

In search of alpha: Updating the playbook for private equity in China

The era of beta-driven growth is over.

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Private equity (PE) in China has been a story of growth. Spurred on by a burgeoning economy—in 2010, China contributed 9 percent of global GDP; by 2019 it contributed 16 percent—investors' appetite for PE has made it the third-largest market in the world, with approximately \$60 billion in additional capital deployed in 2019.

Other factors, however, have limited the growth of PE in China. State-owned companies have historically crowded the market, competing for assets. Private players have often not wanted to sell businesses, preferring to keep them under family ownership. Corporate buyers have remained powerful competitors when it comes to acquisitions, limiting the number of attractive deals. As a result, private equity as a share of GDP in China was just 0.5 percent in 2019. Even adjusting for the

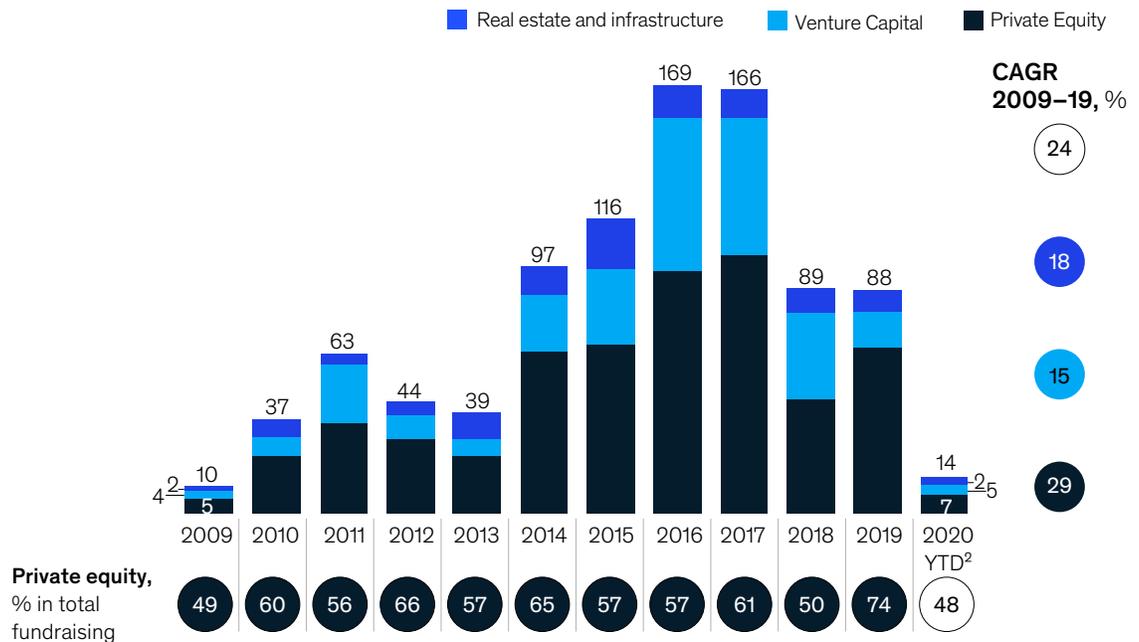
larger role that state-owned companies play in Chinese industry, this significantly lags that of more developed PE markets, such as the United Kingdom, where PE made up 2.6 percent of GDP, and the United States, where PE comprised 2.2 percent of GDP last year.

This gap is one sign that the Chinese PE market has room to grow—and change may be coming. Indeed, it is clear that investors in China are optimistic that new opportunities will continue to arise. From 2009 through 2019, fundraising for PE firms operating in China grew at a compounded annual rate of 29 percent, the strongest growth among all major asset classes (Exhibit 1). And the market shows other signs of change: the size of the average fund in China has almost quadrupled since 2014, and the complexity of the deals has increased as new co-investors have come on board.

Exhibit 1

Share of PE funds in total fundraising grew faster than venture capital and real estate/infrastructure between 2009-19.

Greater China private market fundraising¹, \$ billion



¹ Includes all closed Greater China focused funds and Asia focused funds raised by Mainland China based managers and 40% of fundraising by other APAC focused funds (which has Greater China as one of their location focuses).

² January to July, 2020.

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan.

PE includes buyout, growth, hybrid, balanced, turnaround, co-investment funds; VC includes early stage, startup, seed, expansion/ late stage funds; RE includes unlisted real estate, real estate co-investment; Infra includes unlisted infrastructure, infrastructure funds.

Source: Preqin

The impact of COVID-19 on the economy could provide further opportunities for private equity. Although deal volumes in early 2020 dropped more than 70 percent year-on-year, the rebound is likely driven in part by cash-strapped companies rethinking their business portfolios. Many of their assets are increasingly coming up as potential acquisition targets.

One pattern is clear: funding increasingly flows toward the largest, highest-performing firms. The top ten China-focused PE funds contributed 23 percent of fundraising in 2015 (based on the trailing five-year average); by 2019, they contributed 30 percent. But whereas in the past many firms were able to benefit significantly from China's macroeconomic growth, increased competition for deals likely means that relying on beta will not be enough in the future.

