Research on the Influencing Factors of Private Equity IPO Exit Returns

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Abstract. After more than three decades of rapid development of the private equity investment industry, China has now grown into an important pillar force indispensable to supporting the real economy. Among them, the exit link, as one of the three indispensable links in the operation of private equity funds, determines whether the private equity funds can realize value-added and exit smoothly, which is the ultimate goal of the whole investment activities. This paper compiles the relevant researches on the exit returns of listed companies in recent years, summarizes the factors and characteristics affecting the exit returns of China's IPOs, and the research results show that the realization of maximizing the exit returns of IPOs requires the joint efforts of investee companies, private equity investment institutions and macro policies.

Keywords: Private Equity; Exit Returns; IPO.

1. Introduction

Private equity fund exit refers to the process in which a private equity fund sells or transfers its stake in a portfolio company to recover its investment and realise gains when the invested company reaches the predetermined exit conditions [1]. In this paper, the gains obtained through the initial public offering exit method, excluding the gains obtained through mergers and acquisitions, New Third Board exit, share repurchase, equity transfer, shell listing, bankruptcy and liquidation of these exit methods, focusing on the factors affecting the initial public offering (IPO) exit method.

With the advancement and implementation of the comprehensive registration system reform in the capital market, the exit environment for private equity funds has continued to improve. However, China still faces a complex and severe international environment and pressure of economic transformation and adjustment. According to the National Bureau of Statistics (NBS), the annual GDP in 2023 was RMB126,058.2 billion, a year-on-year growth of 5.2% [2]. At the same time, a total of 415 medium-sized enterprises achieved IPO listing, as shown in Figure 1, of which 274 listed companies have VC/PE institutional background behind them, with a penetration rate of 66%, and the penetration rate fell back again year-on-year. Exit return rate of 374%, slightly lower, the proportion of foreign IPO rose to 25% [3]. Under the influence of the macro-economy, the number of IPO listings declined year after year, VC/PE institutions to replenish the ammunition is still mainly from the IPO exit, the penetration rate in recent years is still at a high value, but the fact is that there are still many institutions failed, book value of equity and the exit rate of return is again low. The problem of "difficult exit" is plaguing and restricting the development of the industry.

