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CAMBRIDGE ASSOCIATES LLC

PRIVATE EQUITY INVESTING IN CHINA

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Report Contents

Executive Summary

- Over the last six years the Chinese private equity market has grown and matured considerably. The number of local managers has increased to more than 150, while many regional and global managers compete in China too. Fund raising has increased from $200 million in 2003 to $15 billion in 2008, driven by bigger fund sizes, a larger manager universe, and an increased investment pace. The market has become more clearly segmented both in style and size, with specialized firms pursuing only growth capital, venture capital, or buyout strategies, and even a few with an explicit sector focus. The limited partner base supporting private equity in China has evolved and now includes a variety of endowments, foundations, pension funds, funds-of-funds, and family offices from around the globe; critically important as well is the growing participation of Chinese investors.

- Growth capital investing in China is still the most compelling private equity strategy because of continued economic growth and financing constraints faced by private companies. The underlying growth of the broader economy and maturation of capital markets continue to offer a set of conditions for good private equity managers to generate attractive returns. Financing for private companies is not readily available in China, where state-owned enterprises receive a disproportionate share of bank financing. A structural need for private equity exists, which has promoted rapid expansion in growth and venture capital investment. Growth capital investment, in particular, avoids the difficulties involved in acquiring control stakes in companies that buyout firms face, or the lack of a material deal flow of non-performing loans that distressed investors encounter.

- Private equity investments in China have performed well, as of December 31, 2008, generating gross average annual end-to-end internal rates of return of 32.7%, 30.6%, and 21.6% (in US$ terms and on a gross basis) on a three-, five- and ten-year basis, respectively. Over each of those periods private equity outperformed public markets by well over 1,000 basis points (before fees and carried interest). Private equity, when pursued through the right manager, can also offer greater transparency, active operational portfolio management, and exposure to high growth sectors underrepresented in the public markets.

- Risks remain, but have been reduced over the last five years. Ongoing corporate governance and transparency concerns, potential regulatory changes, and relatively narrow avenues for exit compared to developed markets continue to beset private equity investors. However, over the past five years exit markets have improved and domestic listings have become a more realistic divestment alternative. Finally, anecdotal evidence suggests that transparency and corporate governance have improved, though they often still fail to meet Western expectations. Nevertheless, private equity managers have shown an ability to navigate these rough waters.

- Manager selection remains critical, given the small universe of high-quality managers in China. Investors should only invest if they can gain access to high-quality managers. Prior to 2003, most institutional private equity activity was dominated by global and regional venture capital firms, which remain key participants in the venture capital market today. Since 2003, growth capital has emerged as the largest segment of the private equity market. Today, investors have a broader set of manager choices than ever before, but partnerships in China remain young compared to other markets. Executive turnover has been an issue in China, which we expect to continue in the near term as a flight to quality makes fund raising for marginal managers more difficult and carried interest expectations for those funds fade. As a result, bottom-up manager selection is paramount, regardless of the manager's investment strategy.

- Cambridge Associates believes that now is an attractive time for investors with existing commitments in China to continue investment and for investors new to China to begin investing on a selective basis, likely with a fund investing in the dominant growth capital space as a first step. The global economic crisis has turned fund raising in China on its head: where many funds were once oversubscribed and difficult to access, today high-quality managers are accepting new limited partners and fund-raising terms are improving. This offers investors a chance to access a market that remains relatively attractive on a global basis, and invest with good private equity managers.

China's private equity market has grown significantly since we last published on this general topic in 2003.[1] Over that period, the number of local managers has increased from about 20 to more than 150 and total fund raising has grown from $200 million in 2003 to $15 billion in 2008. Despite this growth, the market remains relatively immature, with even the most experienced managers on just their second or third fund. Few funds can be considered institutional quality, and over half of private equity capital invested in Chinese companies is still unrealized, according to Cambridge Associates data. Nevertheless, assuming appropriate due diligence in selecting managers, China is an attractive market for private equity investors due to its economic growth prospects and large universe of entrepreneur-led companies in need of private capital. Risks related to transparency, corporate governance, and government regulation persist, but are lower than they were five years ago.

The Case for China Is Still Strong

Starting in the late 1970s, China's economy evolved from a centrally planned system largely closed to international trade to a more market-oriented economy with a rapidly growing private sector. The phasing out of collectivized agriculture, the gradual liberalization of prices, fiscal decentralization, increased autonomy for state enterprises, and a more robust banking system were important reforms. In the late 1980s and early 1990s stock markets were established, the economy was opened to foreign trade and investment, and the non-state sector grew rapidly. China further liberalized its trade and investment regulations in connection with its 2001 entry into the World Trade Organization (WTO). China's GDP increased ten-fold between 1978 and 2008 as a result of its reforms. Measured on a purchasing power parity basis that adjusts for price differences, China in 2008 was the second largest economy in the world after the United States, although in per capita income terms the country is still considered lower middle income (Exhibit 1).

China has not escaped the global economic downturn. Net exports, which account for about 35% of its GDP, have dropped sharply in the wake of reduced foreign demand. Furthermore, the country's property markets deflated rapidly in late 2008 (though certain segments had rebounded by mid-2009), and real GDP growth in 2009 is expected to slow to 8.5% after averaging approximately 10% over the last five years. While consumer spending has proven more resilient than in other markets, nearly half of China's growth in 2009 is likely to be driven by a fiscal stimulus package equal to 15% of GDP (roughly US$585 billion) that was announced in November 2008. The stimulus targets investments mainly in infrastructure improvements, education, health care, and environmental protection, which should further support domestic demand. Thanks in part to the stimulus, bank lending in just the first quarter of 2009 exceeded that in *all* of 2008, raising concerns that it must be reined in. While lending has peaked, it remains high today, with only marginal tightening so far.

Still, China's growth rate is perhaps the best globally, at least among the world's major economies, and one of the few bright spots in the

[1] Please see our 2003 paper *Chinese Venture Capital Investing*.

world economy. Government and household debt are low thanks to prudent fiscal policies, and China's huge current account surpluses have led to the world's largest foreign exchange reserves (over $2.2 trillion). While increased lending may eventually lead to substantial non-performing loan (NPL) problems, the banking system is well capitalized at present and savings rates remain high. On balance, economic factors such as these increase our confidence in the persistence of China's growth story.

Of course, despite (and indeed partially because of) its economic progress, China faces numerous challenges: (1) creating and sustaining jobs for tens of millions of migrants from China's countryside to its cities, new entrants to the work force, and workers laid off from export-sensitive industries; (2) reducing corruption and other economic crimes; (3) reforming a dated national pension system strained by an aging population and unfunded liabilities; and (4) containing the environmental damage and social strife caused by the economy's rapid transformation. From a private equity perspective, however, China is an attractive investment target compared to other markets because it has a large emerging middle class whose consumption of domestic goods and services should support strong and sustained economic growth. Many industry sectors are highly fragmented, with market leaders commanding only single-digit market shares. As a result, there is ample scope for expansion of emerging leaders through organic growth or consolidation, where private equity capital and expertise can be of assistance. In addition to these macroeconomic factors, inefficiencies at a transactional level offer opportunities to the private investor. Information asymmetries, a nascent financial system, and relationship-driven business decisions make it still possible to find proprietary deals, often at valuations favorable to the market comparables. Against this backdrop, we believe that private equity strategies in China can thrive.

The Growth of Private Equity in China

China's private equity industry has grown in three phases over the last 20 years. The country's first private equity funds were raised in the early 1990s. The first market entrants on a significant scale were private investment partnerships such as Jack Perkowski's ASIMCO and the billion-dollar AIG Asia Infrastructure Fund, both of which entered China on the heels of multinational corporations in the early 1990s, seeing opportunity in China's vast, largely untapped market. It is estimated that as much as $6 billion in private equity capital was raised at this time, focused primarily on the restructuring of state-owned enterprises (SOEs), with private equity investors taking minority stakes in joint ventures with such SOEs. However, many of these investments were hurt by the Asian financial crisis that began in 1997 or by corporate governance problems. As a result, most private equity investors abandoned the Chinese (and Asian) market for several years.

The worldwide technology boom in the late 1990s fueled the second wave of fund raising. Regional and international venture capital firms, such as Baring, H&Q Asia Pacific, Walden, and Warburg Pincus, as well as corporate-sponsored venture investors including Intel Capital and Japan's Softbank, entered the Chinese market in earnest. In contrast to earlier investments, these firms focused much more on early-stage opportunities in Internet services and technology (Exhibits 2 and 3). Moreover, the target investments in China were now private start-ups not associated with the government. Venture capital firms were eager suitors, Western initial public offering (IPO) markets facilitated exits, and fund raising reached record levels. However, after the Nasdaq peaked in March 2000, the window of opportunity for Chinese companies to list on public exchanges closed as quickly as it had opened.

The third wave in private equity fund raising followed China's accession to the WTO. From 2003 to 2008, capital commitments to China by limited partners (LPs) grew from $200 million to $15 billion (Exhibit 4). As noted earlier, the number of funds also grew considerably, from 20 or so to more than 150 China-dedicated managers by the end of 2008. Further, we estimate that more than 40 regional or international firms have also raised funds that target Chinese investments in part. In 2008 alone, China-only funds raised $15 billion, which represented 31.3% of all new capital raised targeting Asia. This was almost double the $7.8 billion in commitments raised for India, emerging Asia's other dominant private equity market.

Despite this growth, China remains much smaller than the mature private equity markets of the United States and Western Europe. For example, in 2008, funds that had been raised for private equity, venture capital, mezzanine, and distressed investing in the U.S. market were more than 19 times the amount that had been raised for investment in China. Similarly, overall private equity investment activity in the United States measured more than 2% of total U.S. GDP in 2008, whereas in China it reached only about 0.3% of GDP.

Private equity in China has been affected by the global economic downturn, although not as much as in developed private equity markets. Fund raising slowed significantly, with only $3.6 billion raised by China funds in the second half of 2008, a 71% decline from the first half of the year, and just $2.7 billion raised in the first half of 2009. Likewise, private equity investors committed $9.8 billion to 271 transactions in 2008, a decline from the $10.6 billion investment made in 313 deals the prior year. The drop was proportionately smaller, however, than that experienced in the United States, where private equity volume decreased 74% in 2008, dropping to $111 billion from $434 billion the prior year. Chinese private equity deal volume in the first half of 2009 has remained low, with just $2.5 billion invested, and fund raising for the year as a whole will likely decline for the first time since 2003.

The Current Landscape

The Chinese private equity market is mainly driven by the needs of businesses trying to expand in a rapidly developing economy. While the Chinese markets are maturing, capital to fund growing private enterprises remains extremely limited. Banks, largely owned by government entities, generally offer private enterprises only one-year bullet repayment financings rather than longer-term credit facilities. Longer-term credit is usually only available for SOEs. In fact, even the stimulus-induced wave of record bank lending in early 2009 was directed mostly toward SOEs and the real estate sector, rather than private companies. Anecdotally, we have heard of longer-term bank financing being offered to private firms in the past few months, but it is too early to assess if there is a systematic shift in this direction.