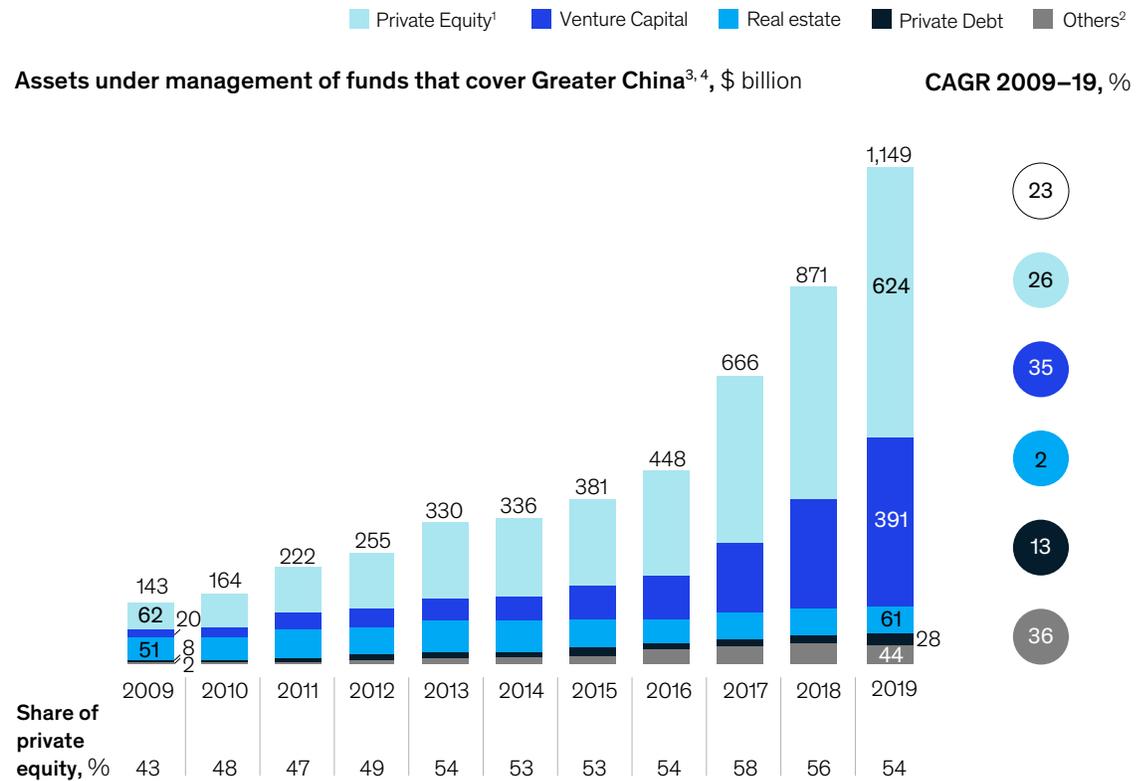
One type of fund that has not benefited from this growth are RMB funds raised by domestic financial GPs, which experienced a steep decline in fund-raising between 2017 and 2019. This drop was the main reason why total funds raised by PE firms in China declined during this period (Exhibit 3).

Valuations of target companies are likely to remain high due to intense competition. PE firms operating in China must also contend with higher levels of uncertainty and risk due to ongoing trade and geopolitical tensions.

To continue to grow and thrive, PE firms operating in China, above all else, will need to acquire new capabilities and adjust their strategies to create value in their portfolio companies.

Exhibit 2

Private equity and venture capital have been the fastest growing private investment vehicles for funds investing in Greater China.



¹Private equity: Balanced, Buyout, Co-Investment, Co-Investment Multi-Manager, Direct Secondaries, Growth, and Turnaround.

²Others include infrastructure, and natural resources investment funds.

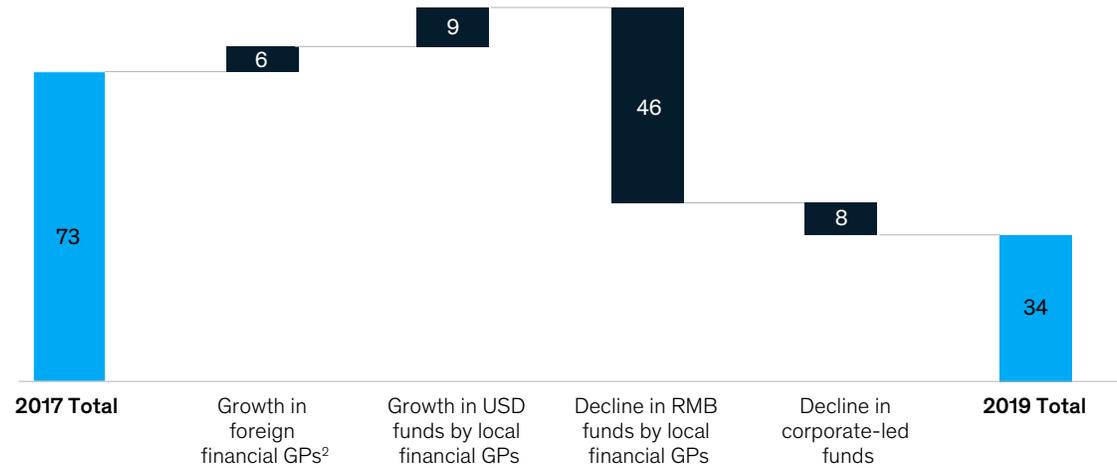
³Greater China includes Mainland China, Hong Kong, Macau, Taiwan.

⁴Including investments of these funds outside of Greater China

Source: Preqin

Biggest decline in fundraising came from RMB funding by Chinese financial GPs, (drop equaled ~65% of 2017 total market).

Greater China focused PE fundraising¹, \$ billion, excl. government-led fund



¹Includes all closed Greater China focused funds and Asia focused funds raised by Mainland China based managers and 40% of fundraising by other APAC focused funds (which has Greater China as one of their location focuses).

²General Partners

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan.

Private equity includes buyout, growth, hybrid, balanced, turnaround, co-investment funds.

Source: Preqin

While in the past funds may have talked about generating alpha as a ‘nice to have’, in today’s challenging economic environment, generating alpha has become a must-have condition for success.

We believe that PE firms need to take four key actions to ensure that they can add value to individual companies, outperform the market, and become institutions that can reliably produce exceptional returns:

1. Articulate a new, clear value proposition to LPs. GPs need to clearly state their differentiated strategy for creating value: become more specialized or achieve scale by, for example, expanding into adjacent asset classes.

2. Achieve excellence in talent, governance, and organization. As a professional services firm, talent is critical, especially in a market like China, where the availability of certain types of specialized talent remains constrained.

3. Refine how to successfully originate and execute on deals. More sector-level expertise and trust built with potential portfolio companies can help with deal sourcing. Having a clear view of—and plan for—how to create value in an asset can boost their ability to execute more complex deals and then deliver that value.

4. Prepare for successful exits, early on. Planning a successful exit should start at least 18 months prior to a planned exit, allowing time for asset owners to shape a compelling equity story.

