Diversified Exploration of Private Equity Exit Path

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Abstract. The exit of private equity investment is a key part of the investment process, which not only affects the realization of investment returns, but also reflects the maturity and activeness of the private equity market. With the development and innovation of the financial market, the exit path of private equity is gradually showing a diversified trend. This paper aims to explore the diversification of private equity exit paths, including initial public offering (IPO), merger and acquisition, equity transfer, repurchase and S-fund transactions, and analyze their characteristics, applicable conditions, advantages and disadvantages, and their impact on the private equity market. The exit path of private equity funds should be comprehensively considered according to many factors such as market environment, enterprise development stage and fund investment strategy, so as to maximize investment returns and minimize risks. Under the background of the increasingly mature and complex capital market, the exploration of diversified exit paths is of great significance for the sustainable development of private equity funds.

Keywords: Private Equity Exits; Diversification; Investment Returns; Capital Market Maturity

1. Introduction

1.1 Research Background

As a new model of direct financing system, private equity investment plays an increasingly important role in recent years. It not only solves the capital bottleneck problem in the development of small and medium-sized enterprises, but also optimizes the corporate governance structure, infuses modern enterprise management concepts, and assists its capital operations such as restructuring and listing, thus becoming an effective way to integrate financial capital and industry. From the perspective of procedure, the operation of private equity investment involves the four main links of "fundraising, investment, management and withdrawal". From the perspective of sustainable development of fund investment, investment withdrawal should be the top priority.

1.2 Literature Review

In 1999, Lerner &Josh [1] divided the Equity capital invested in enterprises in the economic system into two categories: publicly traded and non-publicly traded according to whether they could be traded in the open market, and the non-publicly traded equity was private Equity. Exit is an important process of realizing income from equity investment. Relander et al. studied the situation in Europe and found that, in theory [2], a public listing is the preferred way to realize cash, but now, many private equity funds choose to exit through third-party mergers and acquisitions. Cumming & Macintosh divide exit into two types: full exit and partial exit [3]. They distinguish between full and partial exits by selling all or part of their shares in the investee company through an equity investment fund. For example, IPO is a partial exit, when the investee company IPO, only part of the shares can be sold in the open market, part of the shares are locked up, restricting the private equity fund to sell within a certain period of time. For another example, in the United States, the equity market is more liquid, and IPO is the exit mode with the highest return, followed by acquisition [4].

Andreas Bascha and Uwe Walz(2001) pointed out that the conflict between entrepreneurs and private equity funds lies not only in the distribution of direct economic interests, but more importantly in the choice of exit mode, because exit mode also affects the economic interests of both. The authors note that

Convertible Securities can be used to avoid these conflicts of interest [5]. Bernard S. Brown of the University of Texas and Ronal J. Gerson of Stanford University have studied capital

How the market influences private equity capital raising. They emphasized the strong relationship between the raising of private equity funds and the sound security capital market [6].

In Venture Capital in China (2007), Cheng Siwei believes that the exit methods of private equity funds are not independent of each other, but closely related, and private equity funds generally use these methods to make investment exit planning and decision-making [7]. Wang Xiaodong, Zhao Changwen and Li Kun (2003) mainly constructed a sign evaluation system from three dimensions of return rate, liquidity and other indicators, and concluded that the overall performance of M&A was higher than that of IP0 through the three-dimensional index system, while the performance of liquidation was the lowest [8]. In terms of exit time, Liu Manhong (1998) expressed her views from the perspective of reputation. She believed that private equity funds might chase reputation, and in order to report the performance of the previous fund in time, risk enterprises that were not yet ripe applied for listing. Therefore, the pursuit of reputation by private equity fund managers will have a certain impact on the exit time of IP0 [9]. From the perspective of control right of venture firms, Wang Bin and Lu Wenpeng (2004) also expressed the same view, arguing that IP0 provides a hidden incentive mechanism for venture entrepreneurs to regain corporate control [10]. The incentive mechanism of IPO for venture entrepreneurs is as follows: when the private equity fund withdraws, if the enterprise is cultivated to be publicly listed, the convertible preferred shares owned by the private equity fund will be automatically converted into ordinary shares and liquidated, [11] then the control right stipulated in the preferred stock contract will be lost. Even if the company does not withdraw, the remaining control right will be greatly weakened. Venture entrepreneurs gain relatively more residual control rights, which is also the result that both parties are willing to see (Zhang Yasheng, 2003).