In accordance with the youth, size, and capital needs of private Chinese companies, private equity investments in China are still relatively small compared to those in developed markets. However, the average deal size—$36 million in 2008 (Exhibit 5)—has increased as businesses in China have grown, and some managers have begun investing in SOEs (which tend to involve much larger transactions) again. The amount of available capital from private equity funds has increased as well, with large multinational private equity firms completing the few large transactions that have occurred over the last few years. The biggest deal completed during 2008 was The Blackstone Group's $600 million investment in China National BlueStar (Group) Corporation, a specialty chemicals maker. In 2009, private equity firms made several large private investments in public Chinese equities, including the $2.4 billion and $7.3 billion acquisitions of shares in Bank of China and China Construction Bank.

Growth capital, broadly defined, represents the largest swath of the private equity market and offers the most investment opportunities for managers. Venture capital represents a smaller share of the Chinese private equity market, but is well established and often overlaps with small growth capital. In contrast, traditional control buyouts and distressed investing remain nascent in China as, for structural reasons discussed below, execution risk is higher. However, given the consistently small universe of quality managers across all strategies, the key consideration for the implementation of any private equity program in China remains bottom-up manager selection.

A review of the various subsectors of the private equity market in China is provided below.

Growth Capital Leads

The continued lack of financing alternatives for small but growing private businesses has made growth capital the dominant investment strategy, comprising roughly 65% of total private equity activity by invested capital. As the first generation of private enterprises, some originally backed by venture capital investors, have evolved into more mature businesses, many of China's most established venture capital managers have similarly migrated from early-stage to later-stage venture and growth capital investments. Booming public markets in China (and elsewhere) supported such investments in pre-IPOs and private investments in public equities, at least through 2007.

Almost all growth capital investments in China are minority, non-control investments backing company founders (Exhibit 6). In that context, experienced private equity investors usually seek strong minority protection rights, including earn-out models with ratchet mechanisms that tie the entry valuation to future measures of business performance. Investors often negotiate other negative rights, such as approval rights over major expenditures and strategic decisions, hiring a new chief financial officer, management changes, and the exit. Backing the right entrepreneur is especially critical since it is often difficult to enforce legal agreements in a timely and consistent manner.

Venture Capital in Second Place

After growth capital, venture capital is the most prominent sector in terms of investment activity and total fund raising, accounting for 24% of capital raised in 2008. Venture capital has a relatively long history in China. Since the late 1990s, most of the foreign capital to seed- and early-stage Chinese businesses has come from large, regional investors, such as Warburg Pincus or H&Q Asia Pacific. At that time, much of the investment was in young information technology and media companies, most of which were attempting to adapt successful American business models such as YouTube to local market conditions, with the international venture capital firms providing not only cash but also sector expertise. Increasingly, though, true innovation is occurring in China, including technology-enabled consumer products and energy-related products. However, since backing entrepreneurs localizing Western business models and using established technologies for new consumer businesses—many of them self-funded up to significant revenue levels—still represents a large part of the market, numerous venture capital investors in

China have migrated to slightly later stage venture and even into small-capitalization growth capital.

Buyouts Are Problematic

China's buyout market is less developed than its growth or venture capital markets and accounts for under 15% of total private equity activity in terms of value, and a much smaller percentage of transactions. The buyout market has been held back by a lack of quality assets for which control positions are available for purchase, regulatory hurdles to acquiring control positions, and a lack of financing.

SOEs that are being privatized constitute the main source of potential buyout opportunities. The Chinese government has sought to restructure and significantly reduce the number of SOEs over the past 20 years. The universe of SOEs fell from 114,000 in 1996 to 34,000 in 2003, with further significant reductions estimated since then. Many SOEs were closed rather than sold. In 2002, China's State Council established the State-Owned Assets Supervision and Administration Commission to help restructure and dispose of state-owned assets. However, the government has been reluctant to sell assets to foreign buyers, be it private equity firms or strategic buyers. China may be trying to avoid the type of public backlash that occurred in Japan and Korea after foreign private equity firms earned enormous returns from bank privatizations or sales. The often difficult and time-consuming process of gaining regulatory approval to acquire stakes in SOEs presents another obstacle for foreign private equity investors pursuing control buyout investments. As the size and strategic importance of the company grows and potential ownership stakes increase, more people and institutions—at local, provincial, and state levels—become involved in the approval process, making it harder to secure approvals and execute transactions. To many investors, the process appears bureaucratic, complex, and opaque. Things worsened in 2006 when the Ministry of Commerce's new *Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises* signaled that it would evaluate acquisitions of "leading" businesses by foreign investors more rigorously. This has led in some cases to multiyear approval processes and several failed acquisition attempts, including Carlyle's bid for Xugong Group Construction Machinery Co., a construction equipment manufacturer, the Schaeffler Group's offer to buy Luoyang Bearing Group, a bearing manufacturer, and Coca-Cola's recent bid to acquire juice maker Huiyuan. Anti-monopoly laws stymied the Huiyuan deal, which has likely further discouraged foreign investors from attempting to acquire Chinese companies of national scale or importance.

Buyouts of private firms also remain rare as most entrepreneurs, still first generation, prefer to maintain control. Indeed, managers with whom Cambridge Associates has spoken commented that they become suspicious when entrepreneurs try to sell controlling stakes in their businesses. Another concrete obstacle to buying private firms is the aforementioned lack of financing and dearth of long-term cash flow lending from Chinese banks available to investors. In a few cases, managers have been able to secure offshore loans for companies with wholly owned foreign enterprise structures. The downside of this structure is that it leads to suboptimal tax effects.

Since the market for buyouts is so small, there are few dedicated Chinese buyout funds. For the most part, buyouts are pursued by large local growth capital managers and large multinational private equity firms as part of their overall strategy. While we believe that conditions making buyouts more difficult today will likely change in the long run, most investors are probably best served at this point in time to gain buyout exposure through a private equity firm with a broader investment mandate.

Distressed Opportunities Are Modest

China's distressed market involves mostly the acquisition and work out of NPLs. Until the mid-1990s, and to some extent today, China's state-owned commercial banks followed national credit policies, often neglecting the creditworthiness of the borrower and the monitoring of the repayment in order to focus on achieving other government objectives. Banks were often understaffed and the absence of foreign competition contributed to inefficient operations. As a result, by 2006 an estimated $407 billion of NPLs sat on the balance sheets of China's commercial banks or had been transferred to state-owned asset management companies (AMCs) that have the mandate to manage the loans and/or sell them. State-owned commercial banks currently hold an estimated $143 billion worth of NPLs, while the People's Bank of China carries an estimated $27 billion on its books. There are also NPLs on the balance sheets of SOEs, smaller city banks, commercial banks, provincial banks, and local governments, which has led some to estimate that the Chinese NPL market could actually have been as large as $700 to $900 billion as of 2006. Today's credit largesse may portend a large pipeline of new NPLs in the future.

Although the size of the NPL market suggests the potential for attractive investment opportunities, execution has been difficult and relatively few transactions have occurred. The market to acquire Chinese NPLs has been dominated by the proprietary trading desks of large international investment banks since the asset management companies were created and bad loans from major Chinese banks started being transferred in 1999 and 2000.[2] In recent years, large U.S. firms that focused on distressed debt, such as Avenue Asia, CarVal, and some hedge funds, found that the expected deal flow never materialized. In fact, *no major NPL portfolio sale took place in 2008*, according to accounting firm Pricewaterhouse-Coopers, and the AMCs still appear to be in no rush to sell. However, smaller local distressed private equity firms, such as Shoreline Capital, have achieved modest success in acquiring small, one-off NPL portfolios from the AMCs and local commercial banks. Foreign private equity firms may find such smaller portfolios less appealing because they must compete with local Chinese individual investors to recover principal in an environment of opaque and untested bankruptcy laws, which remain the key risk in the market today.

While the supply of potential NPL investment opportunities theoretically remains large and could possibly grow significantly following the recent wave of government-induced lending, private equity firms have thus far seen very limited actual deal flow. This suggests that investors should proceed with caution. Given the trickle of opportunities, Cambridge Associates believes managers with smaller and more targeted NPL-related strategies are likelier to succeed in the current market environment.

Local vs Foreign or Pan-Asian Funds

Today, investors can choose from a range of local, China-only focused funds, or funds established by foreign private equity firms that may focus on China in whole or in part; the latter may be either affiliates or parts of a multi-office regional network (Exhibit 7). Local firms often understand the domestic market better, offer investors better deal flow through their domestic networks, and handle regulatory hurdles more smoothly (or face fewer such hurdles). At the same time, however, local firms are often less experienced fiduciaries and provide less transparency to LPs. Moreover, pan-Asian and global funds targeting China generally employ

[2] See our 2004 report *Asia ex Japan Distressed Investing*.

global best practices in due diligence and post-investment monitoring, and operate with greater institutional transparency.

Chinese nationals in domestically focused funds, which often include returnees (Chinese nationals who studied or worked abroad and have now come back to China) who have raised capital directly from overseas LPs, dominate growth capital, the largest segment of private equity in China. Several successful Chinese entrepreneurs and high-profile investment bankers have also created funds on the strength of their experience and local networks. Most growth capital funds range in size from about $50 million to $1 billion. Managers such as HONY Capital (founded by Legend Holdings, the parent company of Lenovo), CITIC Capital (a subsidiary of CITIC, the state-council's overseas investment vehicle), CDH (the first firm to raise *renminbi* [RMB] capital from the National Social Security Fund), and New Horizon (founded by Winston Wen, the son of Chinese Premier Wen Jiabao) are examples of funds backed by foreign capital that have successfully pursued control investments of SOEs or private Chinese companies because of their local *guānxi.*[3] For these firms, *guānxi* can provide access to influential decision makers, a better understanding of unclear regulatory processes, and greater credibility as buyers from a public relations perspective.

Foreign firms, whose staffs often include returnees, are more prevalent in China's venture capital and buyout markets than in the growth capital space. They often appeal to Chinese entrepreneurs due to their sometimes longer track records and greater technological expertise from past investments in their European or U.S. home markets. Foreign firms' performance in the venture capital area has been mixed, with some firms ranking among the most successful China-focused venture capital funds and others suffering as a result of unstable teams. In addition to expanding their global funds' geographic coverage to include China, high-profile U.S. venture capital firms such as DFJ, Kleiner Perkins, Matrix, and Sequoia have hired local teams and raised China-focused venture capital funds. Others, such as Doll Capital Management, Mayfield, and NEA have served as cornerstone investors in local venture capital firms. As the market matures, local groups are getting access to local entrepreneurs and their window on global technology trends has grown.

Global mega buyout firms such as Bain Capital, Blackstone, Carlyle, CVC, KKR, and TPG, which all actively pursue opportunities through pan-Asian or global fund vehicles, are among the most active global fund entrants in the Chinese buyout market. However, global managers have been largely unsuccessful in closing control transactions in China. The obstacles cited earlier have forced most of them to invest instead in large capitalization, non-control growth capital opportunities.

As is true anywhere, the success of any fund depends on the firm/team's incentive structure, background, skill set, and network. Chinese teams within global funds will likely spin off in whole or in part, as talented individuals endeavor to obtain a greater share of firm ownership and profits.