Those firms that are able to take action and make changes now can sustain their success in the face of new challenges. To help private equity investors and others get a better understanding of the private capital market in China, we studied data and trends and found that there is still plenty of room to grow. The COVID-19 crisis is likely to further accelerate these trends and provide opportunities for savvy PE investors.

The current state of Chinese private equity

As the market has matured, PE funds focusing on China have started to shift from buying minority stakes in companies toward deals that would give funds more influence over portfolio companies' operations—and growth.

Fundraising is increasingly concentrated within a subset of GPs, driven by better visibility on historical track record and preference of LPs to deal with a limited number of funds. As the difference between performers and laggards becomes more pronounced over time, we expect the industry to become further concentrated. For funds that are able to create value, exits will remain a challenge, as funds operating in China currently rely on corporate buyers to exit in a significant way.

A complex, maturing market with room to grow

In 2019, private equity and venture capital funds deployed \$66 billion of their funds in China, compared to \$71 billion in the United Kingdom and \$471 billion in the United States.

We expect LPs to continue to focus on China. Some of the leading LPs we spoke with during this research told us they would like their asset allocation to mirror a region's share of global GDP. Most firms, however, have not reached this for China, which contributed 14 percent of global GDP in 2019. This trend will likely continue as China is expected to contribute up to 25 percent of global GDP growth from now until 2024.

As investments in China have grown, so have the size of PE deals. Average deal size rose to \$75 million in 2019 from \$36 million in 2009. The same trend toward scale has played out at the other end of the market: both the share and number of deals over \$500 million have increased in the last decade. In 2019, the number of such megadeals rose to 40 (four percent of the total), up from just 4 (1 percent) in 2009.

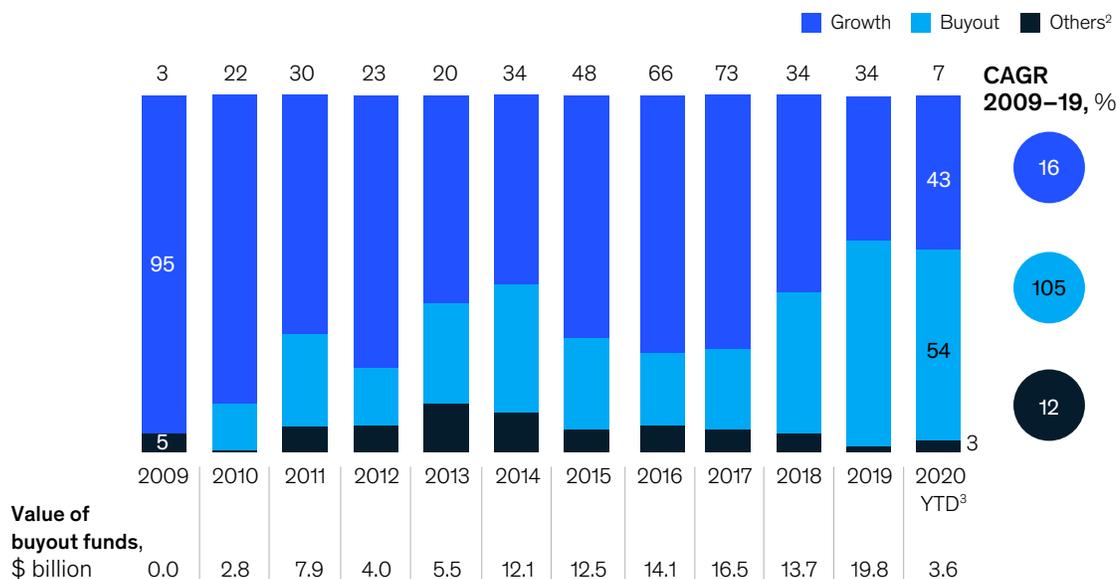
We expect funds operating in China to increasingly seek deals where they purchase a controlling interest in an asset. Such deals give investors direct management control of capital allocation, talent, and exits. Where investors hold minority stakes, it has proved difficult to sufficiently influence their portfolio companies. Buyout funds, which grew by 105 percent CAGR between 2009 and 2019, are now growing more rapidly than growth funds, which grew by only 16 percent CAGR during the same period (Exhibit 4).

The contrast has been particularly stark since 2015, as the capital raised by growth funds fell by 19 percent annually, compared to 12 percent annual growth for buyout funds. The total value of buyout funds reached its highest ever level of \$20 billion in 2019, which represented 58 percent of total fundraising.

This fundraising has raised questions whether too much 'dry powder'—committed capital to GPs but not invested yet—could drive up pricing and erode discipline in the industry. While dry powder has nearly doubled since 2016, the years on hand (how long it takes to invest an amount at current investment levels) in 2019 did not materially go up, and at two years is roughly in line with global levels (1.9 years) (Exhibit 5). In any case, it is likely that capital will be less differentiating than in the past, putting even more emphasis on alpha creation.

PE fundraising is seeing shift toward buyout funds.

Greater China focused PE fund raised¹ by fund type, \$ billion, %, excl. government-led fund



¹Includes all closed Greater China focused funds and Asia focused funds raised by Mainland China based managers and 40% of fundraising by other APAC focused funds (which has Greater China as one of their location focuses).

²Includes hybrid, balanced, turnaround, co-investment.

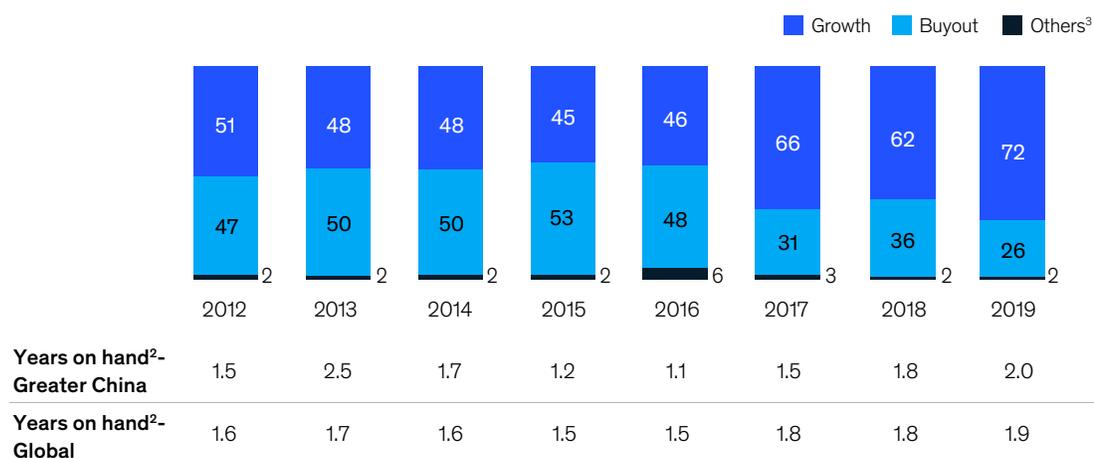
³January to July, 2020.