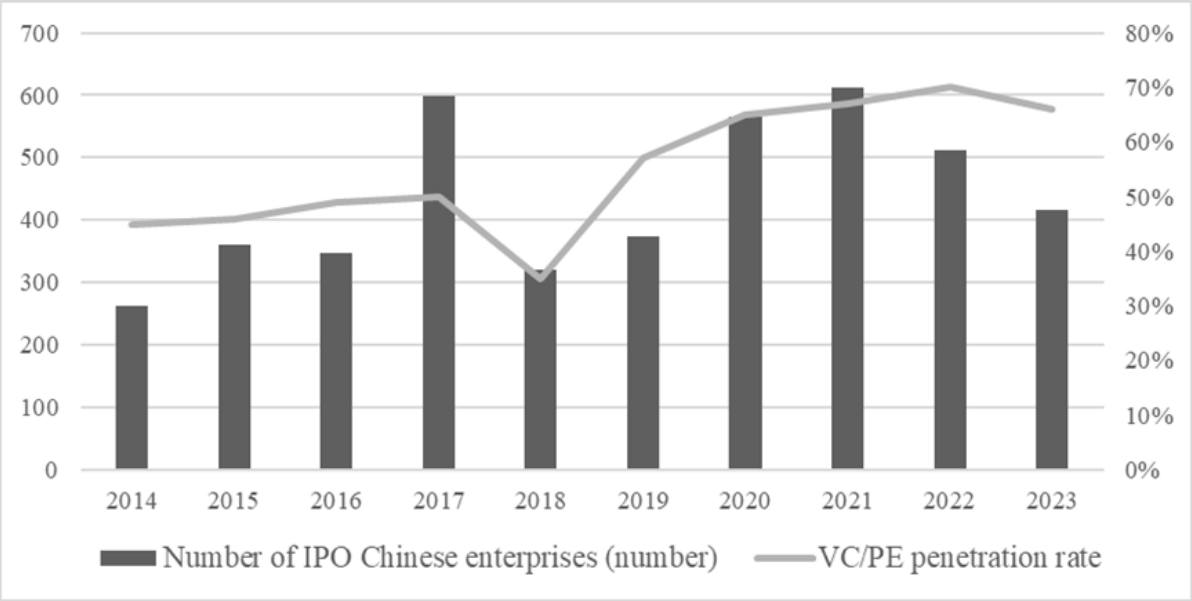


Fig 1. Exit VC/PE Penetration Rate by IPO Method, 2014-2023

2. Basic Concepts and Process of Private Equity IPO Exit

2.1. Definition and characteristics of IPO exit

2.1.1. Definition

IPO is an Initial Public Offering (IPO) issuance, which generally takes place when an investment firm is operating at a desirable level. It enables private equity investors to convert the non-circulating shares they own into public shares to cash out in the market to realise investment returns through the listing of the enterprise [1]. So far, the main ways for private equity funds to go public through IPO are initial public offering stock listing exit, indirect listing exit, listing transfer exit, merger and acquisition exit, and buyback exit.

2.1.2. Characteristics

IPO exit refers to the expansion of financing channels by listing in the secondary securities market after the invested enterprise meets specific conditions, thus converting the shares held by the private equity fund into shares that can be traded in the secondary market, which is easy to sell and liquidate, and it is one of the favoured exit methods of private equity institutions [4]. From Table 1, it can be found that private equity IPO exit has more advantages but requires sufficient cost and preparation time.

Table 1. Advantages and disadvantages of private equity IPO exit

Advantages	Disadvantages
High average return, a way to maximise the interests of investors and enterprises, enhances the popularity of private equity institutions, and broadens financing channels for invested enterprises.	Highest cost, long preparation time, highest threshold for IPO exit, requires regular public disclosure of information, more affected by macroeconomic environment.

2.2. The basic process of IPO and exit for private equity funds

IPO exit refers to the process by which an investor achieves a return of capital by selling its shares or adopting other exit strategies after the IPO of the investee company. To go public through an IPO, a company must go through a rigorous nine-step process before it is finally listed. After the IPO, the investor will decide whether to reduce/transfer the shares, and if so, the private equity fund will choose an appropriate exit strategy and finally recover the capital; otherwise, it will continue to sell

through brokers or market makers. The basic process of IPO listing and exit of a private equity fund is shown in Figure 2.