There Are Few Funds-of-Funds

The number of private equity funds-of-funds devoted solely to China is limited. We are aware of one firm, Jade Invest, which has raised $100 million in commitments for LP investments in Chinese private equity funds. American Securities, a U.S. private equity firm, is also seeking to raise a fund-of-funds for China. However, a robust Asian fund-of-funds manager universe exists; many of these funds-of-funds invest between

[3] Guānxi are a set of networks and influence, which is a central concept in Chinese society.

40% and 50% of their capital commitments in Chinese private equity funds. Some of these are considering setting up a fund-of-funds focused solely on China, while others are exploring raising funds-of-funds for domestic (i.e., Chinese) LPs denominated in RMB.

Evolution of Investment Structures

Since 2005, the Chinese government has worked to reform the private equity industry in order to keep more assets onshore, promote the further development of domestic capital markets, both private and public, and assist onshore investors. As a result, offshore funds investing capital on behalf of international investors face greater regulatory hurdles and more competition from local capital sources. LPs can invest in China through different fund structures while the funds themselves can invest through different investment structures.

Offshore Funds

Traditionally, foreign LPs have invested in China through funds structured as partnerships or companies in jurisdictions such as the Cayman Islands and denominated in U.S. dollars or other international currencies. While offshore funds remain the primary method of accessing China's private equity market, regulatory changes have affected these vehicles, and there is also competition from newer, onshore structures. Until about 2005, offshore funds investing in Chinese firms would establish an offshore holding company, which would then acquire all of the assets of the target firm, thus creating a wholly owned foreign enterprise. It was easy to obtain Chinese government approvals to create this structure and exit through a sale or offshore listing did not require further approvals. However, pursuant to China's State Administration of Foreign Exchange (SAFE) Circular #75, introduced in 2005, SAFE's pre-approval was required for any restructuring of an existing domestic business (as opposed to startups) into a wholly owned foreign enterprise through the offshore transfer of the assets of the Chinese operating company. In addition, in 2006, China's Ministry of Commerce issued revised merger & acquisition (M&A) regulations requiring pre-approval for certain offshore structures and joint approval by the Ministry of Commerce and the China Securities Regulatory Commission of foreign listings for onshore investments. As a result, offshore funds, for the most part, now invest directly into onshore entities, which means that certain approvals are at times required, lengthening the investment process. Likewise, divestment must typically occur onshore via a domestic listing in Shanghai or Shenzhen, which is also likely to delay the distribution of realized proceeds given that they must be converted into foreign currencies as they leave the country.

Joint-Venture RMB Funds

Following the foreign-invested venture capital enterprises regulations of 2003, managers gradually began adopting joint-venture funds, which became prevalent within a year or two after the regulations were passed. These funds allow foreign capital to reside onshore, possibly commingled with RMB capital raised from domestic LPs, in a structure that resembles a partnership. This structure overcomes some of the risks and uncertainties faced by offshore funds. Advantages include faster deal execution due to the elimination or expedition of currency conversion and Ministry of Commerce approvals, a straightforward path to exit on the domestic public markets, and the ability to offer RMB capital to entrepreneurs who prefer it. On the other hand, it suffers from some tax leakage, not being a pass-through entity, and the fact that some of these vehicles are constrained by investment restrictions, such as being limited to technology-related investments. Several general partners (GPs) have interpreted these restrictions quite loosely, placing these structures in a legal gray area. GPs have structured joint-venture funds in different ways, including creating a joint-venture fund using part of the offshore fund or investing the entire offshore fund through the joint-venture fund, as well as either keeping the joint-venture fund purely foreign funded or commingling it with RMB capital raised from domestic investors.

Domestic or "Pure" RMB Funds

The Chinese government has promoted locally funded private equity, leading to a rapid rise in onshore, RMB-denominated funds. A new PRC Partnership Enterprise Law took effect in June 2007, introducing limited liability partnerships, the standard structure for private equity funds in more established jurisdictions, for the first time in China. However, the law only governs domestic partnerships in which foreign LPs cannot invest (a recent and limited loosening of this requirement is discussed below). Other government measures have included lifting a six-year-old ban on direct equity investments by domestic securities firms and encouraging SOEs and other national, provincial, or local institutions to make anchor investments in private equity funds focused on particular regions in China. Locally backed onshore funds also face fewer restrictions when investing in industry sectors deemed sensitive by the government. *Asia Private Equity Review* estimates that 100 RMB-denominated funds totaling $4.1 billion were raised or announced in 2008 alone, representing 27% of total capital raised for China-focused private equity funds, up from a negligible amount two years earlier (Exhibit 8).

The bulk of the Chinese domestic funds have a development mandate, as they are often backed by various SOEs and government entities. An example is the Bohai Industrial Investment Fund, set up in 2006, which raised RMB 6.1 billion (about $1 billion) from government entities and SOEs, among them the China Development Bank, the National Social Security Fund, and the Postal Savings Bank of China. This fund, managed by Bank of China, was designed primarily to support the development of the Binhai New Area, a special economic zone in Tianjin and the broader Bohai Bay area.

In addition, many traditional private equity managers that cater to overseas investors have set up onshore funds as a supplement to their offshore vehicles. These RMB funds offer several advantages, including the ability to invest in a local company much more swiftly, since they do not need to undergo a lengthy approval process (reportedly upwards of three months) to convert capital into local currency. Some funds have been structured as separate partnerships, while others are joint ventures alongside local government sponsors. A smaller set of managers has also created RMB-denominated side-pocket vehicles in parallel with an offshore fund, treating them as portfolio investments of the offshore fund.

Foreign-invested RMB funds generally do not have development mandates, though some have partnered with local governments, such as the Gobi-Binhai Fund, the Legend-Zhongguancun Fund, and the SAIF-Tianjin Fund. The private equity firms typically seek to benefit from relationships with local authorities through local deal flow and support of portfolio companies, such as in the form of subsidized rents in technology parks.

Finally, developments in late 2009 have allowed foreign GPs to establish limited liability partnerships with domestic investors, paving the way for a new structure which combines partnership privileges, domestic capital, and foreign investment expertise. The regulatory framework for such funds is still evolving and is currently only applicable to partnerships registered in Shanghai. There is the possibility that foreign investors will be allowed to invest in such a partnership to a certain limit (calculated as a percentage of the fund size) while preserving the "domestic" nature of the fund, ensuring its ability to invest in sectors where foreign investment is restricted or prohibited.

Reaping the Rewards: Exit and Repatriation

Historically, all private equity investments were made through offshore structures and realized through offshore exits; as a result, the mechanics of onshore exits and repatriating proceeds are still somewhat unproven. Investors should be aware of considerations regarding listing and lockup rules, taxes, and repatriation.

For example, after being listed on a Chinese stock exchange, shares will be locked up for between one year (in the case of non-controlling or minority shareholders) and three years (in the case of controlling or majority shareholders, or for share issuances purchased 12 months or less prior to the IPO). Investors in typical growth capital vehicles, therefore, should expect a one-year lockup on their entire shareholding.

Proceeds from dispositions in mainland China are also liable to a withholding tax. However, most managers use a Hong Kong vehicle to avoid this tax, as that jurisdiction has a tax treaty with China. Funds have been successfully repatriated when the right procedures were followed and the necessary approvals, especially those related to currency conversion, were obtained.

Why Private?

Over the last several years, private equity has demonstrated several investment advantages relative to public market opportunities in China, including better returns and a number of qualitative factors that mitigate some of the comparative risks of investing in Chinese private equity. Today, private equity investments are being modeled to achieve internal rates of return (IRRs) of 20% to 30% and multiples of invested capital of about 2.5, substantially higher than in the United States. Such returns appear achievable, however, assuming that target companies experience average annual revenue and earnings growth rates of 15% to 20%—rates that have often been exceeded in the past—and considering the possibility that some multiple arbitrage will be generated in future exits on public markets.

The table below provides an illustrative fund model and the sensitivities to returns of a company investment, assuming all investments perform the same and are equally weighted. Returns in the table are generated without leverage and net of fees, which are assumed to be similar to those charged by private equity funds in other markets.

Illustrative Fund Returns Matrix

Net Internal Rate of Return (IRR)

P/E Arbitrage at Exit	Annual Earnings Growth Rate: 10.00%	12.50%	15.00%	17.50%	20.00%
0.0x	12.40%	14.50%	16.60%	18.70%	20.90%
2.5x	16.10%	18.40%	20.60%	22.90%	25.20%
5.0x	19.50%	21.80%	24.20%	26.60%	29.00%
7.5x	22.50%	24.90%	27.40%	29.90%	32.40%

Net Multiples to Limited Partners

P/E Arbitrage at Exit	Annual Earnings Growth Rate: 10.00%	12.50%	15.00%	17.50%	20.00%
0.0x	1.7x	1.9x	2.0x	2.2x	2.4x
2.5x	2.0x	2.2x	2.4x	2.6x	2.9x
5.0x	2.3x	2.5x	2.7x	3.0x	3.3x
7.5x	2.6x	2.8x	3.1x	3.4x	3.7x

Notes: P/E arbitrage at exit represents the absolute increase in earnings multiple. For example, if you bought at 5.0x and exit at 7.5x, your P/E arbitrage multiple is 2.5x, and your net IRR would be between 16.1% and 25.2% depending on the annual earnings growth rate.

Better Historical Return Profile from Private Equity than from Public Investing

Cambridge Associates data through December 2008 indicate that Chinese portfolio companies of local and foreign private equity firms generated average annual end-to-end IRRs of 32.7%, 30.6%, and 21.6% (in US$ terms and on a gross basis) on a three-, five-, and ten-year basis, respectively. These companies far outperformed the China A-Share Index's average annual compound returns of 22.1%, 7.0%, and 5.8% over the same period of time in US$ terms (see table below). However, most of the nearly 1,000 portfolio companies tracked by Cambridge Associates were invested in 2006 or later and returns have not yet been realized for a large majority of them.

Chinese private equity funds have also been much less volatile than public markets, which experience significant short-term capital inflows and outflows from both domestic and international investors. In the wake of the global financial crisis, the net asset values of private equity investments suffered less than prices of public equities because most private equity managers, prior to 2007, secured better valuation terms than those offered by public companies. For example, at their peak, Chinese-listed companies on the Shanghai Stock Exchange were valued at a price-earnings (P/E) ratio of over 50 (Exhibit 9), which is more than 2 standard deviations above the average P/E ratio of about 29 between December 31, 2002, and December 31, 2008. Most private equity transactions at the peak were completed at P/Es of between 10 and 20. In addition, investors in private markets will benefit from any fall in public market valuations by achieving attractive purchase multiples from entrepreneurs who will have less access to IPOs for liquidity. However, existing investments may be negatively affected, as near-term exit potential is dampened.

Other Advantages of Private Equity

Private equity can also offer investors exposure to sectors such as health care, information technology, media, retail, or travel that are closely tied to growth driven by China's emerging middle class, but still underrepresented on the stock markets. By contrast, energy, financial, and telecommunications conglomerates compose a disproportionate share of the public markets, including most of the blue chip companies in China. Furthermore, most of the domestic indices, including the Shanghai Composite Index and MSCI China, are composed of large firms that retain significant state ownership.