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan. Private equity includes buyout, growth, hybrid, balanced, turnaround, co-investment funds.

Source: Preqin

Despite record high dry powder, years on hand is largely in line with global levels.

Greater China focused PE funds – dry powder¹, %



¹Includes dry powder of Asia focused funds, with Greater China as one of their location focuses.

²Years on hand is PE capital committed but not deployed, divided by trailing 3-year average PE equity deal volume.

³Includes hybrid, balanced, turnaround, co-investment.

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan. Private equity includes balanced, co-investment, growth, buyout, turnaround fund.

Source: Preqin, AVCI

Concentration in larger GPs

The maturing market has made it easier for prospective LPs to evaluate GPs' performance, which has contributed to the concentration of funding with large GPs. A recent survey indicates that past performance, deal pipeline, and duration of track record are now the top three factors in GP selection.¹ At the same time, LPs prefer to deal with a limited number of funds for operational efficiency and compliance reasons. COVID-19 might have

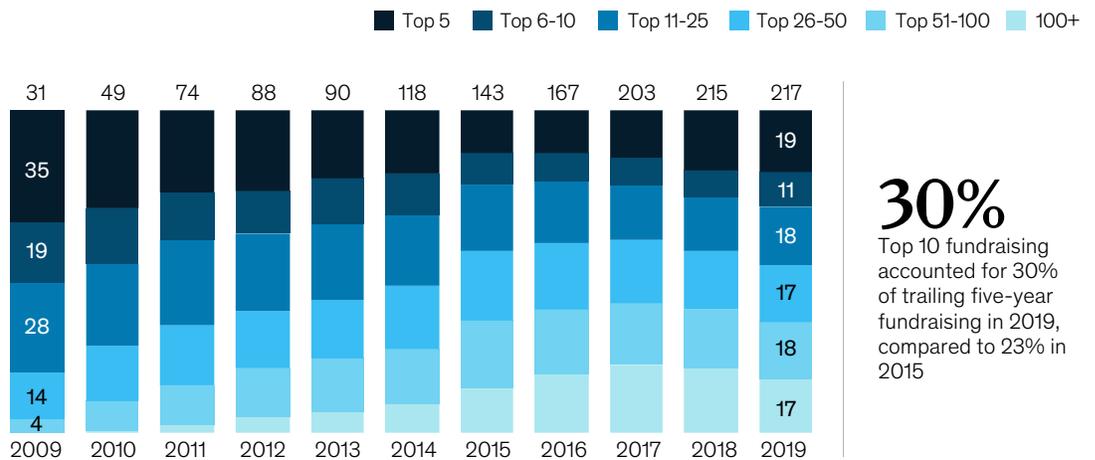
accelerated this trend, since the lack of in-person meetings may favor GPs that are already familiar to LPs. The average size of Greater China-focused private equity funds has increased to \$816 million in 2019 from \$93 million in 2009.

Although we see similar trends in other markets such as the United States, China has become more concentrated than these markets (Exhibit 6). The trend toward larger average fund size is likely to continue. This is also visible in the halting growth in

Exhibit 6

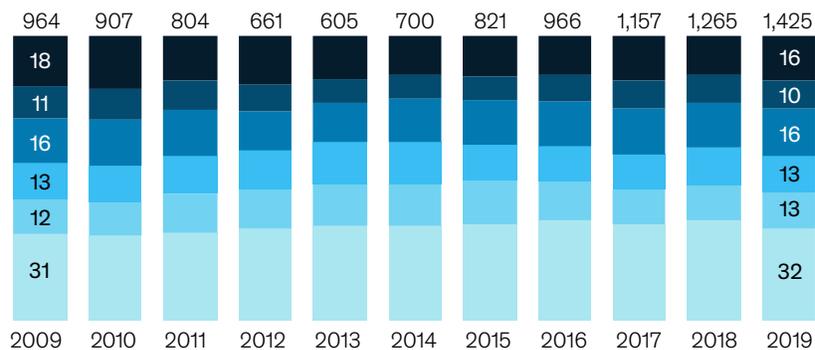
Increasing concentration of fundraising in China towards largest funds.

Greater China focused PE fundraising by financial GPs¹, Trailing Five Years Cumulative, \$ billion, %



30%
Top 10 fundraising accounted for 30% of trailing five-year fundraising in 2019, compared to 23% in 2015

Private equity fundraising in US, Trailing Five Years Cumulative, \$ billion, %



26%
Top 10 fundraising accounted for 26% of trailing five-year fundraising in 2019, compared to 23% in 2015

¹General Partners.

In January to May 2020, financial GPs raised 11 funds with USD 6.4 Bn total fundraising value (top 5 funds accounting for 87%), with relatively small impact on the trailing five year cumulative fundraising.

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan. Private equity includes buyout, growth, hybrid, balanced, turnaround, co-investment funds.