1.3 Research Significance

It is of great theoretical significance and practical value to study the exit path of private equity funds. It not only helps to promote the healthy development of the private equity fund industry, improve the resource allocation efficiency of the capital market, promote enterprise innovation and industrial upgrading, but also provides theoretical basis and practical guidance for policy formulation. Therefore, the in-depth study of the exit path of private equity funds is of great significance for promoting the high-quality development of our economy.

2. Private Equity Exit Path Overview

The withdrawal of a private equity investment fund means that after the value of the invested enterprise reaches the expected level of the private equity investment fund, the equity of the enterprise held by the private equity investment fund is converted into the capital form through the capital market in the most efficient way at the appropriate time, so as to maximize the income and exit the enterprise, and realize the appreciation of the capital value or reduce the loss.

2.1 Initial Public Offering (IPO) Exit

IPO exit is the most mainstream exit way, often can bring higher returns to the fund, in line with the private equity fund's pursuit of "high risk, high return" characteristics. The listed places of enterprises are mainly divided into several categories: listed on the main board in China, such as the Shanghai Stock Exchange and Shenzhen Stock Exchange; Listed on other multi-level capital markets in China, such as the Science and Technology Innovation Board, Growth Enterprise Board, Beijing Stock Exchange, etc.

The advantage of an IPO exit is that investors can get a higher return and the company can gain independent decision-making power. The disadvantage is that the threshold of public listing is higher, the cycle is longer, and good capital market conditions are required to be able to carry out this exit. In addition, there are many challenges in IPO exit, such as high requirements for enterprises, strict supervision, adequate information disclosure requirements, long fund lock-up period and large risk of asset price fluctuations during the period.

IPO exit methods vary across markets. China implements the approval system for securities issuance, while the United States implements the registration system for securities issuance. The former plays an important role in protecting investors' rights and interests and controlling investment risks, but objectively, it also reduces the efficiency of the capital market and the fundraising effect of enterprises. In addition, the two places also have differences in the supervision and ownership structure of listed companies.

2.2 Indirect Listing Exit

Indirect listings, also known as backdoor listings, used to be A popular way for Chinese companies listed in the US or Hong Kong to return to the A-share market. Its operation mode can greatly shorten the listing time, save the listing cost, and avoid some supervision and information disclosure requirements. However, this model also has defects. First, it is difficult to find a suitable shell company target; second, backdoor listing is a hotbed for all kinds of insider trading, which is prone to disturb the order and value system of the capital market, and is the key risk prevention object of the regulatory layer.

Another indirect way to go public is through a SPAC (Special purpose Acquisition Company) listing in the United States. SPAC itself is a publicly traded investment vehicle, which has no basic business when it is listed, and the funds are dedicated to the future transfer to the appropriate target for acquisition, and then reverse acquisition itself to make the private company go public. Listing through SPAC has the advantages of significantly shortening the cycle, significantly saving procedures and steps, and high success rate.

2.3 Exit from Equity Transfer

Equity transfer withdrawal is mainly carried out in the over-the-counter equity trading market, that is, the National SME share transfer system (New Third Board) or the regional equity trading market (fourth board). The OTC market has the advantages of relatively relaxed listing conditions, shorter time and lower cost for enterprises. When enterprises develop to meet the conditions, they can be transferred to the Beijing Stock Exchange, GEM or Science and Technology Board for listing, which is a good supplement to the main board of the exchange.

However, China's OTC equity trading market is still in a relatively early stage, and the level of listed enterprises in the New Third Board and other markets is uneven, and the overall performance of the market is poor. Specific to the fund exit level, the current listed transfer of income returns are low, the liquidity of funds and assets is poor, the pricing system of the underlying equity is not market-oriented, preventing the OTC market from playing a greater role in the exit scenario.

In addition, the fund often transfers the equity obtained in the past investment rounds and is relatively inferior in the rank of shareholders' equity to new investors in the way of "selling old stocks". However, this method often relies on non-public information and intermediary matching, and is mostly "opportunistic" transactions that are further away from the professional trading market, which is not market-oriented enough.

