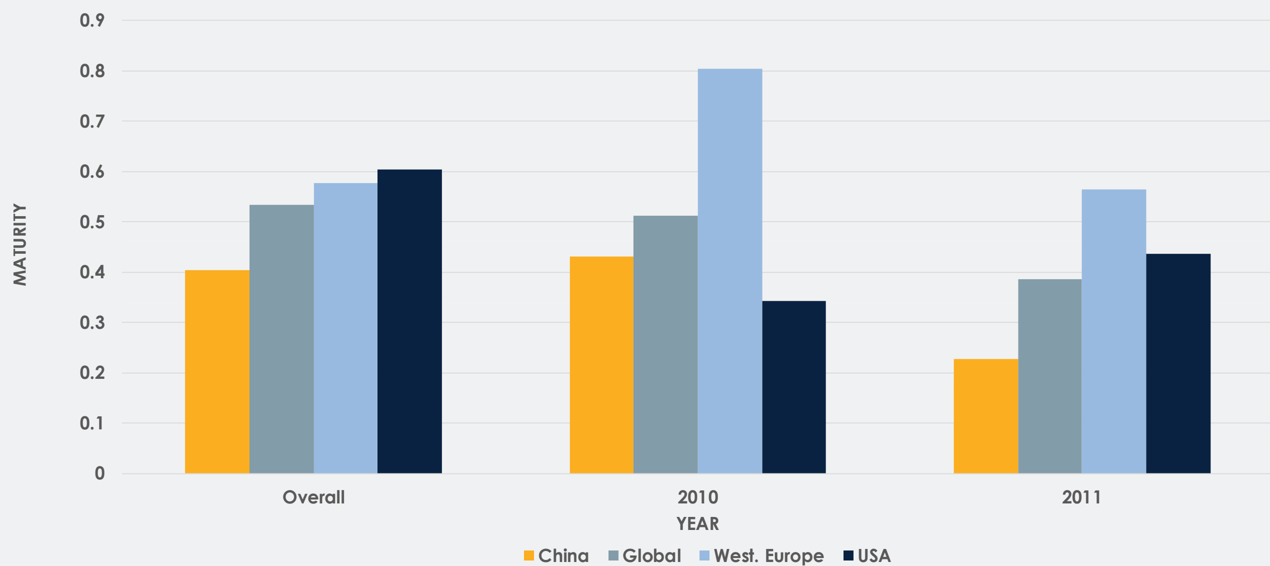
Chinese VC funds mature more slowly

Some of this performance is still largely in the making. The maturity of Chinese VC funds, measured by the distributed divided by the total value (Fig. 3), reaches only 40% while other funds exceed 50%. Some of the outperformance described above is therefore theoretical. Not only are Chinese VC funds on aggregate less mature, but they also mature more slowly, as shown by the detailed analysis of individual vintage years. Individual vintage years show very contrasted results. However, comparing the maturity of Chinese and global VC funds, the former are systematically less mature than the latter, whether overall or vintage year by vintage year.

Chinese VC funds are on aggregate less mature, and they also mature more slowly than their peer group.

Copyright © 2019 eFront. All rights reserved.

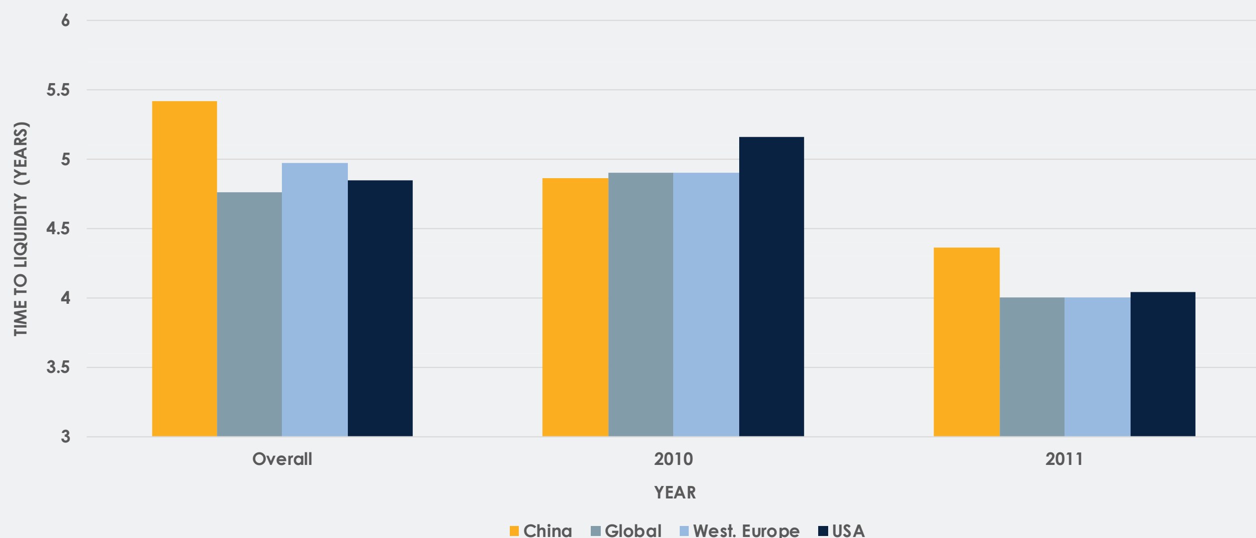
Figure 3 – Maturity of venture capital funds, by region