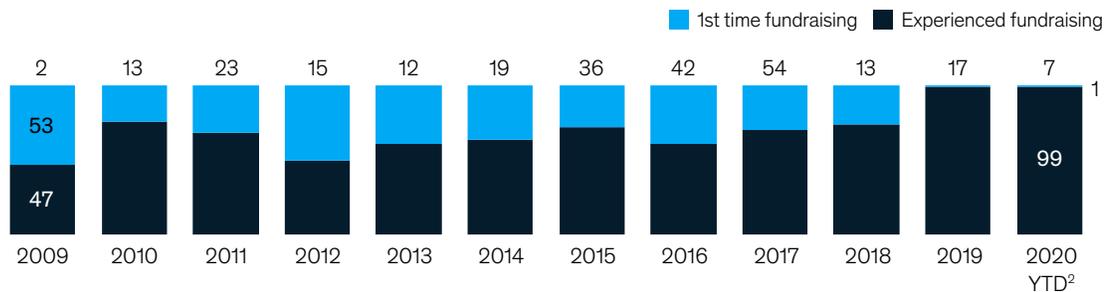
Private equity includes buyout, growth, hybrid, balanced, turnaround, co-investment funds.

Source: Preqin

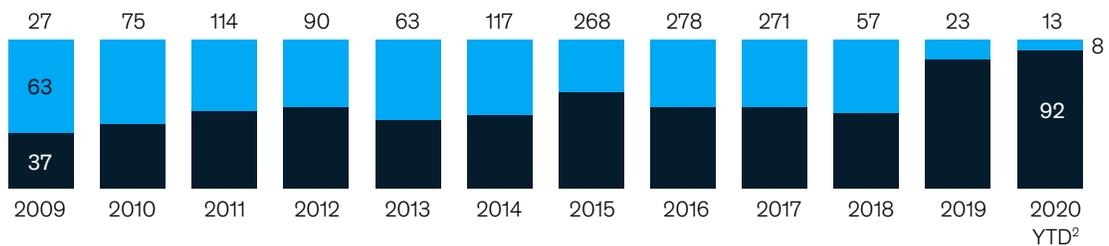
¹ Preqin Investor Survey.

Among Chinese GPs, ones with a track record managed to raise funds in 2019, while new funds dropped to record lows.

Greater China focused PE funds raised by Chinese GPs¹, \$ billion



Number of funds raised, %



¹General Partners.

²January to July, 2020.

Note: Greater China includes Mainland China, Hong Kong, Macau, Taiwan. Private equity includes buyout, growth, hybrid, balanced, turnaround, co-investment funds.

Source: Preqin

new GPs in Greater China. The percentage of funds that raised capital for the first time is the lowest in at least the past ten years, dropping to 13 percent in 2019 and even lower in the first five months of 2020 (Exhibit 7).

This level of industry concentration suggests that many smaller funds could face a more challenging future. Indeed, funds of less than \$1 billion made up 88 percent of the funds raised in 2009, but just 20 percent in 2019. New funds raised \$16.3 billion in 2017, but less than \$200 million in 2019.

Highly reliant on corporate buyers

Sales to a strategic corporate player, or trade sales, are the predominant exit route for PEs in Greater China. Since 2016, corporate buyers have accounted for 80–90 percent of exit value and 70–90 percent of the number of deals (Exhibit 8).

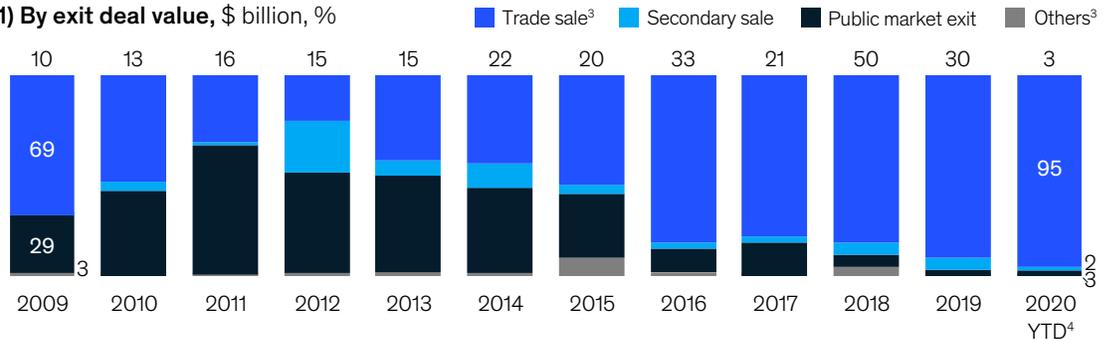
Over the last five years, the trend has been towards fewer, larger exits. The total number of exits in the China market had declined to 112 by 2019 after peaking at 229 in 2014, while the average deal value climbed to \$267 million from \$96 million over the same period.

IPO exits, which made up 40–60 percent of exit deal value between 2010 and 2014, have decreased substantially to around 5 percent in 2018–19, while secondary sales have always made up a comparatively small proportion of exit deals (6 percent on average between 2014 and 2019). Nevertheless, many GPs expressed their expectation that secondary deals could increase, driven partly by the growing number of PE-owned companies. This reliance on corporate buyers in China means that fluctuation in spending on corporate M&A poses a risk for the overall Chinese PE market.

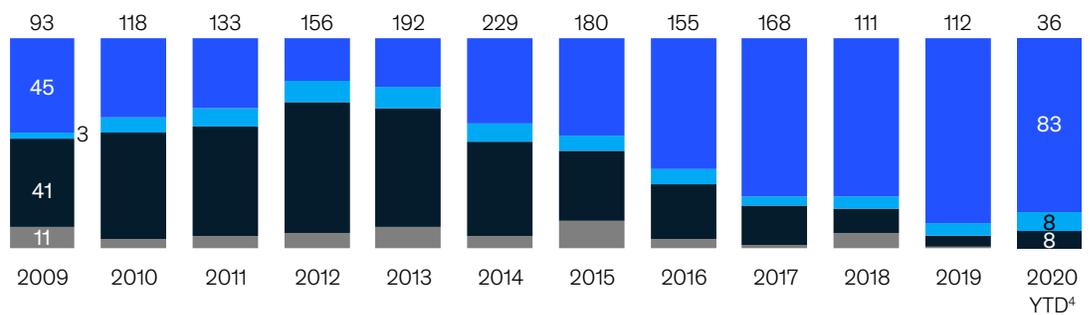
Trade sale is the predominant exit route for PE investments, accounting for ~90% of exits since 2016.

Greater China¹ PE-backed portfolio² exits

(1) By exit deal value, \$ billion, %



(2) By number of exit deals, %



¹ Greater China includes Mainland China, Hong Kong, Macau, Taiwan.

