

**Standing out in China's  
private equity market:  
An interview with Frank Su,  
Managing Director, Head  
of Private Equity Asia, CPP  
Investments**

*by Ivo Naumann and Wouter Baan*



The COVID-19 pandemic is having profound impacts, among them the accelerated adoption of digital communication tools in businesses and workplaces.

But the difficulty of meeting people in person is also having unintended consequences, not least for China's private equity industry. In a field that fundamentally relies on trust, the pandemic is consolidating PE fundraising among China's larger and more established general partners (GPs), as limited partners (LPs) shy away from investments in partners they have yet to meet face-to-face.

Yet enterprising GPs can still make their mark, according to Frank Su, Managing Director and Head of Private Equity Asia for the Canada Pension Plan Investment Board (CPP Investments), a Canadian global asset manager with more than 400 billion Canadian dollars under management.

CPP Investments invests as both GP and LP, providing Mr. Su with a unique perspective on how partnership models in China's PE industry are evolving, and how GPs with unique understanding of a particular industry, or a strategy to capture market white space, can attract the attention of increasingly discerning investors.

Sitting down with Ivo Naumann, a Shanghai-based Partner who heads McKinsey's private equity practice in Greater China, and Wouter Baan, an Associate Partner in Hong Kong, Mr. Su discusses the top four sectors to watch, how global asset managers can empower their GPs to institutionalize, and why secondary exits will become increasingly relevant in China.

**McKinsey:** Private equity has risen rapidly in China, and is now the third-largest market in the world, but as a percentage of GDP in China it remains relatively small. What is your view on the future of the market, and how will it be different than it has been in the past?

**Frank Su:** China's PE market is nascent compared with the US, so there is still strong growth ahead of us. PE is an important means of company financing, and the Chinese government is encouraging more direct financing to companies, so a long-term PE investor fits very well into that picture. The market is also evolving, from mostly minority growth capital to more control-buyout deals. That trend will continue to support the growth of the China market.

**McKinsey:** How will China's moderating GDP growth impact PE? What will be the impact on fundraising and sourcing of investment opportunities?

**Frank Su:** The major impact is that the source of value creation is shifting. So, 10-15 years ago, PE funds could still ride the macro tide and benefit from multiple expansion. Nowadays, PE returns increasingly come from value creation after the closing of the transaction. PE deals have become more complex and increasingly resource intensive. In terms of fundraising, investors dig deeper to understand how GPs make money, and whether that strategy will be sustainable in future.

**McKinsey:** Where are some of the opportunities or sectors in which PE will enjoy growth in future?

**Frank Su:** Three long-term sustainable trends underpin the market and present interesting opportunities: Consumption upgrading, disruptive business models, and productivity improvement. The infrastructure for PE business in China is also developing, so we have more availability of talent. The advisor network has also advanced, and there are more debt financing options. This means there will be interesting opportunities for more control deals. Sector-wise, we think four sectors are interesting: healthcare, consumer, financial services, and technology.



## Frank Su

### *Vital statistics*

#### **Education**

Received an MBA from the Kellogg School of Management at Northwestern University and a BA from the University of International Business and Economics in Beijing.

#### **Career highlights**

Leads the private equity business in Asia as Managing Director, Head of Private Equity Asia, for the Canada Pension Plan Investment Board, a Canadian global asset manager with more than 400 billion Canadian dollars under management.

Served as Principal for PE investments in Asia, with a focus on Greater China, for Bain Capital, and as a Manager for Bain & Co. in Shanghai.

Contributed to Ericsson's expansion in China as a Business Development Manager.

Served COFCO as a trader for four years.

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**McKinsey:** What impact will COVID-19 have on the PE industry? Deal activity seems down, but in the last crisis we saw deal activity pick-up rapidly about 6-8 months after the trough. Will we see a similar phenomenon play out this time?

**Frank Su:** COVID-19 has given the industry an unprecedented shock. GPs are spending a lot of time on asset management to support their portfolio companies. In terms of deal activity, the virus presents difficult challenges around physical distancing; you can't meet with people in person. That makes it tougher for both deal sourcing as well as from a diligence perspective. Then there is the uncertainty around what remains an evolving crisis. These things caused a pause in the industry over the past few months.

In China, things are starting to pick up. There are opportunities around more COVID-19-resilient sectors: online healthcare businesses, or the online education business, which somewhat benefited from the pandemic. Will deals come back sooner, or as quickly as the global financial crisis? I think it's still uncertain. People need to see how the pandemic plays out. In terms of returns, GPs are being more prudent when they underwrite new deals, and have a higher bar to even consider a deal, so you'd expect those deals that do go through to generate better returns than those agreed in normal times.