In addition, private equity firms can mitigate some of the key risks investors face in public Chinese markets. In particular, managers can undertake thorough due diligence, negotiate and structure minority ownership rights and protections, and maintain meaningful access to management teams or appoint their own senior company officers. Private equity investors with sizeable stakes can insist on reporting standards

Public Versus Private: Performance Comparison
As of December 31, 2008 • U.S. Dollars

	Chinese PE & VC End-to-End IRR	Datastream China A-Share Index Average Annual Compound Return	Hang Seng Composite Average Annual Compound Return
One-year	-32.42%	-62.54%	-46.07%
Three-year	32.68%	22.14%	2.23%
Five-year	30.64%	7.02%	6.33%
Ten-year	21.55%	5.82%	7.11%

Sources: Cambridge Associates Non-Marketable Alternative Assets Database and Thomson Datastream.
Notes: All return data are calculated by Cambridge Associates and are as of December 31, 2008. Chinese private equity and venture capital returns are on a gross, company-level basis.

and financial controls that offer more transparency than many Chinese public companies provide. All of these measures can reduce concerns about corporate governance and shareholder rights, an important consideration given the mismanagement, fraudulent reporting, and misalignment of interests between management and shareholders that have periodically plagued publicly listed Chinese companies, including some listed in Hong Kong and Singapore, as well as private ones.

Emerging Domestic Exit Markets

In recent years, public markets have been the main avenue of liquidity for private equity investors in China. For example, most of the $4.7 billion of the capital realized by such investors in 2007 was generated via IPOs (Exhibits 10–12). However, Chinese private equity investments realized through the public markets in 2008 fell by 84% to $640.5 million due to price declines and a sharp fall in the overall volume of IPOs worldwide. Moreover, whereas until 2007 nearly all Chinese companies were listed offshore—mainly in Hong Kong, Singapore, and the United States—in 2007 and 2008 about 200 IPOs, more than half of the total, took place on China's exchanges. Part of this shift can be traced to the aforementioned Chinese government regulations discouraging offshore structures and listings as well as the growth of onshore, RMB-denominated funds. Thus, private, foreign-backed Chinese enterprises now sometimes find it easier to list on the local public markets because of more flexible listing requirements and a reduced post-IPO lock-up period. However, the queue to receive approval to go public on the domestic Chinese exchanges can be long, and the order in which companies are allowed to go public can seem arbitrary.

As of December 2008, the Shanghai Stock Exchange, China's principal domestic exchange, included 864 companies with a total market capitalization of $1.4 trillion, making it the sixth largest in the world in US$ terms, compared to 15th in 2003.[4] Over the last five years, the value of shares traded on the exchange increased more than sevenfold, with liquidity also increasing significantly. A second market for smaller companies, the Shenzhen Stock Exchange, was home as of December 2008 to 740 listed companies with a total market capitalization of $353 billion.

In October 2009, the ChiNext exchange, hosted by the Shenzhen Stock Exchange and modeled on the Nasdaq, opened. The long-planned exchange has lower listing thresholds than the existing Shanghai and Shenzhen exchanges. The market cap of each of the 28 companies that were initially listed more than doubled on the first day of trading. Performance has since been volatile, with several 10% price drops in a single day. There are reportedly 160 companies in the pipeline to list on ChiNext and the new market has created another exit option for private equity– and venture capital–backed companies.

While the evolution of Chinese public markets supports private equity investment activity, other exit avenues, such as M&A and recapitalizations, still face significant impediments. As much of the private equity capital invested in recent years remains unrealized, exits remain an issue, as discussed later.

Risk Outlook Improved, but Many Risks Remain Unchanged

While the opportunity set in China has grown substantially over the last five years, many of the

[4] However, the "investable" part of the market was considerably smaller, given the number of shares owned by the Chinese government and the restrictions faced by foreign investors.

challenges of the past remain. Transparency concerns, a constantly shifting regulatory environment, and relatively narrow avenues for exit (though much improved) continue to be concerns today. Moreover, very few firms possess a realized, successful track record, and many firms have suffered from significant turnover among their investment staff.

China-focused private equity funds (whether run by local or by foreign managers) charge LPs fees similar to those of private equity funds in established markets such as Europe and the United States, namely management fees of up to 2% and carried interest of 20%, subject to a preferred return to LPs of between 8% and 10% IRR. Carried interest is almost always calculated on a fund basis rather than deal-by-deal basis. Like private equity funds in Europe and the United States, the fund term is generally ten years, with optional extensions. Other ancillary fees also follow the traditional model, with management fee offsets from transaction, investment banking, directors', and monitoring fees ranging between 50% and 100%. However, the overall sizes of such ancillary fees are expected to be much lower than in Europe and the United States. The downturn in global private equity fund raising has, to date, only marginally impacted terms for China-focused private equity funds, although Cambridge Associates encourages investors to seek terms that align interests between GPs and LPs in the current environment that gives LPs more negotiating power.

Government Regulation

The government's involvement in the economy continues to complicate private equity efforts. As noted earlier, foreign private equity requires approval for most investments as well as currency conversion, and is also restricted from investing in certain industries, such as defense and certain media subsectors. Regulations can change swiftly, and the various arms of China's bureaucracy governing foreign investment do not always act in concert. Additionally, legal reforms in China are incomplete and, while China's accession to the WTO has been positive for the process, the consistent application of the law is not guaranteed.

Transparency, Shareholder Rights and Corporate Governance

Transparency continues to be a key issue in China for both private equity investors and their LPs. Though fund managers have cited improvement in recent years, corporate governance and shareholder rights are still not as widely accepted as in developed markets. Due diligence can be difficult, accounting practices are inconsistent, and the incidence of fraudulent reporting is high. Business is often relationship based, and buy-in from management is critical. Moreover, enforcing rights against owner-entrepreneurs, or even managers, can be extremely difficult. In 2008, a number of high-profile cases created headlines, such as TPG's prolonged efforts to oust management at Nissin Leasing, an equipment finance business servicing small- and medium-sized enterprises. Finally, fund-level governance issues, such as GP ownership, the split of carried interest between fund managers and other sponsors, and outside investment restrictions, are not always clear either, and the potential for conflicts of interest between offshore and onshore funds has grown, as discussed later.

Many of the abovementioned issues are not unique to private equity. In addition, as discussed earlier, we believe that strong private equity managers that operate using international standards can reduce many of these risks.

Emergence of RMB-Denominated Funds

The aforementioned proliferation of RMB-denominated funds adds an additional layer of complexity for LPs approaching the Chinese market. The longer-term impact of these RMB funds remains unclear. While domestic capital could become a significant competitor to overseas capital, the large state-backed industrial development funds discussed earlier have invested thus far on a limited scale, raising some questions about the model. Furthermore, Chinese investors have short histories as private equity investors; their long-term commitment to the asset class is uncertain.

For offshore investors, the key concern remains the alignment of interest between onshore and offshore funds established by the same manager and the potential crowding out of foreign investors by local capital, which is subject to less regulatory scrutiny. In these circumstances, LPs must judge their alignment of interest with GPs on a case-by-case basis. As regulation of private equity in China continues to evolve, it is possible that the separate regulatory frameworks governing offshore and onshore investment vehicles might converge, making any of the relative advantages that one may have over the other irrelevant.

Narrow Exit Avenues

IPOs remain the key avenue for exit for private equity investment in China, as discussed earlier. However, while the maturation of the domestic stock markets has increased exit opportunities locally, the abovementioned regulatory changes have made offshore exits (both IPOs and M&A) more difficult. Moreover, exits from onshore IPOs remain more precarious because of the need, noted above, for various approvals and the one-to-three-year lock-up requirement.

Recapitalizations are also unlikely liquidity events because domestic banks lend to private enterprises on a limited basis (as discussed earlier) and foreign financial institutions are unable to offer RMB-denominated banking services to local individuals and enterprises. As a result, investors are now increasingly reliant on domestic IPOs or M&A to generate realizations, meaning that fewer monetization alternatives for private equity exist than is the case in other markets.

Emerging Manager Universe

China-focused private equity partnerships continue to have shorter operating histories than firms in more developed markets, presenting a broad level of organizational risk across the market, even among the relatively smaller subset of institutional quality managers. Investment talent and operating know-how, as well as team experience in negative cycles, are also often not yet at the same levels as those in more developed private equity markets. Executive turnover is an issue that has affected nearly all private equity firms in China in recent years and has been fuelled by the large amount of capital flowing into China, leading to fierce competition for talent. Some of the most experienced private equity professionals have left established firms to raise their own funds or have been hired as key local partners by global private equity firms setting up new offices in China. The competition for talent has extended through the ranks down to junior professionals and occasionally tests loyalties in immature partnerships. We believe that high turnover will continue over the next few years and will also be driven by diminished expectations for carried interest at certain funds that have invested too aggressively in recent years.

Implementation in China

For investors seeking to begin or continue to build a portfolio in China, superior manager selection is paramount. The market has become segmented by strategy, including growth capital, venture capital, buyouts, and distressed investing. Some managers have been migrating strategies over time within existing funds or as they raise new funds, have established a range of products targeting different strategies, or invest in different strategies opportunistically from the same fund. Growth capital dominates the opportunity set, as it addresses the private sector's need for equity financing and allows investors to capture much of the China growth story. Furthermore, it does not suffer from constraints related to acquiring majority stakes in high-quality assets or NPLs. Indeed, traditional venture capital managers' creep toward late-stage venture and even growth capital investments validates the compelling growth capital opportunities that exist in China, but has increased competition. Buyout and distressed investing are still niche strategies.

As a result of the broad opportunity set and still-emerging nature of private equity in China, manager selection remains critical. Whether investing through a local, China-focused fund, or a foreign-sponsored fund targeting opportunities in China, the same criteria should apply.

Conclusion

China has made progress in transforming itself into a more attractive investment destination over the past five years. The legal system has improved and some market reforms have gained traction. Private equity in China represents an attractive opportunity for investors both on an absolute basis and relative to Chinese public markets, which it has outperformed substantially over the last one-, three-, and five-year periods. Capital is badly needed to support growing businesses in one of the world's fastest growing economies, and private equity is well placed to fill this gap.

However, many risks, some typical of private equity in similar less-developed markets and some specific to China, remain. Consequently, manager selection is always paramount, as it is in other markets. Only GPs with strong local networks, solid experience, well-developed organizational platforms, and strong alignment of interests with LPs can deliver compelling risk-adjusted outperformance. While the manager universe is large, few managers fulfill such criteria. With these guidelines in mind, the opportunity for private equity in China remains clear and present. The investible universe is large and access to the best managers, which was difficult in recent years, has improved, with some international institutional investors recently reining in commitment levels due to liquidity and other concerns. Therefore, we believe it is a good time for investors to consider Chinese private equity.