² All portfolios backed by private equity firms.

³ Trade sales include exits via selling shares to corporate buyers or buyouts by corporate buyers; Secondary sale includes exits by selling shares to PE or VC investors; Public market includes IPO and open market sale (the owner of the portfolio sells their shares via secondary market); Others include share buyback and written off.

⁴ January to July, 2020.

Source: AVCJ

GPs need to manage for alpha

In recent years, China's economic growth, though still robust, has been steadily falling; the 2019 real rate of GDP growth was 6.1 percent, compared to 10.6 percent in 2010. Before COVID-19, the McKinsey Global Institute estimated that growth in China would hover around 5.1–5.4 percent between 2022 and 2024. The current economic crisis will likely cause these growth rates to fall, though they will likely still be robust compared to global averages.

Investors have not tempered their return expectations as a result of slowing economic growth. An August 2019 Preqin Investor Survey found that 58 percent of LPs would still expect an annualized net return of 15 percent or above from Greater China–focused PE and VC funds, and that 10 percent of LPs would expect returns of more than 30 percent.² In an environment where fast macroeconomic growth is no longer a given, capital is increasingly flowing to leading funds. Therefore deals where PE firms take a controlling stake in a portfolio company will be at even more of a premium.

² In August 2019, Preqin surveyed more than 50 investors and published the results in report "Preqin Markets in Focus: Private Equity & Venture Capital in Greater China's Innovation Economy".

For many years, China's consistently high rates of macroeconomic growth made relying on overall market growth a sustainable strategy. To achieve desired returns today, however, PE firms will have little choice but to switch their focus from beta to alpha.

To succeed in evolving their organizations and acquiring the ability to create alpha, PE firms in China need to take four key actions:

1. Articulate a new, clear value proposition

To stand out, GPs need to have a well-defined value proposition. In the past, it may have been sufficient to simply set up an operating group, but the bar has now risen. GPs need to clearly articulate value creation propositions, and they have to demonstrate they have the capability and talent to actively manage portfolio assets and create value at scale.

GPs looking to develop and define their distinctive value creation proposition can choose one of two paths. First, they can choose to become specialized. Industry expertise is increasingly important, both to deliver on the full potential of portfolio companies and to be able to quickly respond to disruptions such as COVID-19. In addition, funds with strategic specializations (such as distressed businesses or corporate carve outs) could see an increased supply of assets and will be better able to price those assets than generalist funds.

A second option for GPs is to achieve scale by expanding into adjacent asset classes. In line with many global firms, leading Chinese GPs have begun to transform themselves into firms with arms in multiple industries or areas such as credit, real estate, or infrastructure. At the same time, pension funds, insurers, and other Chinese investors have added PE arms. Operating at a larger scale can promote greater brand recognition, a larger set of deal opportunities (e.g., larger, more complex, cross-border), scale effects in the back-office, an enhanced ability to diversify risk, and potential synergies between asset classes. For example, some funds are leveraging their public markets or debt teams to support portfolio companies in their debt-raising, IPO preparation, or bolt-on M&A activities.

2. Achieve excellence in talent, governance, and organization

Talent is still at a premium in China, especially in professional services industries such as private equity. While there is an increasing number of experienced and specialized people available—some of whom might have even worked with PE firms in the past—finding and attracting them still poses a challenge.

Update processes and structures

Small, founder-run firms with centralized operations can succeed in high-growth environments like China, but this becomes more difficult as they grow. GPs need to step up their talent development initiatives by building a larger talent bench with a more diverse range of skill profiles, institute formal succession planning, and develop new organizational processes and structures. While many founders of regional and local firms in China are now in their 50s or 60s, and may have no plans to slow down or retire, LPs will likely ask about succession planning during future fundraising efforts.

PE firms can also promote diversity in their talent base by embedding guidelines and initiatives into their recruitment and personnel development processes.

PE firms can also install formal structures and define clear roles that introduce rigorous analytical and fact-based decision making into their organization.

And PE firms should go beyond their traditional focus on managing financial risk and develop capabilities that enable them to proactively manage cybersecurity and reputational risks.

Embedding new processes and structures into their organizations will also help GPs as they transition from a strong reliance on beta growth to a greater focus on alpha value creation. Tried and tested playbooks and structures help ensure that GPs are leveraging industry best practices, as well as firm-specific learnings and expertise. Some firms in China are building up internal expertise around

functional topics such as digitization, procurement, and operations. Such playbooks also significantly compress the time before implementation can start. In some instances, they can reduce this by 6–12 months.

Though some functional playbooks can be borrowed from other Asian or mature markets, in many areas, China requires a bespoke plan. This is due to China's unique digital environment, fragmented investments spread across a wider range of industry sectors, and capabilities that don't transfer easily across sectors or geographies.

To create sustainable impact, PE firms operating in China need a combination of functional expertise, the capacity to design and implement value creation plans, and the ability to manage change. While firms are often good at hiring functional experts, the latter two categories are often overlooked. A better solution may be having a smaller core team tasked with orchestrating a transformational program in a specific portfolio company. To make this happen, firms need to work closely with internal and external specialists.

Front-load portfolio companies' talent decisions and match talent to value

Firms have a tendency to delay making decisions about their portfolio companies' executives in the interest of building positive relationships with management teams. Although most firms claim to always invest in a strong management team, based on our analysis of 180 investments globally, only 44 percent of portfolio company CEOs stay from deal signing to exit. On average, CEOs are replaced 2.2 years after deal closing, and we see a similar trend in the China region. Therefore, performing a talent check up as early as possible is essential.

A talent check up has two major parts. First, GPs need to identify the 25–50 most important roles in the company. Those roles are usually either associated with the EBITDA the company currently creates or an EBITDA stream that it could generate and capture in the future, and they may be much deeper in the organization than just the top

management. But it is also important not to overlook the key roles—such as the head of sales in key regions or the head of product development—that enable value creation. Second, GPs need to ensure that they have the right talent in these critical roles; they should develop a list of the key tasks that need to be performed in each and assess the capability of the executive currently holding the position to perform them.³

One large China-based PE fund, for example, mandates that, immediately after a deal closes, each of its portfolio companies conduct a talent-to-value exercise. Typically, 2 percent of the people in their organization create 80 percent of the value—and that they need to identify those people throughout the entire organization. To find these core value creators, first the deal team and operating team jointly review the largest value creation opportunities and determine what skill sets and mindsets are required to deliver that value. They then assess whether the right people are in place, swiftly replace those who don't work out, and work to retain and motivate those who are a good fit.