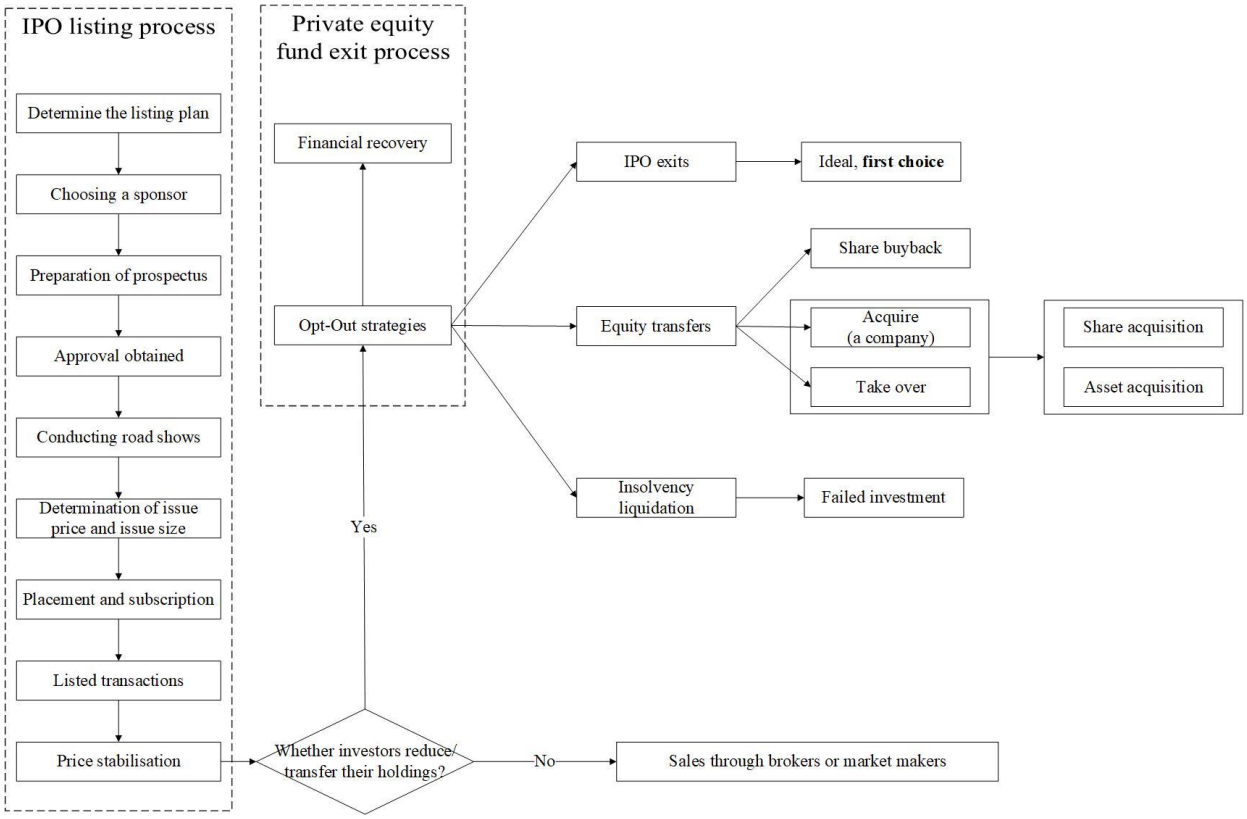


Fig 2. The basic process of IPO listing and exit for private equity funds [5].

2.3. Comparison between IPO exit and other exit methods

China's private equity fund exit channels are diversified, and the IPO exit method has many differences compared to other exit methods, mainly from the listing costs, capital gains, enterprise visibility, transaction process, shareholder exit restrictions, and business pressure in six aspects different from other exit methods.

2.3.1. Listing costs

It is necessary to bear higher listing costs, including lawyer's fees, accountant's fees, underwriting costs, etc. Other exit methods, such as mergers and acquisitions and equity transfers, are relatively low cost.

2.3.2. Capital gain

It can bring higher capital gain because the valuation of the enterprise will usually be increased substantially after listing. Other exit methods have relatively lower returns.

2.3.3. Enterprise visibility

The enterprise visibility helps to increase the visibility and brand image of the enterprise, thus enhancing its competitiveness. Other exit methods have a relatively small effect on corporate awareness.

2.3.4. Transaction process

The process is more complicated and time-consuming, including filing, auditing, enquiry and pricing. Other exit methods such as M&A, equity transfer and other transaction processes are relatively simple and time-consuming.

2.3.5. Restrictions on Shareholder Exit

After IPO exit, shareholders are subject to more stringent restrictions when selling their shares in the secondary market, such as the lock-up period, etc. In other exit methods, shareholders are not allowed to sell their shares in the secondary market. In other exit methods, shareholders are free to sell their shares after the transaction is completed.

2.3.6. Pressure on business operation

After IPO exit, enterprises will face stricter regulation and market pressure, which may have an impact on their operation and performance. Other exit methods have relatively less pressure on business operations.

3. Factors Influencing Private Equity IPO Exit Returns

3.1. Factors from the Perspective of Investee Companies

It has been found that factors such as the operating conditions of investee companies, the industry they are in and the market environment have a more significant impact on IPO exit returns [6-9].