Summary of Considerations When Investing in Chinese Private Equity

		Advantages	Disadvantages
Growth Capital			
	Macro	• Fast-growing economy with significant private sector capital needs	• Overcapacity in many sectors
	Micro	• Large target market • Exit route through initial public offerings improved	• Competitive market • Minority issues: corporate governance, transparency, and alignment concerns
Venture Capital			
	Macro	• Few alternative sources of capital and expertise	• Short history of innovation
	Micro	• Some technological innovation • Large domestic market for localization of foreign technology and concepts • Exit route through initial public offerings improved	• Most managers migrating to growth • Companies can be bootstrapped because of low start-up costs • Few early stage investments
Buyouts			
	Macro	• Large base of domestic companies • Government push to privatize some state-owned enterprises	• High regulatory hurdles • Limited bank financing (no leveraged buyouts)
	Micro	• State-owned enterprise restructuring needs • Control aligns interests and creates more transparency	• Control opportunities limited • Adverse selection • Exit routes less clear
Distressed			
	Macro	• Large supply of non-performing loans • Ongoing capital misallocation	• Legal complexity • Enforcement unevenly applied
	Micro	• Inefficient market • High barriers to entry • Potential deep value in collateral	• Sellers under little pressure • Local processes incur political risk

Exhibit 1

The Chinese Economy Versus Some Developed and Emerging Economies

2008

Country	Population (m)	GDP ($bn)	GDP per capita ($)	Real GDP growth (%)	Inflation (%)
China	1,328	4,327	3,259	9.0	5.9
India	1,186	1,207	1,017	7.3	8.3
United States	304	14,441	47,440	0.4	3.8
Brazil	190	1,573	8,295	5.1	5.7
Japan	128	4,911	38,457	-0.7	1.4
Germany	82	3,673	44,729	1.2	2.8

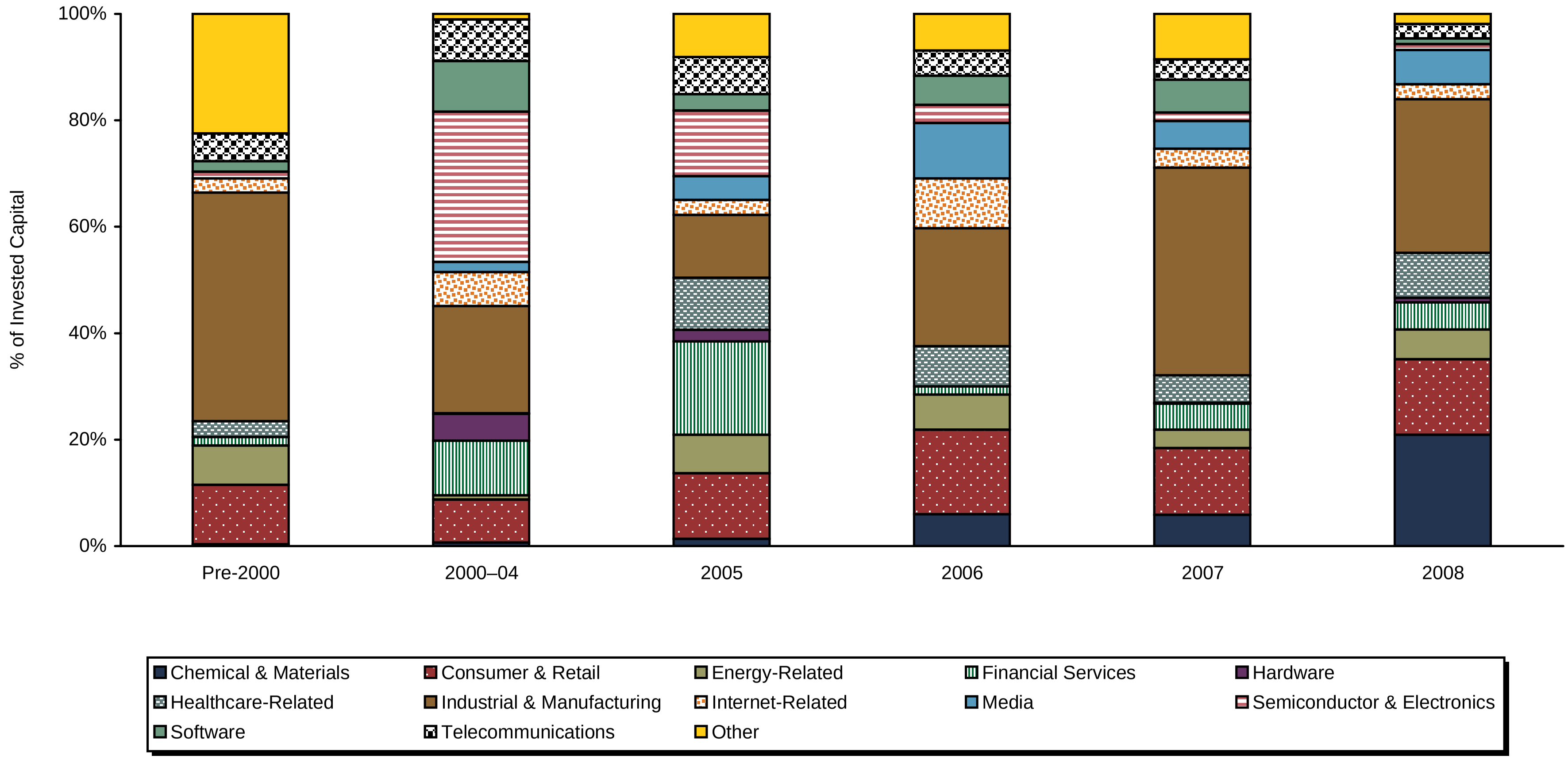
Source: International Monetary Fund.

Notes: All data are as of December 31, 2008. Brazil's GDP, GDP per capita, and population figures, as well as Japan's GDP per capita and population figures, are estimates.

Exhibit 2

Chinese Private Equity Investments by Industry

2000–08

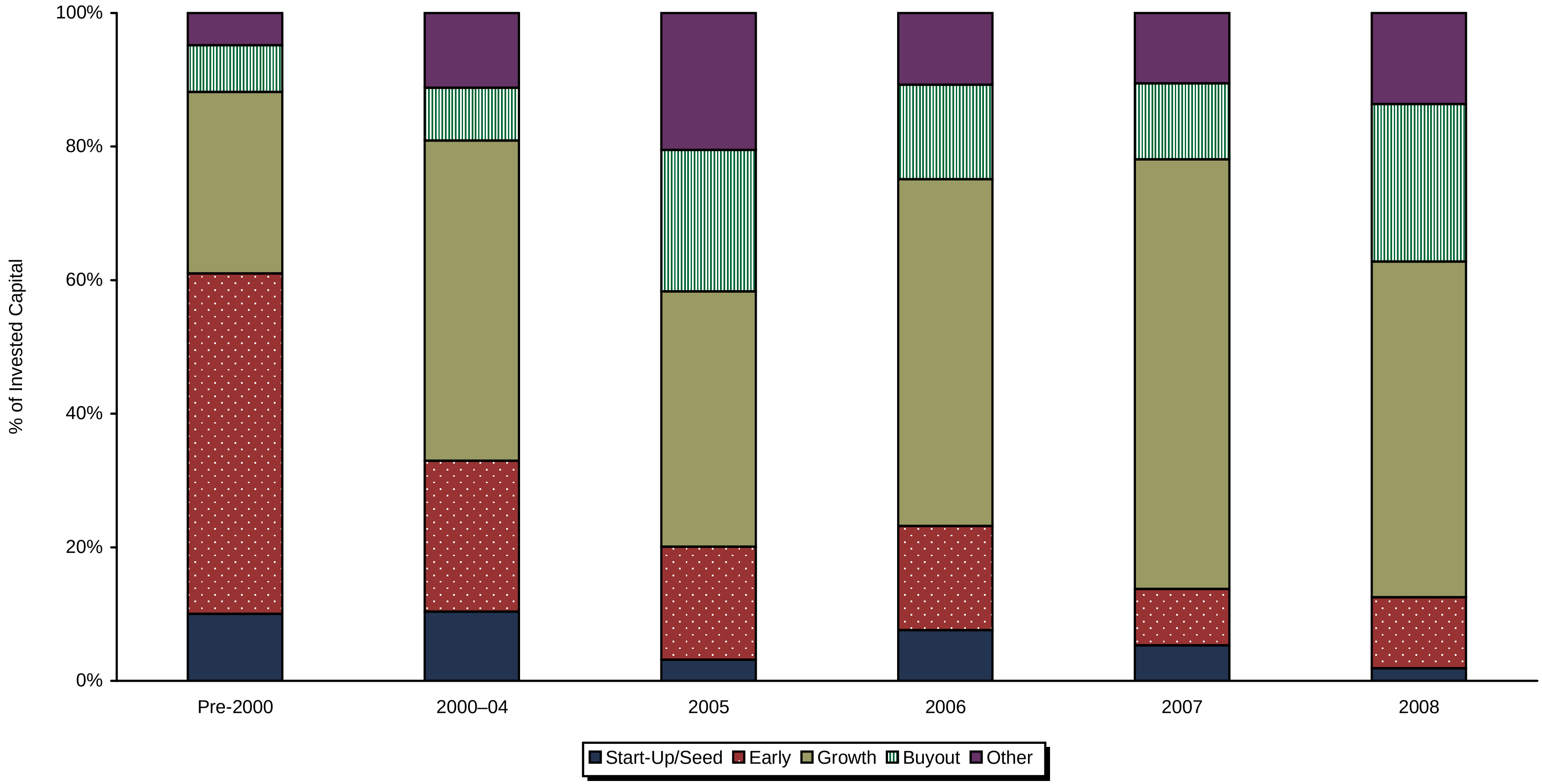


Source: Cambridge Associates Non-Marketable Alternative Assets Database.
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 3