Source: eFront Insight, as of Q3, 2018.

This is confirmed by the time-to-liquidity, which is measured as a function of the TVPI and the IRR of the pooled average performance of VC funds (Fig. 4). Overall, Chinese VC funds record a much longer average holding period. This is due to a slower distribution pace (Fig. 5), as notably illustrated by the VY 2011 but not the VY 2010 (Fig .4).

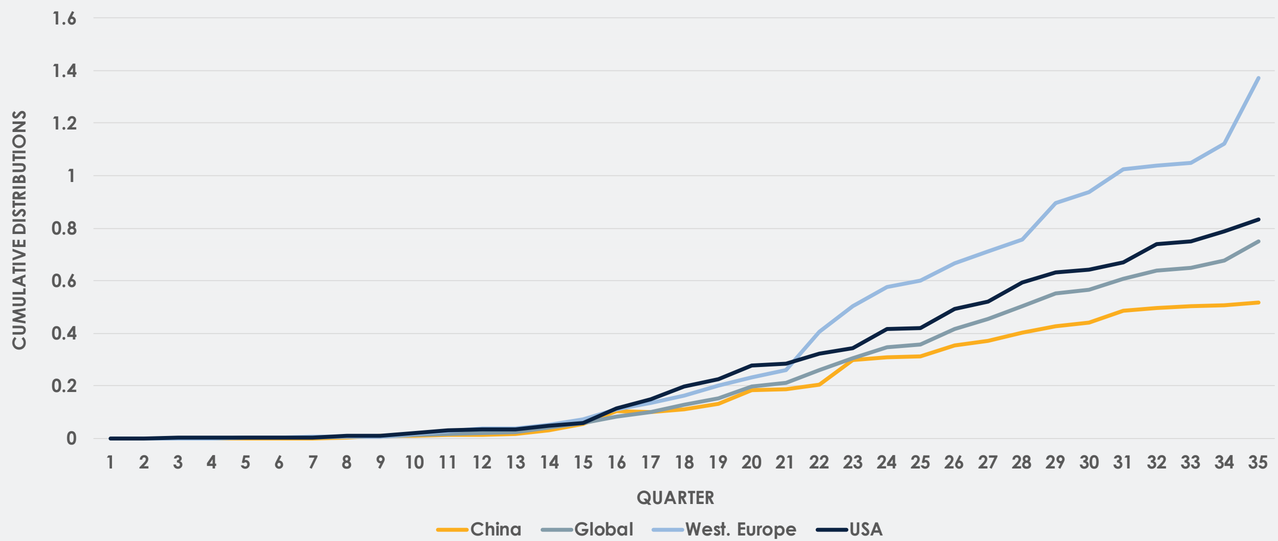
Figure 4 – Time-to-liquidity of venture capital funds, by region



Source: eFront Insight, as of Q3, 2018.

 Copyright © 2019 eFront. All rights reserved.