**McKinsey:** What do these changes mean for PE funds themselves? How should they evolve to stay successful around investment strategy, talent, value proposition?

**Frank Su:** There are two things funds need to do. One is to generate cutting-edge insights in the industries or markets they cover. The second is to develop a network of like-minded partners. The China market is very dynamic. For GPs to be able to create value, they need to be at the forefront of understanding an industry, and what is changing within it. They need to partner with the CEO and company executives. That means more emphasis on industry analysis and innovation around assessing industry trends.

On the partnership front, PE is a very resource intensive business. GPs need to leverage all the resources they can, both internally and externally. Building that network of potential partners, including LPs, and industry executives, is important to be able to tap those resources. At CPP Investments, our direct private equity investment approach has always been a partnership model. Over the years, we've tried to strengthen relationships with our GPs on the ground. My team here endeavors to bring the best of CPP Investments investment globally to Asia.

As a global organization, we have industry experts, and expertise on deal diligence and asset management. We try to bring that to this market, and help our partners grow their business on a deeper level.

**McKinsey:** How is PE deal flow evolving in the China context, and are PE firms ready to adjust to the shifts you have been talking about?

**Frank Su:** The bulk of future private equity returns will come from value creation. Creating alpha is important. It's not easy, because it requires a bit of transformation in terms of GPs' capability. If you look at China deals 10-15 years ago, when we did due diligence on GPs, they would talk about their deal origination capabilities; how they can

do complex deals. This element has become increasingly commoditized. So, how they can be a better owner of a particular business has become increasingly important. We've seen GPs in China make good progress there; both in terms of building their internal teams, as well as leveraging external partners and advisors.

Creating alpha is about knowing what makes a difference in terms of the business model in the particular areas you are competing in. And then, finding the right talent to execute a strategy that makes sense, and being a supportive shareholder to the business. Is the China market ready for that? In certain sectors, consumer internet for example, China is perhaps ahead of the US market. There are lots of new business models that have been emerging. GPs have been part of that, helping companies figure out what works and what does not. Overall, China is still developing. You still see a bit of a shortage of talent. But over time, that talent will emerge and the market will be ready for it.

**McKinsey:** One element that people always talk about is the role of operating groups, or portfolio value creation groups. What's your view on their importance, and also on what works, and what doesn't work?

**Frank Su:** There are different GP approaches. One is to have a dedicated operating team. They focus on asset management, creating value. Other GPs engage professional managers and deploy them full-time into the company as part of the management team. Both ways work. It's really about having the right talent for the companies that you're working on, or for the specific subject matter that you are trying to tackle. Secondly, it's how you as a GP ensure there is accountability, motivation, and full ownership from this value creation effort—whether it's from your operational team, or the right manager coming into the company to run the business. Whether they prefer an operating team, or continue to hire professional managers, doesn't matter.

**McKinsey:** We see that increasingly fundraising is going to a smaller set of funds. Is this an ongoing trend? From an LP perspective, what are some of the considerations that would make you invest in a narrower set of GPs?

**Frank Su:** COVID-19 has accelerated that process, because the LPs feel more comfortable conducting virtual diligence on a GP they already know, versus talking with new managers online. That said, new managers can still differentiate by excelling in a particular sector, or offering a unique strategy in the market white space. As an LP, when we look at a new GP, one question we always ask is, what will this GP bring to our portfolio that is different from what we already have? If the new manager can differentiate in that way, they still have a chance. Otherwise, we want to make sure there's full interest alignment between us and our GPs. We want our GPs to be compensated when they are generating returns for their investors.

In PE, size does matter. On one hand, you need size and scale to pursue certain deals. The scale of your business can bring in synergies as well. On the other hand, growing too fast can distract the GP and drive interest misalignment. As an LP, we always focus on helping GPs develop their secret sauce of generating returns, in the hope we can grow together with the market.

**McKinsey:** Can you give some examples of the kind of specialization, or unique strategies, that we might see in China?

**Frank Su:** Healthcare is one industry that we really like. When we pursue opportunities in that sector, we increasingly appreciate the special expertise you need to be able to evaluate opportunities. For example, we invested in a new manager last year, a China healthcare-focused fund. The GPs are all medical doctors whose expertise generates differentiated insights and vision. Adding those GPs to our network has been very valuable because they bring us not just access to new deals that we typically can't evaluate, but also knowledge that we can leverage as an external partner.