Chinese Private Equity Investments by Stage

2000–08

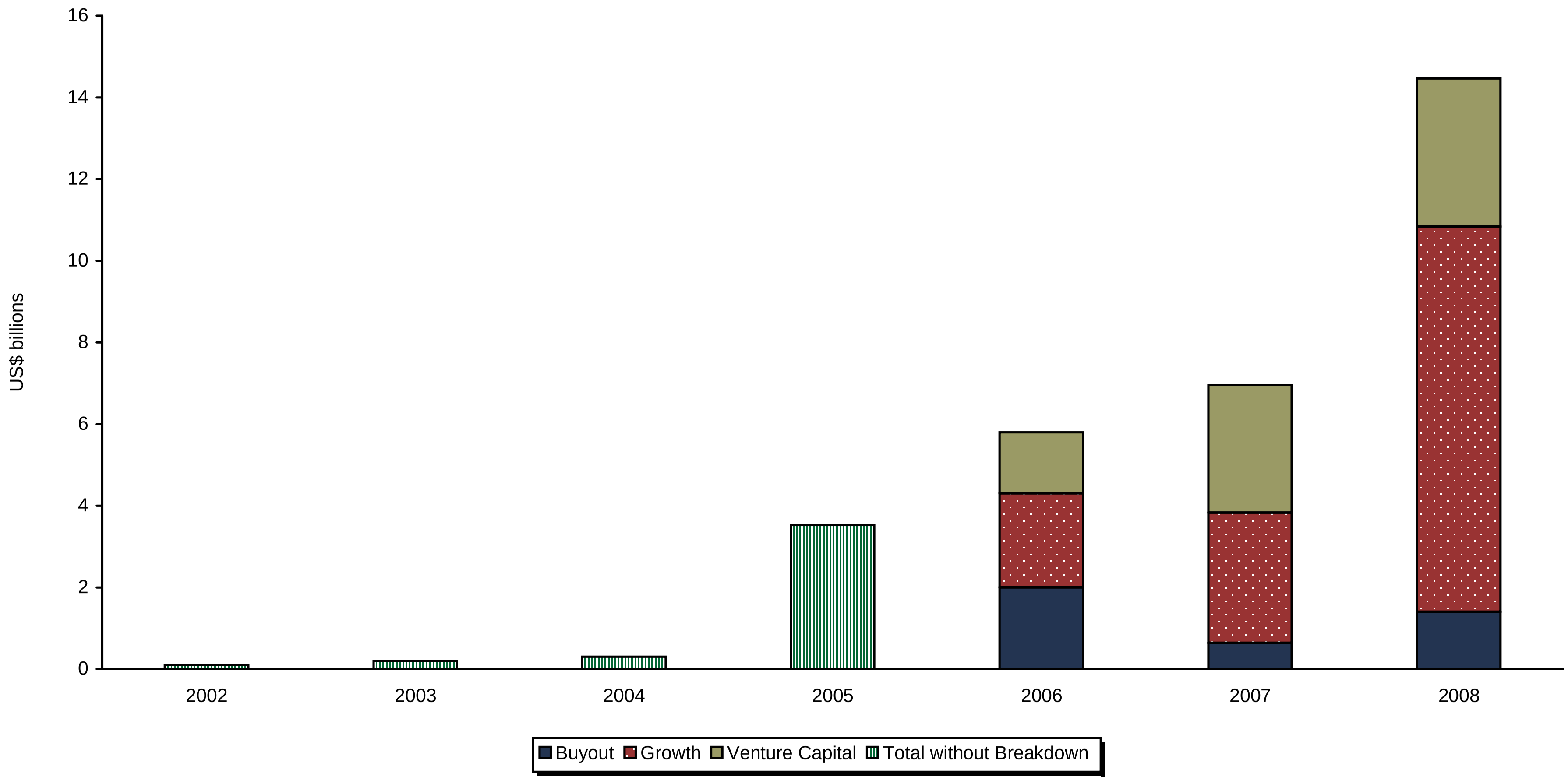


Source: Cambridge Associates Non-Marketable Alternative Assets Database.
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 4

Chinese Private Equity Fund Raising by Stage

2002–08

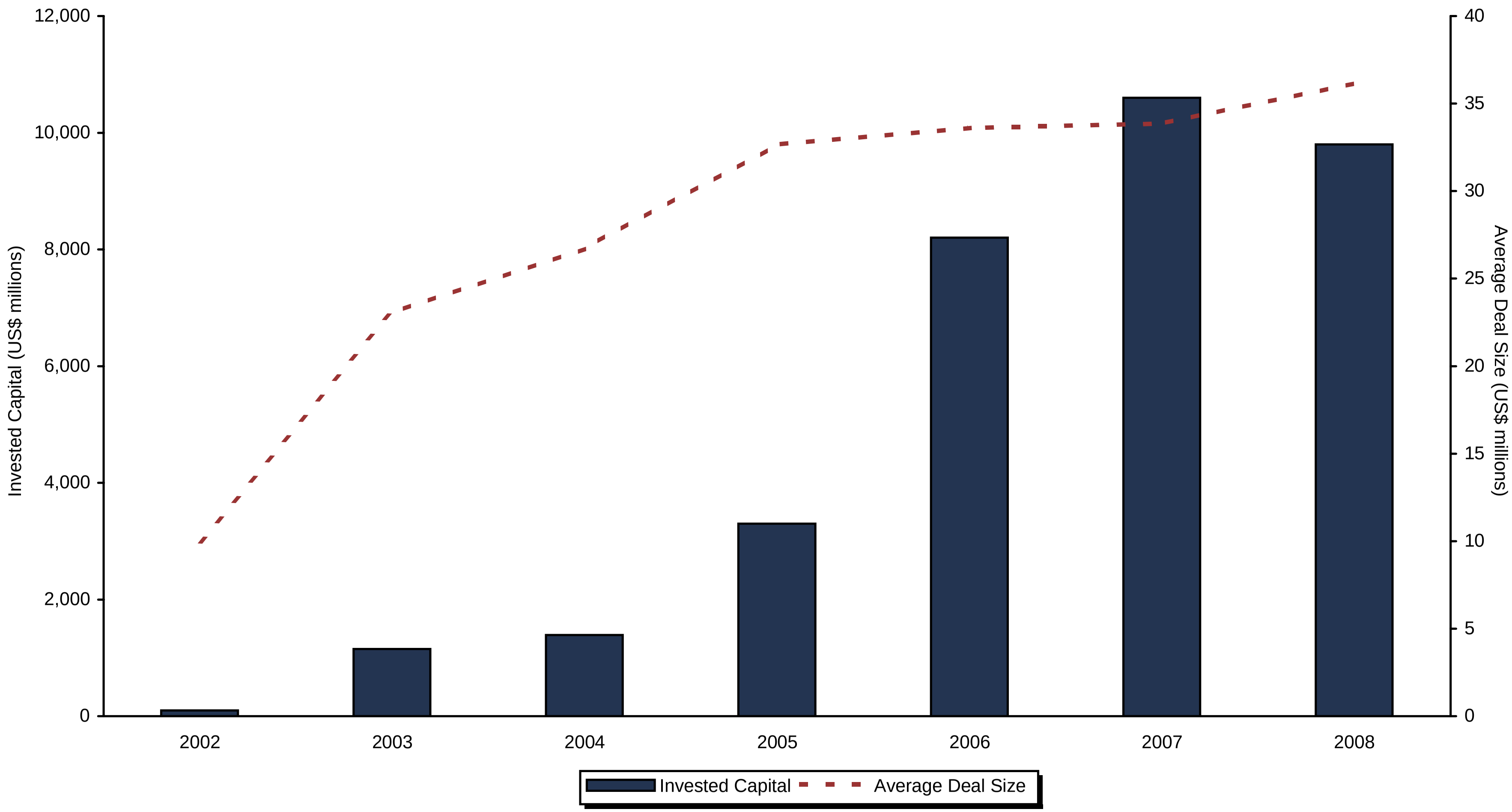


Source: *Asia Private Equity Review.*
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 5

Chinese Private Equity Investment Activity

2002–08

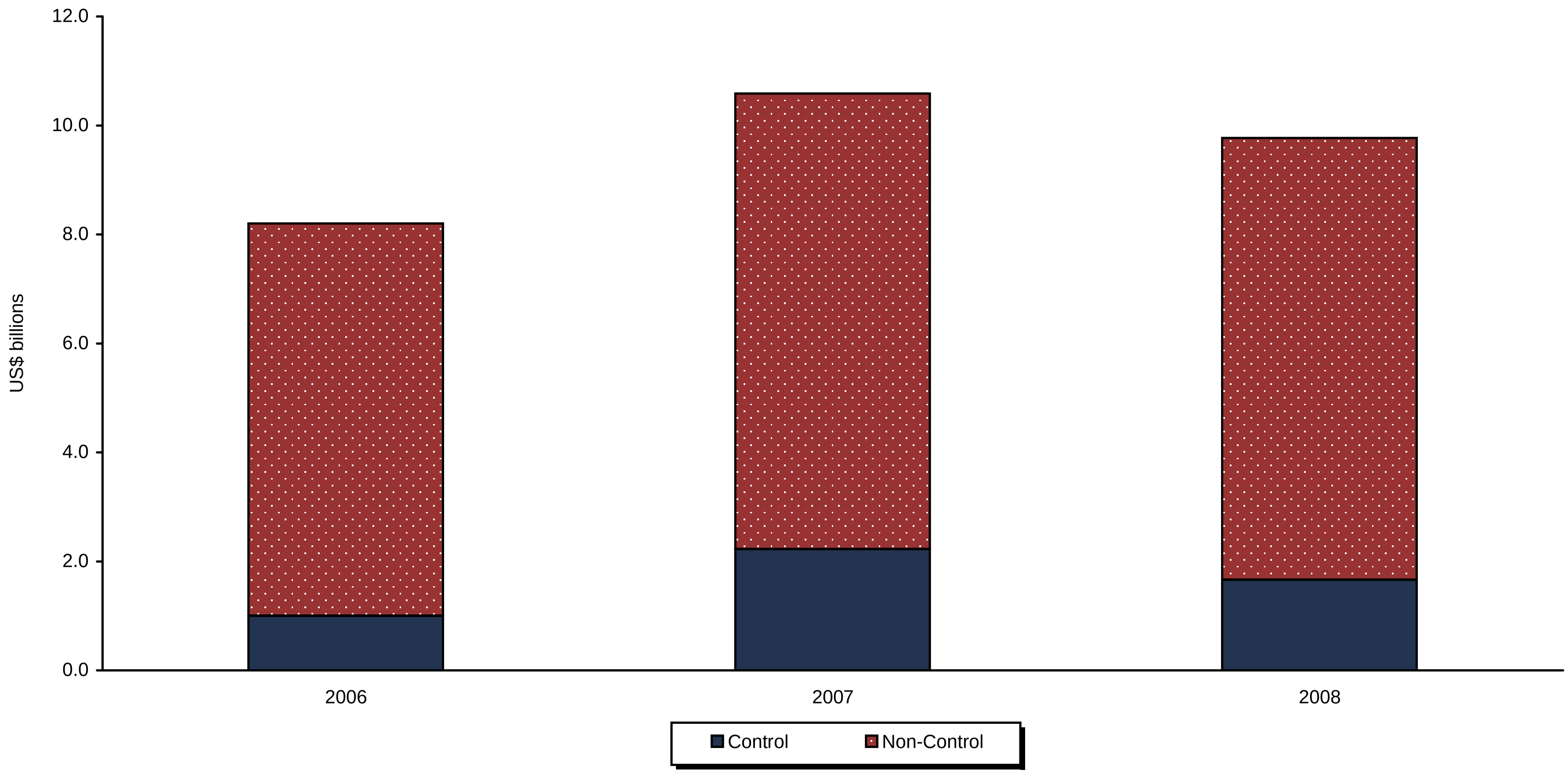


Source: *Asia Private Equity Review.*
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 6