2.4 Merger Exit

M&A exit refers to an exit mode in which the target enterprise invested by private equity funds chooses to sell itself to the acquirer by way of acquisition or merger. The core of M&A withdrawal is to transfer all the equity or controlling equity of the invested enterprise to the acquirer, so as to realize the withdrawal of all or most of the original shareholders of the target enterprise.

M&A exit cycle is short, the procedure is simple, and avoid the listing ban period, can be immediately realized at one time, is a more ideal exit way. However, the yield brought by M&A is uncertain. In the negotiation of a M&A transaction, there is a natural conflict between the price demands of the two parties on the equity of the enterprise, and the fund is often in a passive position with limited bargaining power. In practice, most fund returns from mergers and acquisitions are much lower than those from ipos.

Merger and acquisition withdrawal has deep practical significance in the current situation. First of all, M&A withdrawal is to meet the objective requirements of the continuous development of market economy. Secondly, from the perspective of micro private equity investors and the merger and acquisition parties, M&A exit also has incomparable unique advantages. The merger and acquisition withdrawal of private equity investment has a high degree of marketization and flexibility, there is no lock-up period, and there is no need for high sponsorship, underwriting and other fees. Private equity investors or original shareholders can achieve a one-time complete withdrawal from the target enterprise and quickly recover their investment, which helps accelerate the cycle of private equity capital.

M&A exit is still in the embryonic stage in China, and the further development space is still subject to many restrictions. In the future, with the further development of China's capital market, M&A withdrawal may become the most important exit channel for domestic equity investment institutions.

2.5 The Secondary Fund Transaction Exits

The Secondary Fund invests in the secondary market of private equity funds, that is, directly acquires company equity or fund shares from the original investors. Secondary Fund transactions have many advantages. For example, the acquired fund shares usually have been operated for a period of time, and the exit conditions are close to maturity, which can significantly shorten the realization cycle. For another example, most of the acquired fund shares have a relatively clear investment portfolio pool, which can reduce investment risk compared with a blind fund pool.

There are still several problems to be solved in the development of the Secondary Fund. First, the fund law stipulates that private equity funds can only raise funds for qualified investors with certain conditions, but when the fund shares are transferred, they are required to disclose information to third parties. Secondly, there are often pre-emption clauses in the original fund contract to restrict the transfer of fund shares, which requires all investors to give up the right to transfer to a third party, leading to lengthy negotiations and procedures in practice. Finally, there is also a lack of standardized valuation methods for the pricing of the shares to be transferred. There is almost no liquidity for the shares of private equity funds, nor is there a market transaction price, and there are few comparable transaction samples. Therefore, how to reasonably determine the fair value of the shares also needs continuous exploration.

2.6 Buyback Exit

Repurchase withdrawal is the redemption of the shares of the enterprise owned by the fund by the company's management or founding shareholders, so as to realize the withdrawal. Unlike in the U.S. market, it is common in China for funds to sign performance betting agreements with companies as a condition of investment, and when the company fails to meet the agreed targets, the fund can force the original shareholders or the company to buy back its shares.

Repo exit is the safest and most stable way, and it is also a guarantee option in case of investment failure. In the case of a company, buying back shares can also preserve the independence of the company and the founder's control of the company when there is a disagreement with shareholders over business performance and development philosophy.

3. Comparative Analysis of Private Equity Exit Paths

3.1 A Comparative Analysis of IPO Exit and M&A Exit

An IPO exit is generally considered to be one of the most common and desirable exits, enabling the leap and appreciation from the private equity market to the capital market. For a long time, IPO exit from the unlisted state to the capital market usually produces a huge value-added income, and as a public company in the capital market, it can bring a good and positive corporate image.

However, since the second half of 2012, the capital market has declined, especially with the suspension of IPO issuance, the main exit channel of private equity investment - IPO exit channel has been blocked, and many projects invested by private equity funds are facing the embarrassing situation of no exit. During this period, private equity investment has gradually formed a multi-channel exit model with equal emphasis on IPO and M&A exit, supplemented by over-the-counter market exit, old stock transfer, and buyback exit.