3.1.1. Enterprise operating conditions

The exit benefit of private equity investment is negatively correlated with the gearing ratio of the investee company, and when the company is a state-owned private equity holding company, the lower the company's gearing ratio, the higher the growth [6]. The exit benefit of private equity investment is positively correlated with the return on net assets of the investee company. The profit model of private equity investment institutions is to provide full range of financial support for the invested enterprise, in order to obtain the equivalent value of the enterprise's shares. When the value of the enterprise rises, the capital is withdrawn by transferring the shares, and the capital appreciation is finally realized [7]. The higher the return on net assets of the enterprise, the greater the potential of the enterprise to use its own assets to achieve capital appreciation, and the more favoured by private equity investment institutions.

3.1.2. Corporate governance structure

The study found that the pay performance sensitivity of companies with private equity participation is significantly higher than that of companies without private equity participation, i.e., private equity participation makes the company management work harder to improve the company's performance, which in turn improves its own pay level. It also improves the level of corporate governance [6].

For the company, in addition to the need to pay attention to the establishment and improvement of the corporate governance system, should also develop a supporting supervision mechanism to ensure that the corporate governance structure is reasonable, and can be implemented in depth, to play its due role [8]. Not only that, as an important component of the corporate governance structure of the enterprise financial personnel and internal audit personnel, should also be effective measures to continue to improve their comprehensive ability, proficiency in a series of basic skills for the long-term development of the enterprise to create the conditions, lay a solid foundation, as soon as possible to complete the listing, so as to obtain the ideal exit earnings.

3.1.3. Industry

The industry in which the enterprise is located is also one of the factors affecting the IPO exit return of private equity investment, high-tech emerging industries have more development potential, despite the higher risk, but still can attract private equity investors to invest. First of all, Wu Yamei selected 20 August 2010 - 31 December 2015 in Shenzhen GEM listed with private equity support as the initial sample, concluded that investing in high-tech industries will not necessarily obtain higher exit performance, the reason is that in the selection of 201 investment project samples, there are 146 investment project samples belong to non-high-tech industries, high-tech industry samples are too

small [9]. High-tech industry (such as: software industry, IT industry, pharmaceutical industry, etc.) private equity investment is very intensive, the reason is that these high-tech industry development potential is strong, the space of capital appreciation is large, the higher the exit return of private equity investment institutions [7].

3.2. Factors from the Perspective of Private Equity Institutions

Factors such as the size, management experience, and investment strategy of private equity investment institutions can have an impact on IPO exit returns. It is found that private equity funds with larger capital size, rich management experience and investment strategies and timing tend to achieve higher IPO exit returns [10-15].

3.2.1. Capital size of the institution

The exit return of private equity investment is positively correlated with the capital scale of private equity investment institutions [10]. Firstly, private equity institutions with large capital can attract high-quality professional management personnel, who can use their professional knowledge to strictly control the exit link, which is conducive to the smooth articulation of the capital cycle process.

Secondly, according to the data of CICC, the TOP250 private equity institutions participated in a total of 3,182 transactions, accounting for 33% of the market as a whole, and the total investment scale was $68.5 billion, accounting for 44% of the market as a whole [11]. This means that the head institutions contribute 30-40% of the number of deals and deal size of the whole market. Private equity firms are raising trillions of dollars annually, and only the headline firms continue to be generous [12]. It follows that relatively headline institutions are more likely to realise higher IPO exit returns.

3.2.2. Investment strategy and experience of fund managers

The manager of a private equity fund must have sufficiently mature expertise and comprehensive capabilities [13]. Private equity investment institutions with a high degree of maturity have stronger core competitiveness than other competitors and can provide better value-added services to invested companies. Investors need to have a high level of professionalism, tight risk control, a willingness to invest for the long term and a high degree of focus in order to minimise risk and maximise returns [14].