Chinese Private Equity Deal Nature

2006–08

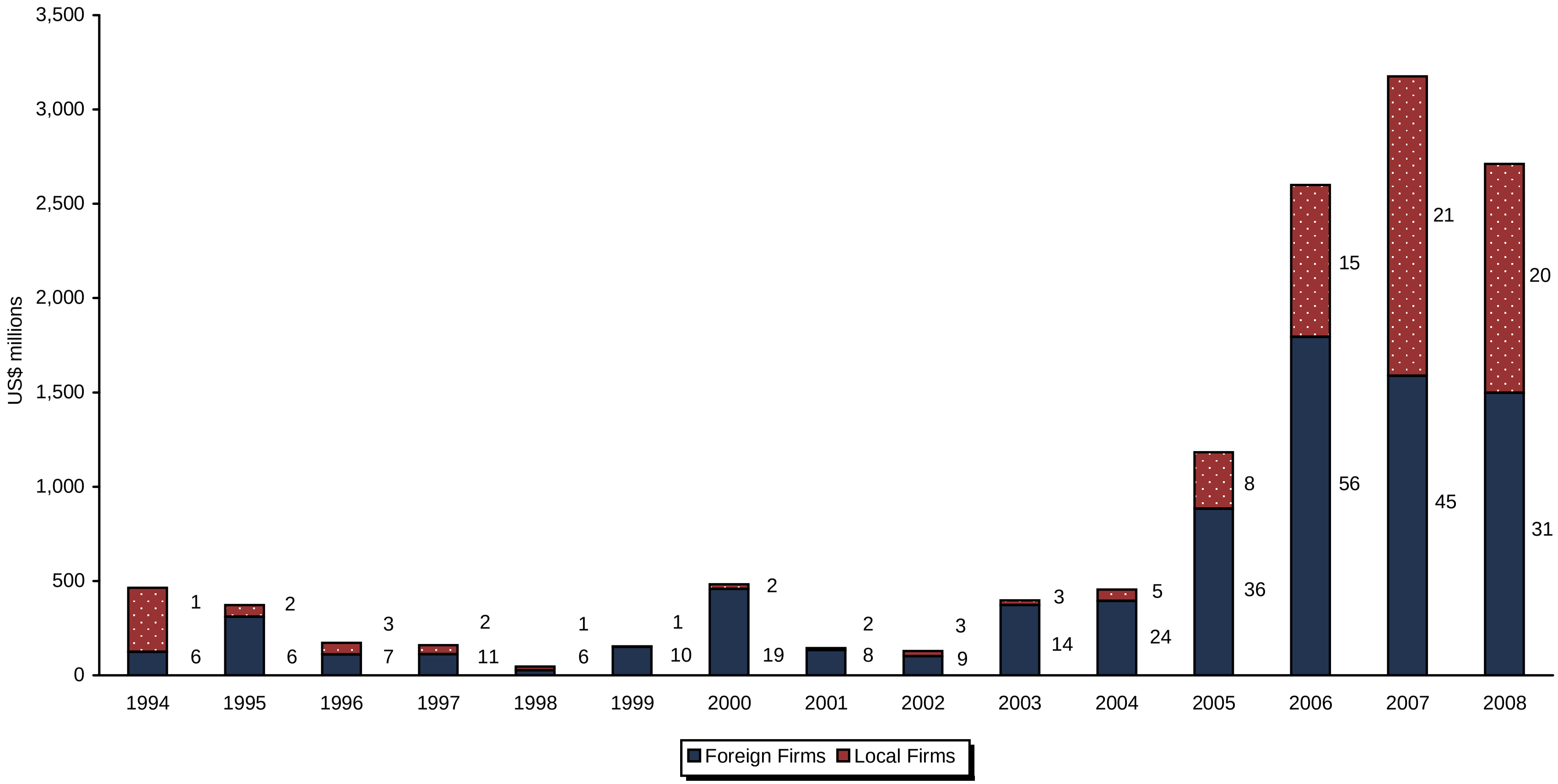


Source: *Asia Private Equity Review.*
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 7

Foreign Versus Local: Private Equity Investments in China

1994–2008

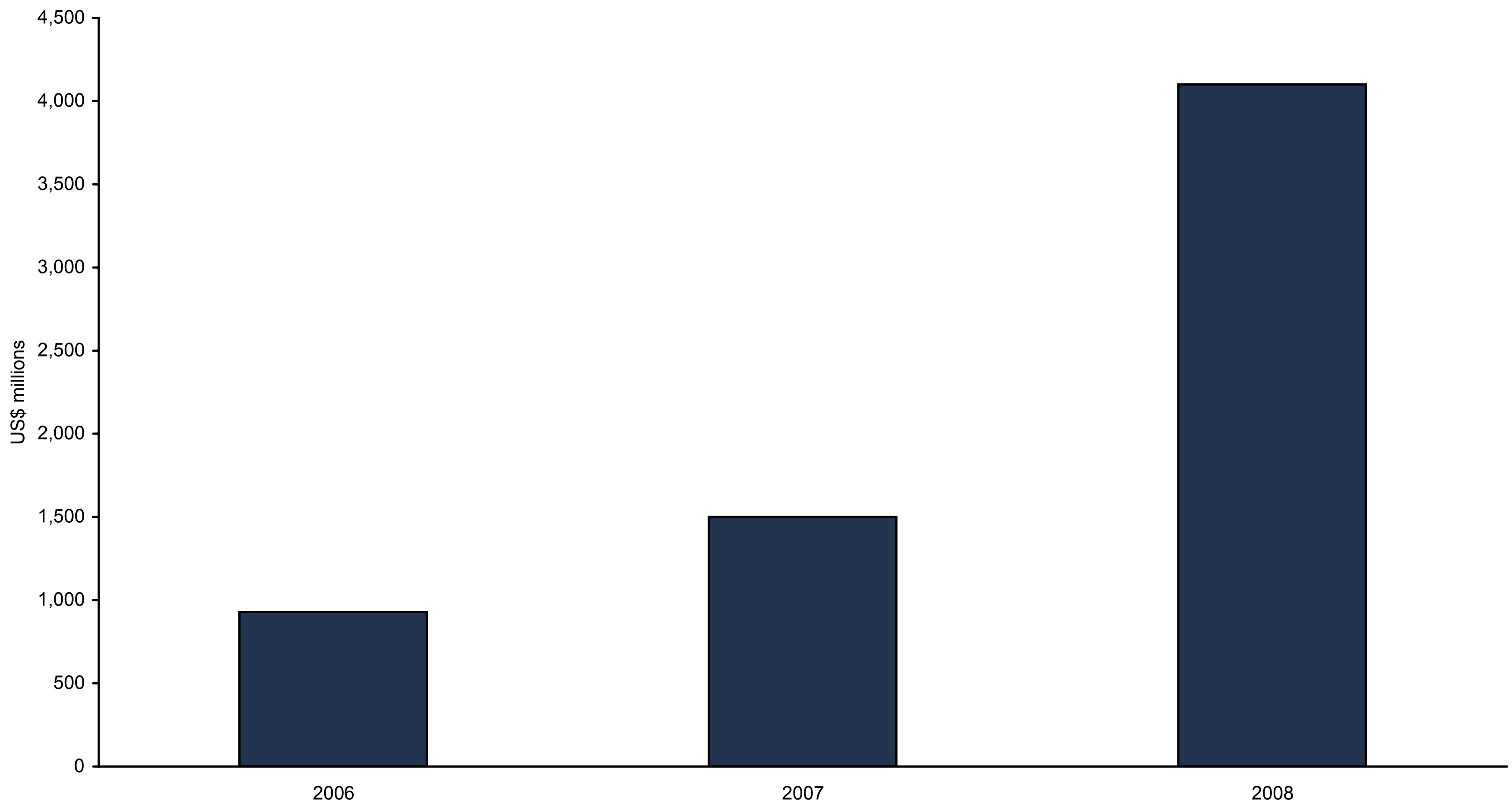


Source: Cambridge Associates Non-Marketable Alternative Assets Database.
Notes: Private equity includes buyouts, distressed, growth capital, and venture capital. Numbers represent the number of firms.

Exhibit 8

Renminbi Fund Raising

2006–08

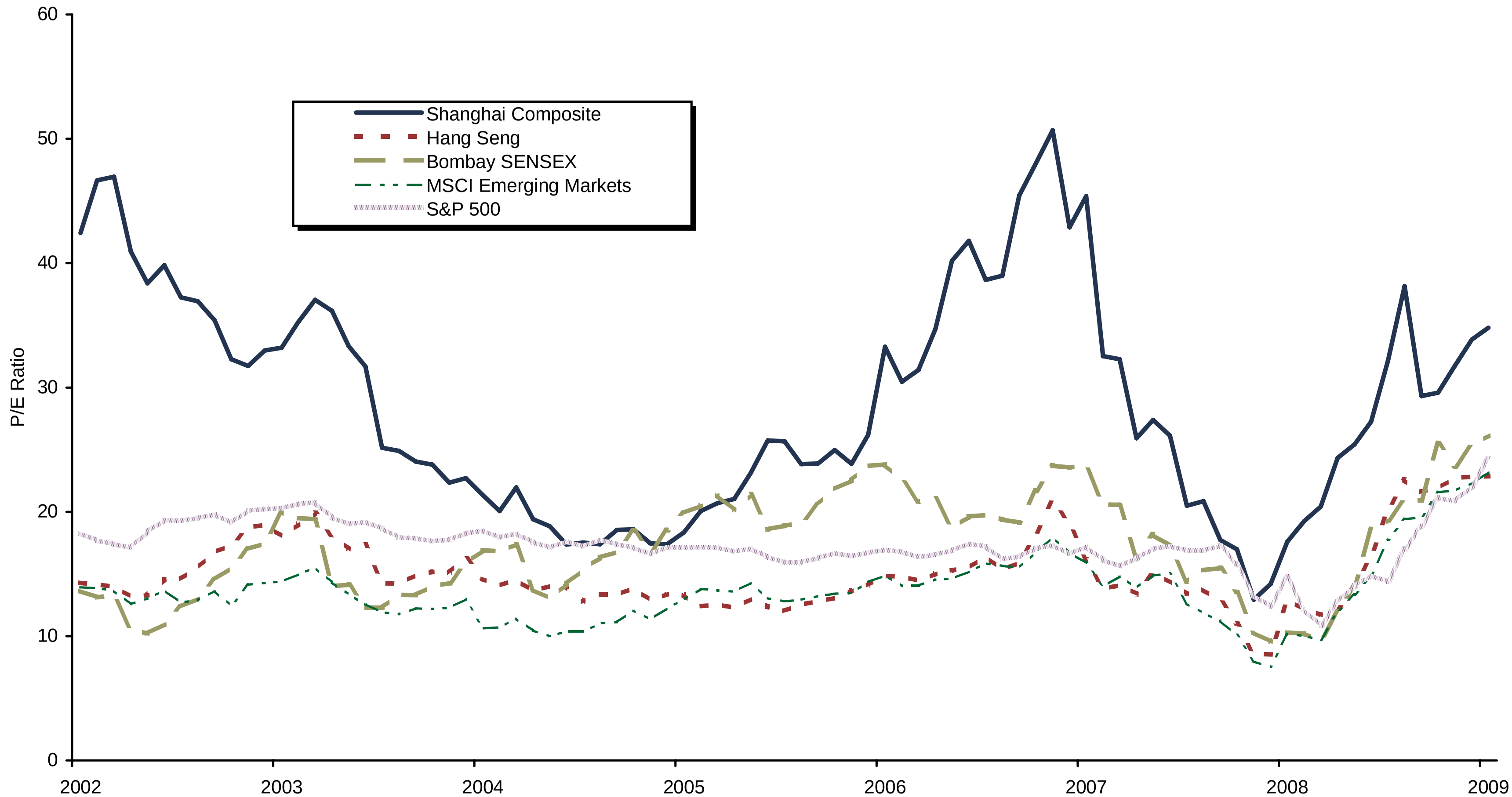


Source: *Asia Private Equity Review*.