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3.2 The Choice of Exit Path under Different Market Environment

Under different market environment, the exit path choice of private equity funds will be different. In a bull market environment, IPO exits are usually able to earn higher returns and are therefore more favored by private equity funds. In the bear market environment, IPO exit may face greater challenges, at this time, M&A exit, equity transfer exit and other paths may be more appropriate.

In addition, under different market environments, the choice of the exit time of private equity funds is also crucial. Choosing to exit at the right time can maximize investment returns and reduce investment risks.

4. Private Equity Exit Path Challenges and Coping Strategies

Although the exit path of private equity funds is diversified, it still faces many challenges in practice. These challenges not only come from external factors such as market environment, policies and regulations, but also involve internal factors such as the investment strategy and management ability of private equity funds.

4.1 Market Environment Challenge and Countermeasures

The capital market is affected by macroeconomic, policy adjustment, geopolitics and other factors, and has great volatility. The uncertainty of the market may cause private equity funds to face problems such as lower valuations and lack of liquidity when they exit. Private equity funds should strengthen their research on macroeconomic and market trends and develop flexible investment and exit strategies. At the same time, diversifying the portfolio to spread the risk and reduce the impact of a single project or market fluctuations on the overall exit.

With the rapid development of private equity market, competition is becoming increasingly fierce. In terms of quality project competition and exit timing, private equity funds are facing great pressure from their peers. Enhance the fund's professional capabilities and brand influence, and attract high-quality projects through differentiated investment strategies and high-quality services. At the same time, strengthen cooperation with other private equity funds, investment banks, etc., to jointly develop projects and exit opportunities.

4.2 Policy and Regulatory Challenges and Countermeasures

The regulatory policies of private equity funds in various countries are constantly adjusted and improved, which may affect the exit path and cost of funds. It is necessary to pay close attention to changes in policies and regulations, and timely adjust investment strategies and exit plans. Strengthen communication with regulators, understand policy orientation and regulatory requirements, and ensure compliant operations.

Tax incentives are one of the important factors attracting private equity funds, but the adjustment of tax policy may affect the returns and exit costs of funds. It is necessary to make reasonable use of preferential tax policies, pay attention to the changing trend of tax policies, and do tax planning and risk management in advance.

4.3 Internal Challenges and Coping Strategies

The operation of the invested enterprise directly affects the exit of the private equity fund. If the company is poorly run and the performance declines, the fund may face problems such as lower valuations and difficulty finding buyers when it exits. Strengthen due diligence and post-investment management of investee enterprises, provide necessary support and value-added services to help enterprises improve operational efficiency and profitability. At the same time, establish long-term cooperative relations with the invested enterprises to jointly cope with market changes and challenges.

In the process of exit, private equity funds may face the problem of information asymmetry between the investee and potential buyers, resulting in valuation differences and negotiation difficulties. It is necessary to strengthen information disclosure and transparency, and establish a good communication mechanism with investee enterprises and potential buyers. At the same time, professional institutions (such as accounting firms and law firms) are used to conduct due diligence and valuation assessments to ensure the fairness and rationality of the exit process.

4.4 External Cooperation Challenges and Coping Strategies

In the exit process, private equity funds need to work with investment banks, law firms, accounting firms and other professional institutions. The choice of partner directly affects the smooth and cost-effective exit process. It is necessary to establish stable partnerships and choose professional organizations with rich experience and good reputation for cooperation. At the same time, strengthen the evaluation and supervision of the partners to ensure the smooth progress of the cooperation process and compliance.

The cross-border exit path may face challenges from laws and regulations, tax policies, and foreign exchange controls in different countries. We should strengthen the research on the legal environment and regulatory requirements of the target market, and formulate reasonable cross-border exit strategies. At the same time, professional cross-border legal services, tax planning and foreign exchange management support are sought to ensure the compliance and smooth progress of the cross-border exit process.

5. The Innovation and Development of Private Equity Exit Path

5.1 The Exploration of Cross-Border Exit Path

With the accelerated development of globalization, cross-border private equity investment activities are increasingly frequent, and the exploration of cross-border exit paths has become an important issue. Cross-border exit not only means IPO or merger in the overseas capital market, but also includes capital exit through cross-border S-fund transactions, cross-border equity transfer and other ways. The advantage of this cross-border exit is that it can take advantage of valuation differences, liquidity advantages, and regulatory policy differences in different capital markets to create greater exit value and flexibility for private equity funds.