Formalize and refine the talent pipeline for GPs

Finding and retaining the right talent in China is especially crucial given its relatively shallow talent pool, particularly for executives with PE experience. Competition for talent will likely intensify, and having the right talent will become even more important, since the average fund size is increasing and the bar is rising on the capabilities needed to create value in portfolio companies. The COVID-19 economic environment could present a good opportunity to proactively acquire top talent.

PE talent should evolve on multiple dimensions. As the industry moves change greater specialization, it requires more specialized people who can spot value creation opportunities at potential investment targets early on, and then later work with management to deliver them. GPs should also look beyond traditionally financial backgrounds and actively recruit functional experts in areas such as transformation and digitization, or in specific functional areas like pricing or operations. Firms

³ For more on matching talent to value, see <https://www.mckinsey.com/business-functions/organization/our-insights/linking-talent-to-value>.

should build up a wider network of advisors across geographies, functions, and industries so that they can ramp up quickly.

Finally, GPs need to be prepared to restructure their partnerships. To attract—and apprentice—the next generation of leaders, the shareholding structure of future PE firms should acknowledge the changing structure of the leadership team. Founders who were formerly lead partners need to begin stepping back and allot a larger share of deal upside to the next generation of leaders. GPs in more developed markets are further along in this process. In China, however, succession planning will become a more salient issue as founders age and the need for a clear plan becomes more important, and as LPs increasingly put more focus on this.

Assess PE firms' organizational health

While some investors have started to take a more structured approach to assessing talent in their portfolio companies, most are still in the early stages of applying the same rigor to their own organizations. One large PE firm in China surveyed its employees across seven dimensions that correlate with company performance. They looked at topics ranging from leadership effectiveness and sense of direction to innovation and learning. While the survey results confirmed the firm's strengths, they also highlighted gaps in leadership which the firm's top executive team addressed with a series of coaching and development sessions.

Evaluate fund's value proposition for talent

Attracting and retaining the best talent requires a careful calibration across compensation, nonfinancial incentives, culture, and professional development opportunities. While financial rewards play a large role, paying more attention to overall culture and career paths might strengthen a fund's talent proposition. Staff working in operating groups often express the concern that they are not valued as much as deal partners. Resolving this perception could provide an advantage in attracting the right people to operating groups, an area of increasing importance.

3. Refine originations to more successfully source and execute on deals

In the past, owners of fast-growing target companies were not keen to sell majority stakes, since they typically didn't need to do so. Also, PE investors that didn't have the right capabilities themselves tended to invest in a management team and trust them to run the company. As a result, most PE investment deals in China have been minority investments—in the past 10 years over 90 percent⁴ by deal count, and 80 percent by deal value, on average—which suggests that GPs in China might not have invested in the capabilities or talent needed to price and execute buyout deals.

GPs operating in China need to increase their capabilities around the sourcing of buyout deals and other more complex deals, as well as developing the sector expertise needed to judge and price available assets. They must also improve their ability to deliver on subsequent value creation. To do so, they must build expertise in deal sourcing and increase the efficacy of their operating team.

Build expertise around deal sourcing and execution

Many transactions take several years to complete. This gives firms time to proactively assess opportunities—a more common practice in Western markets than has been observed in China so far. More often than funds in China care to admit, they respond only to investment opportunities initiated by the sell side. This results in a less than ideal understanding of the industry and target.

We have, however, seen several deals where PE firms that proactively started earlier enjoyed an advantage. They often were able to build closer relationships with the target company's management, engaged with industry experts to develop a more precise investment thesis, and able to track the industry and similar deals for a longer period of time. Particularly in China, it will be crucial to build relationships within a sector and with possible target companies and advisors, since family business sell-offs are expected to increase as the first generation of Chinese entrepreneurs

⁴ <https://www.avcj.com/>, McKinsey analysis.

enter retirement. PE firms should scan and prioritize family-owned companies, and proactively engage with them by building an ownership transition plan supported by a strong strategic rationale for the PE investor to play a role.

In addition, the current economic climate may lead to an increase in opportunities for specialized investors and loan financing for distressed companies. There may also be more scope for bolt-on acquisitions. However, it may still take a few months for the right opportunities to arise, as sellers often need to adjust their expected valuations to reflect changes in the macroeconomic environment.

Deal execution will also be crucial. In light of COVID-19 and the background of slower growth in China, one of the core capabilities necessary for GPs—and particularly relatively small players—will be the ability to explore and handle more complex transactions. The number of complex transactions—such as carve outs from companies rethinking their business portfolio—is likely to grow given the current economic climate.

For example, a China-based PE firm recognized the potential value in carve outs and realized that it lacked needed capabilities to execute this. One partner within the fund was tasked to own the topic and was given resources to build up the necessary capabilities. The partner regularly scans the industry to identify the companies where carve outs could come up (with a longer term goal to proactively approach these companies). They also, early on, build up relationships with external experts (who can advise on carve outs or the relevant industries) and with the management teams of target companies.

Increase the efficacy of operating groups

As global PE firms seek to boost investment returns, operating groups have become an increasingly prevalent feature of their organizations. These groups focus on providing strategic direction and support to their portfolio companies. For example, they drive measurable performance improvement,

monitor and report, and support broader change efforts. Nevertheless, we observe too often that operating groups are more often used as SWAT teams when there is a narrowly defined topic, and are less often a core part of the investment thesis. Although operating groups are now an established part of most large PE firms, their size and composition vary significantly.⁵

Operating groups matter, especially during a crisis. We reviewed the performance of 120 PE firms active since 2009 and calculated their returns before, during, and after the global financial crisis. Our results indicate that portfolio operating groups may have proved their worth most clearly in the downturn; between 2009 and 2013, GPs with operating groups achieved IRRs roughly 500 bps higher than those without.