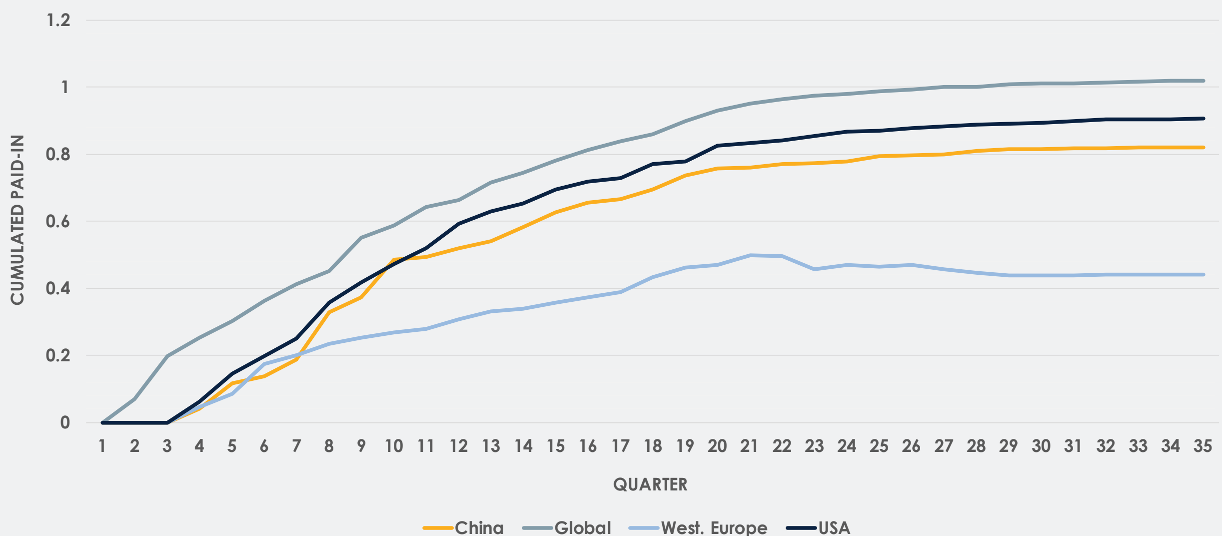
Figure 5 – Cumulative distributions of venture capital funds, by region



Source: eFront Insight, as of Q3, 2018.

Is 2010 an outlier? Not necessarily: there might be an optical effect involved. The time-to-liquidity indicator measures an average exposure at a given time. However, if funds deploy capital more slowly and are still active, as funds from VY 2010 and 2011 are, then their average holding period could appear shorter simply because they deployed capital more slowly. However, in this specific case (Fig. 6), this is not confirmed. Chinese VC funds deployed capital in a similar way to their American peers. Thus, 2010 is an outlier for Chinese VC funds.

Figure 6 – Cumulative paid-in of venture capital funds of vintage year 2010, by region



Source: eFront Insight, as of Q3, 2018.

 Copyright © 2019 eFront. All rights reserved.

Interestingly, US VC funds do not show a systematic and significantly shorter time-to-liquidity than their peers. This could imply that their peers from other regions do not have the opportunity or the right to re-invest early distributions. In assessing the relative performance of VC funds by region, this is potentially an important factor to consider.

Conclusion

Chinese VC funds divest more slowly than their peers from other geographical regions. There are multiple possible reasons. One is the difficulty of IPOs, as local authorities tightly control public listings. Another is that local companies take longer to gather the critical mass of activity and thus attract local and international buyers. A third reason might be that local regulations on ownership limit international acquisitions. A fourth is that local companies are more difficult to assess for buyers due to higher uncertainties. The consequences are that assessing the performance of Chinese VC funds is more difficult as it materialises over a longer period of time. It might also be more volatile, as IPOs are determined not only by market conditions but also non-financial factors.

Chinese VC funds deployed capital in a similar way as their American peers, therefore the longer time-to-liquidity is due to slower exits.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

 Copyright © 2019 eFront. All rights reserved.

About eFront

eFront is the leading pioneer of alternative investment technology, focused on enabling alternative investment professionals to achieve superior performance. With more than 850 Limited Partner, General Partner, and Asset Servicer clients in 48 countries, eFront services clients worldwide across all major alternative asset classes. The eFront solution suite is truly unique in that it completely covers the needs of all alternative investment professionals end-to-end, from fundraising and portfolio construction to investment management and reporting. For more information, please visit www.efront.com

About eFront Insight

eFront Insight is a sophisticated web-based analytical platform dedicated to alternative investments and combining granular, high quality investment data reported by General Partners, leading market benchmarks and other relevant sources in order to generate unique insights and facilitate investment decision making. eFront Insight is available to both General Partners to digitize data exchanges with investors and to Limited Partners to enhance decision making.

Learn More:

request@efront.com

Our Offices:

Sydney | Montreal | Jersey | Beijing | Hong Kong | Santo Domingo (DR) | Paris (HQ) | Cologne Mumbai | Tokyo | Luxembourg | Belgrade | Singapore | Cape Town | Abu Dhabi | Dubai | Seoul London | Boston | New York City | San Francisco