However, cross-border exit also faces many challenges, such as differences in laws and regulations in different capital markets, tax issues, foreign exchange controls, cultural differences, etc. Therefore, when making cross-border exit, private equity funds need to fully understand the legal environment, regulatory requirements and market characteristics of the target market, formulate a reasonable exit strategy, and seek professional legal and financial adviser support.

5.2 Exit Path Innovation Enabled by Science and Technology

The rapid development of technology has brought innovative opportunities for the exit path of private equity funds. For example, the application of big data, artificial intelligence, blockchain and other technologies can improve the efficiency of due diligence on the target enterprise, the accuracy of valuation, and the transparency of the transaction process, thus reducing the exit risk. At the same time, the development of financial technology has also spawned new exit methods, such as blockchain-based equity trading platforms, which can provide a more convenient and efficient solution for the equity transfer of private equity funds.

In addition, technology empowerment can also promote the digital transformation of the private equity fund industry, improve operational efficiency and service quality, and create a better market environment for fund exit.

5.3 The RRise of the Green Exit Path

With the global attention to sustainable development and environmental protection, the green exit path is gradually emerging. Green exit refers to the process of private equity fund withdrawal, pay attention to environmental protection, social responsibility and corporate governance (ESG) and other factors, through the selection of ESG standard exit, to achieve a win-win economic and social benefits.

The green exit path can include enterprises investing in green industries such as environmental protection and new energy, through IPO or merger and acquisition; It can also be in the exit process, take environmental measures, optimize the corporate governance structure, etc., to improve the ESG performance of the enterprise, so as to improve the market value and competitiveness of the enterprise.

The rise of the green exit path is not only in line with the global trend of sustainable development, but also helps to enhance the social image and reputation of private equity funds, attracting more investors' attention and trust.

6. Conclusions

The exit path of private equity funds is the key link between investment and return. The diversification phenomenon not only reflects the complexity of the capital market and the flexibility of private equity funds, but also reveals the coping strategies of funds under different market environments, policies and regulations, internal and external cooperation of enterprises and other factors. Through a detailed analysis of the exit path of private equity, this paper reveals the advantages and disadvantages and applicable conditions of various exit methods (such as initial public offering, merger and acquisition, equity transfer, and other methods), and deeply discusses the challenges faced by funds in the exit process in terms of market environment, policies and regulations, internal and external cooperation.

In terms of market environment, private equity funds need to pay close attention to the volatility and uncertainty of the capital market, and flexibly adjust investment strategies and exit plans to cope with the risks brought by market changes. At the same time, in the face of increasingly fierce competition, the fund needs to enhance its professional capabilities and brand influence to occupy an advantage in the competition for high-quality projects and the timing of exit. In terms of policies and regulations, private equity funds need to pay close attention to changes in policies and regulations, strengthen communication with regulators, and ensure compliance with operations. Especially in the case of greater uncertainty of preferential tax policies, funds need to make reasonable use of preferential tax policies, do tax planning and risk management in advance. In terms of internal enterprises, private equity funds need to strengthen due diligence and post-investment management of investee enterprises, provide necessary support and value-added services, and help enterprises improve operational efficiency and profitability. At the same time, the fund needs to establish a long-term cooperative relationship with the investee enterprises to jointly cope with market changes and challenges to ensure a smooth exit. In terms of external cooperation, private equity funds need to select suitable partners to cooperate in the exit process, especially when cross-border exit, they need to strengthen the research on the legal environment and regulatory requirements of the target market, and formulate reasonable cross-border exit strategies. At the same time, funds need to seek professional cross-border legal services, tax planning and foreign exchange management support to ensure that the cross-border exit process is compliant and smooth.

To sum up, the exit path of private equity funds is a complex and changeable process, which requires comprehensive consideration and response in many aspects. By strengthening the research and response ability of market environment, policies and regulations, internal and external cooperation of enterprises, private equity funds can achieve the goal of capital appreciation and risk control during the exit process, and create greater value for investors. In the future, with the continuous development of the capital market and the increasing maturity of the private equity market, the exit path of private equity funds will be more diversified and complicated, and funds need to constantly innovate and optimize the exit strategy to adapt to market changes and changes in investor demand.

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