Take the example of one of the largest Asian PE firms that was the lead investor in a global biotech company, which it took from a Series A investment in 2014 to IPO in 2018. The firm used in-depth research and pharmaceutical industry expertise to provide strategic support, especially in formulating the company's go-to-market plan in China and the United States. The PE firm's team is actively involved with the portfolio company's management team in commercial strategy, registration policy, clinical development, international cooperation strategy, and talent recruitment.

PE firms looking to redouble their focus on alpha should increase the efficacy of their operating team by adopting the following practices:

A. Focus on operational value. In our experience, many operating teams struggle to focus on the most impactful value-adding levers. Without a quantified view on the areas with the largest improvement potential, value may be left on the table. Further, with a limited understanding of where the biggest pockets of value in the company lie, the deal partner may sometimes exercise an outsized influence on which portfolio companies the operating team

⁵ For more on effective operating groups, read Jason Phillips and Dhruv Vatsal, "Private equity operating groups and the pursuit of 'portfolio alpha'," mckinsey.com, November 6, 2018.

spends their time. We have found that more value can often be achieved in moving an asset from good to great rather than trying to rescue troubled assets. Building a useful overview of value creation requires deep functional and industry expertise to identify, size, and then execute on value creation.

B. The right operating group setup. The structure of an operating group should complement the needs of the portfolio company and the overall strategy of the fund. Operating partners or external advisors need not solely provide advice and guidance. They can also work alongside management teams to provide deep sector-specific knowledge and transformation capabilities. In addition to the execution team, therefore, the operating group should include—or have access to—both industry experts and deal partners. As deals become more specialized and value capture more complex, GPs will need to think about how best to deploy operating resources and external expertise across their portfolio companies.

C. Rigorous portfolio review rhythm. The operating group and deal partners need to be aligned on the details of the portfolio's current status. A monthly portfolio review should focus on value creation through a system of key performance indicators (KPIs) that is both consistent across the portfolio and more granular than a basic red-yellow-green classification. The review should take a forward-looking perspective—including, for example, next steps, three-, six-, and 12-month plans, and the next set of KPIs to focus on—mapped to concrete actions along the entire length of the journey to exit.

One thing that has become clear in recent months is that funds and their portfolio companies need to think through key industry factors and build scenarios for how these could play out. During COVID-19, PE firms that had clear cash management playbooks in place were able to get the situation under control and shift toward market share growth and acquisitions faster than firms that lacked such plans.

D. Detailed operational playbook beyond the 100-day plan. Playbooks allow GPs to differentiate their capabilities around specific investment areas and execution capabilities. They should be used to implement rapid changes to portfolio companies and execute complex strategic moves. A well-tested mechanism to reduce indirect spending, for example, will provide deal teams with reassurance about the volume of savings that can be underwritten, and how quickly these can be banked. A playbook that details the steps needed to carve out a company and set up essential business functions so it can operate independently will provide investors with a greater degree of comfort about the risks they are taking on—and the steps in the process toward realizing a return on their investment.

4. Properly prepare for successful exits

In the pursuit of healthy returns, most private equity GPs are primarily focused on making great entries. While many also understand the need for great business transformations for their portfolio, they often pay less attention to making a great exit.⁶

PE firms operating in China have to contend with an additional challenge: exit routes that continue to be limited, or at least crowded. At exit, nearly all Chinese portfolio companies are sold to corporations in the secondary market—there are extremely few IPOs. Moreover, the current economic climate threatens to further limit corporate buyers in their M&A plans, putting more pressure on already squeezed exit routes for Chinese firms.

Therefore it is even more important for investors in China to be more proactive and to start exit planning early. Those that succeed in more rigorously preparing for exits can increase EBITDA by between 2 and 5 percent and generate convincing proof of EBITDA upside for potential buyers. To achieve these results, firms must conduct readiness planning about 18 months prior to a planned exit. Between 12–18 months prior to a planned exit, PE owners should embark on a second wave of performance improvement. PE investors should also be ready to answer buyers' tough questions.

Approximately six months prior to exit, PE investors should take a hard look at who they think will be interested in buying their asset and determine what equity story would be most compelling to them. At a more tactical level, it is necessary to tailor an equity story to the level of sophistication and awareness of the universe of potential buyers, educating them where necessary. An equity story provides fact-based answers to difficult questions and plant seeds for the value creation story for the next buyer.⁶

To get started, PE firms should make exit plans part of the value creation agenda for all portfolio companies from the start. Ideally, two to three years before they intend to sell, GPs should start thinking about credible elements that could be part of the equity story and the investment thesis of the next buyer.

This might result in management starting new initiatives to create some of the elements that will be important for a future buyer.

Conclusion

Clearly, there is still a great deal of opportunity for PE firms operating in China. Perhaps more than ever before. However, in China's PE market, investors can no longer rely on ever-increasing multiples and overall market growth to achieve required returns. Rather, GPs will need to acquire new operational

capabilities that will enable them to work closely with management teams to create alpha.

For many years now, PE firms in China have said they needed to generate alpha. In reality, however, they've been supported by beta-driven returns. In the new environment of slower economic growth, however, funds will need to work extra hard to understand how to generate true alpha.

While some PE firms have developed these capabilities in an ad hoc fashion, many firms operating in China have not yet taken the comprehensive approach we have described. Those firms that do choose to take a decisive and comprehensive approach to enhancing their ability to create value for their portfolio companies can gain a real advantage. This is particularly true given PE firms' need to weather the current economic crisis and prepare for the next normal. The degree to which firms can effectively manage the crisis while preparing for a recovery whose timing and duration is uncertain will be a major differentiating factor between stronger and weaker funds.

Today, PE firms in China have a window of opportunity learn what it takes to generate 'true alpha.' Going forward, generating alpha will be essential to surviving—and thriving.

⁶ For more on the elements of an equity story and tailoring messages to specific audiences, read, Guillaume Cazalaa, Wesley Hayes, and Paul Morgan, "Private Equity Exit Excellence: Getting The Story Right," mckinsey.com, August 1, 2019.

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