**McKinsey:** What's your perspective on the strategy funds should pursue as they increase in size? Should they be specializing, or expanding into more asset classes?

**Frank Su:** We see both, not just in China, but globally. You've got funds that want to be very focused. Some specialized managers want to be more focused, and don't want size to become a burden. They have a contained fund size each time, and when they need money, they come back to the market to raise it. That's because when you have too much money, and you are under pressure to spend it, you can make inefficient decisions.

Scaling broadly makes sense if you want to institutionalize your fund, and make sure there's a sustainable platform for your talent. There could be synergies created among different business lines.

Both approaches have value. When we look at our managers, and at the evolution of our strategy, we want to maintain interest alignment between the LPs and the GPs, and ensure we are comfortable that their strategy will continue to deliver returns.

**McKinsey:** Can you talk a bit about the journey that Chinese GPs are making toward institutionalization?

**Frank Su:** Across China, most GPs are still first generation, and the founders are still very much committed, still young, relative to their peers in the US. We haven't seen many examples of successful transitions from one generation to the other, but that is largely also true globally.

That said, Chinese GPs in our portfolio are increasingly aware and mindful about building that institution, building that team or the next layer of leaders in their fund. Even if the founder is still very much engaged in the day to day, he or she has been building the next layer of MDs taking increasingly important roles in the organization. As an LP, we would love to play a role helping our GPs make that transition. We feel our global experience can be relevant to our managers in China.

**McKinsey:** Given that China is still nascent compared to the rest of the world, do you expect that Chinese funds will be able to mature and catch up to their more developed peers?

**Frank Su:** Some Chinese managers are already on a par with global peers, whether in terms of professionalism or the size of their fund. They have enjoyed a follower's advantage in having someone to learn from, and don't have to make the same mistakes as some earlier funds.

In the past 10-15 years, Chinese managers have seen pretty dramatic change in their industry. Not just sectoral shifts, but changes in the way you exit. Chinese GPs benefit from that as they bring different perspectives to their investments, and plans to grow their own business. I'm very confident that over time you will see successful GPs at the same level as the globally renowned ones.

**McKinsey:** What's your outlook on the evolution of the exit market in China?

**Frank Su:** The market will evolve like the US market in terms of having more options or channels for exit. That's already happening. Ten years ago, most exits were through IPOs in offshore markets. Now, GPs are able to list a company domestically in Asia, and exit from there. So, the IPO channel has already expanded.

Increasingly, we see secondary exits, whether to a financial sponsor or a strategic partner, becoming relevant in China. That helps fill control deal opportunities as well. With the development of the debt financing market, I wouldn't be surprised if we see more capital restructuring, dividend-type exits as well.

**McKinsey:** What are your primary concerns as an LP going forward?

**Frank Su:** As an LP we care a lot about the long-term relationship with our GPs. We want to make sure that we can grow with our GPs over time and support them along that journey. Increasingly, we

found that deepening our relationship with our GPs across the value chain is important.

As a global asset manager, we have other lines of business that could be relevant to our GPs. For example, our public market colleagues could help a GP as it goes through the process of listing one of its portfolio companies. From a PE perspective, we want to do more with our GPs in the form of pursuing deals together.

That process helps us build trust and mutual understanding between the two teams. It's very important in building a lasting long-term relationship that can last through cycles. When we look at our GPs nowadays, other than looking at the track record, evaluating the strategy, and the team, we increasingly focus on whether we will be able to build an in-depth relationship down the road. That has become crucial.

**McKinsey:** There's still a record-high level of dry powder in China and Asia. Is that a sign of trust in the industry, or are there risks related to the pressure on GPs to deploy it, for example asset prices artificially rising?

**Frank Su:** PE in China has a good track record, and firms deliver a good return, so from an investor perspective, there's increasing demand for that. On the other hand, it does create risks to the industry, or to GPs.

There will be pressure on returns if the supply of good opportunities does not grow in parallel to demand. It also means that increasingly, the GPs need to up their game a notch, because money increasingly becomes a commodity. You have to be a better owner as a GP of that asset, and deliver value creation after owning the deals.

For GPs, the last thing you want is to grow too much ahead of yourself, and have the pressure of deployment, and make wrong decisions that could hurt the franchise. So far, with our GPs, we haven't been concerned about that. People have been very disciplined.

**Ivo Naumann** is a partner in McKinsey's Shanghai office; **Wouter Baan** is an associate partner in Hong Kong.