Once the private equity investment institutions that the investee company's development is slow or due to other factors that lead to the project can not meet the expected goals, it is necessary to decisively withdraw funds to stop losses, if the exit is timely, even if the investment fails to recover a certain percentage of the investment amount to reduce the loss of continued operation. This requires a high degree of maturity of private equity investment institutions with a lot of hands-on work experience, and investment projects are more familiar with the background of the relevant investee companies to understand more profound, in the choice of investment projects when the discerning ability to obtain high returns [15].

3.2.3. Timing by the fund manager

The exit decision of an equity investment is not static, and the proper timing of exit is critical to investment returns. Exiting too early may lead to missing out on desired returns, while excessive delays can lead to increased risk and reduced liquidity [16]. Mastering the timing of exit is a great challenge for fund managers. The development process of a business can be divided into five stages: start-up, growth, maturity, prosperity and decline. Usually, the optimal exit timing should fall in the mature stage of the enterprise.

3.3. Macroeconomic Policy Perspective Factors

Macro factors can have an impact on private equity IPO exit returns. The main factors are capital market environment factors, regulatory policies and regulations [17-19]. New policies to guide the

future direction of the financial industry will inevitably cause a change in the response and strategy of investors as well as investees.

To support the development of private equity funds, China has taken several measures, such as optimising the approval and regulatory environment, launching incentive policies, and supporting funds to invest in innovative companies. In addition, China plans to establish a more standardised private equity fund market, incorporate private equity funds into the public fund regulatory system, and enhance the transparency and market stability of private equity funds [17].

Meanwhile, within one month of the official landing of the full registration system, the nominal passing rate reached 90%, but the actual passing rate was 55%; in the first quarter of 2023, the nominal passing rate was 85%, but the actual passing rate was only 47%; and the Kechuang board from March 2019 to 25 April 2023, the cumulative number of companies accepted 879 companies' declarations, and the actual passing rate was about 64% [18]. As the supply-side structural reform of the stock market, the decline in the approval rate of projects in the pilot registration system, it is clear that this policy has a negative correlation with the IPO project [19].

4. Conclusion

This study collates and categorises the factors affecting the IPO exit returns of private equity investment, and then concludes that: firstly, for investee companies, if the investee companies are in the high-tech industry, they are indeed more likely to be "favoured" by private equity institutions, but regardless of what industry they are in, they still need to improve their own overall return on net assets, reduce the gearing ratio, ensure a reasonable governance structure and develop a supporting regulatory system; secondly, for private equity investment institutions, the capital scale is crucial, determining whether they can have strong capital or not. Reduce the gearing ratio, ensure a reasonable governance structure, and develop a supporting regulatory system; Secondly, for private equity investment institutions, the capital scale of private equity investment institutions is crucial, determining whether they can have strong financial support, and at the same time, recruiting sufficient professionals need to have a tight risk control ability, choose the right time, and make the right choice; Thirdly, for macroeconomic Third, for macroeconomic policies, the introduction of new regulations will trigger both positive and negative changes in IPO exit returns, in terms of the existing full registration system after the landing of the current strict regulatory requirements for IPOs to pass, although the lower rate of passing may lead to a reduction in the exit returns of IPOs, but improve the quality of IPOs passed, which is conducive to the passing of IPOs to obtain a more efficient exit returns.

Although this paper collates a large amount of literature, there are still shortcomings: this paper is based on the literature found to summarise and generalise, there is a possibility of omission of literature, which leads to the omission of the generalised impact factors; for the macroeconomic policy factors, the policy landed on the ground for a short time, and the relevant literature is limited, so this paper is not able to reflect the impact results well. Most of the existing studies are based on the investee company's return on net assets or equity-related financial data to analyse and study, and there are fewer studies on the actual comparative study of IPO exit returns between different industries, as well as on the factors of the company's internal regulatory system; secondly, for macroeconomic policy factors, after the policy has landed, it may take a longer period of time for the policy to develop, which will ultimately result in the positive or negative impact of the Results.

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