Exhibit 9

Comparative Price-Earnings Ratios

December 31, 2002 – December 31, 2009

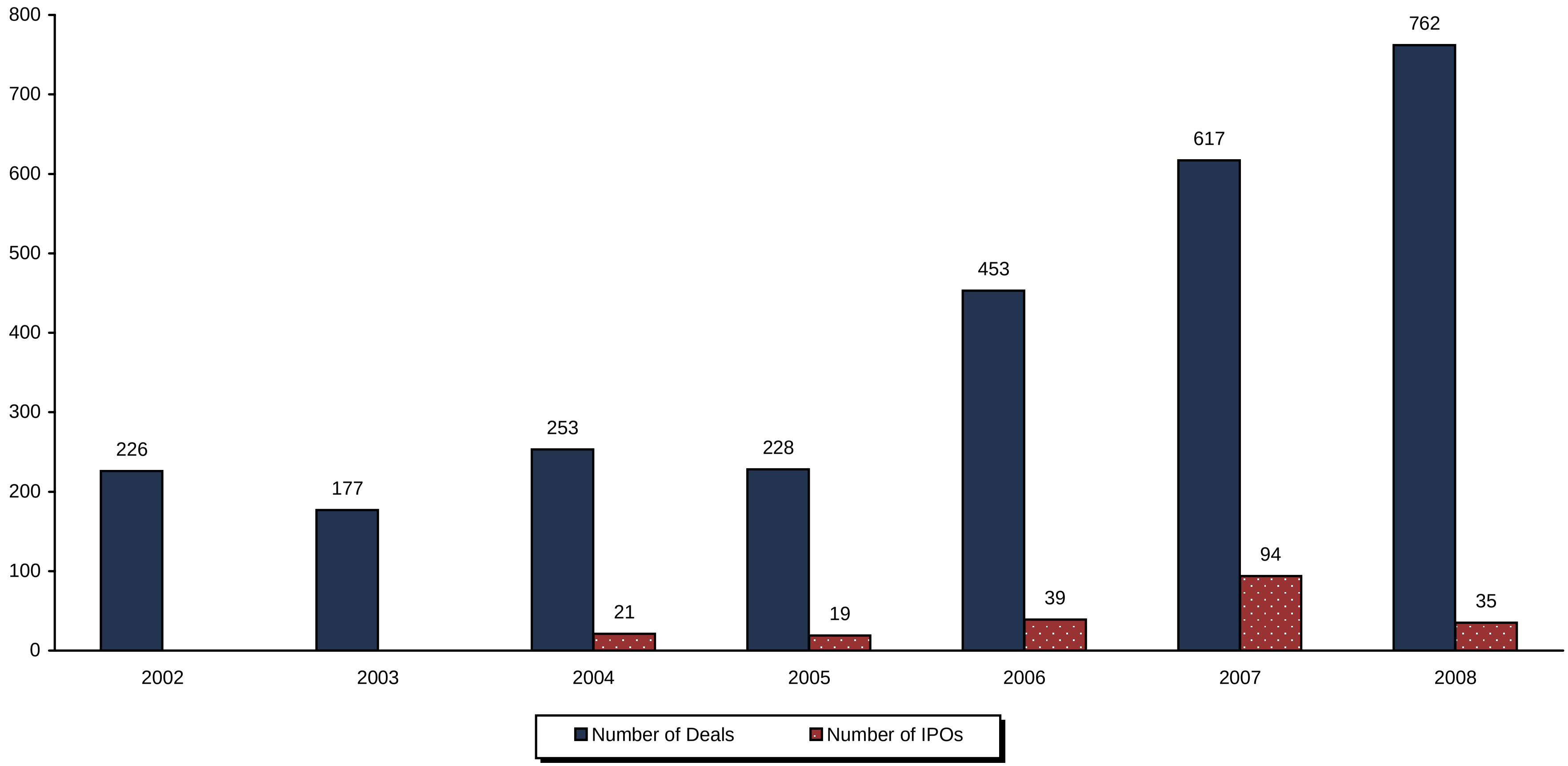


Sources: Bloomberg L.P and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Price-earnings ratios are calculated on a trailing 12-month basis.

Exhibit 10

Private Equity–Backed Investments Versus Private Equity–Backed Initial Public Offerings

2002–08

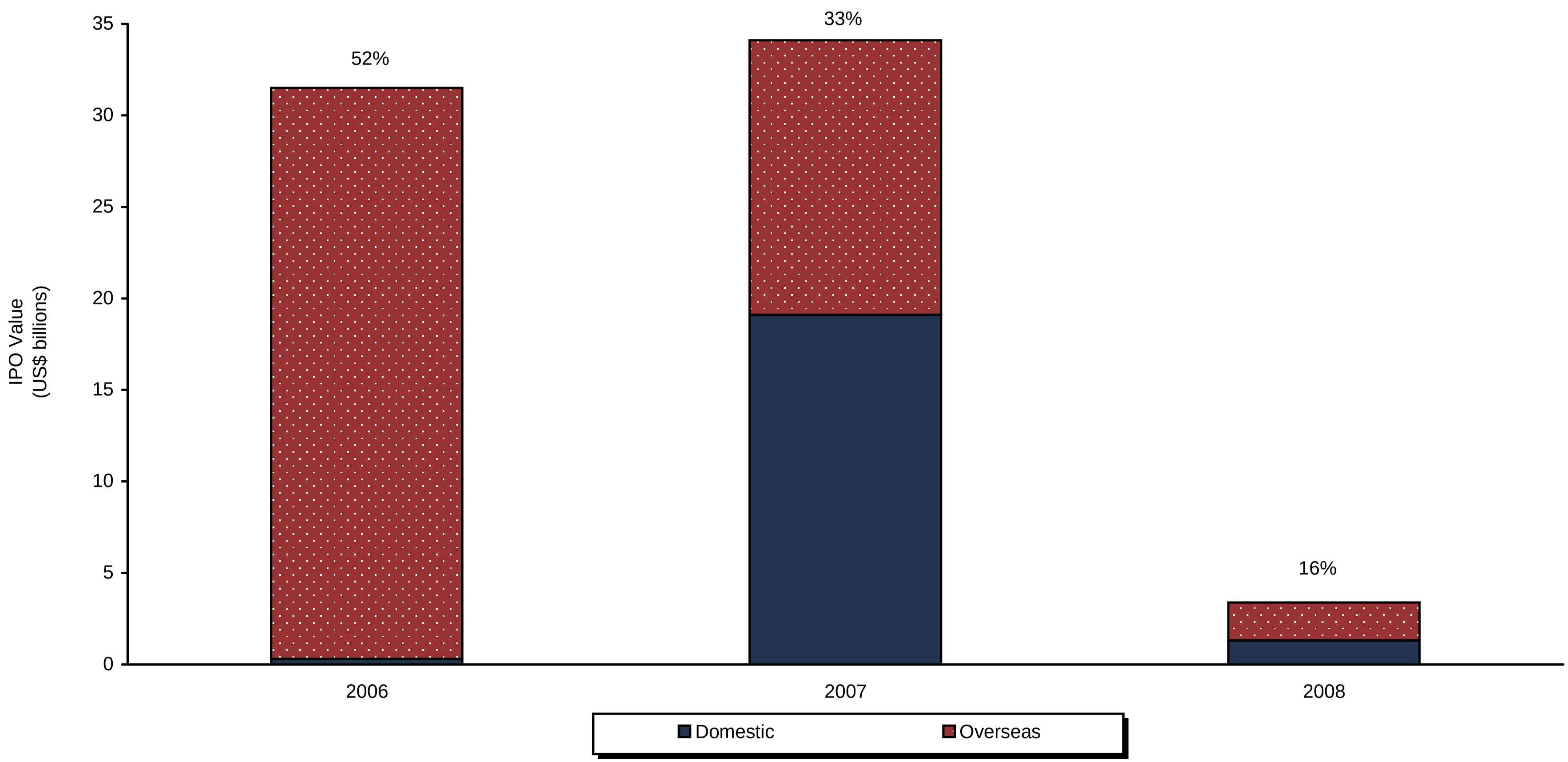


Source: Zero2IPO.
Note: Private equity includes buyouts, distressed, growth capital, and venture capital.

Exhibit 11

Private Equity–Backed Initial Public Offerings: Domestic Versus Overseas Listings

2006–08

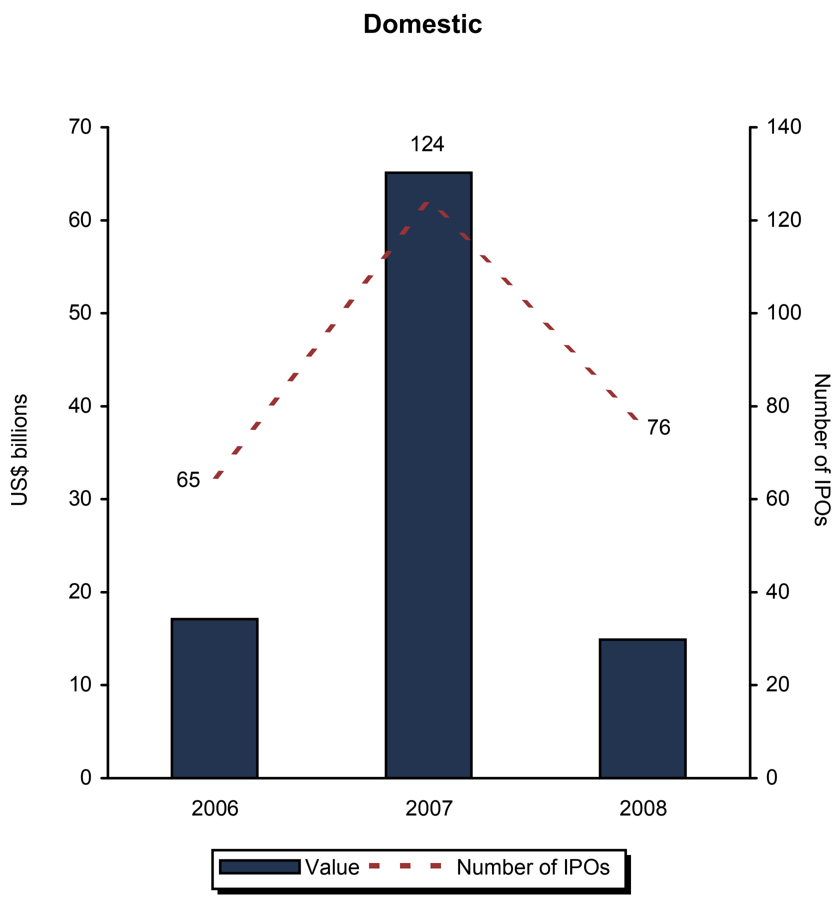


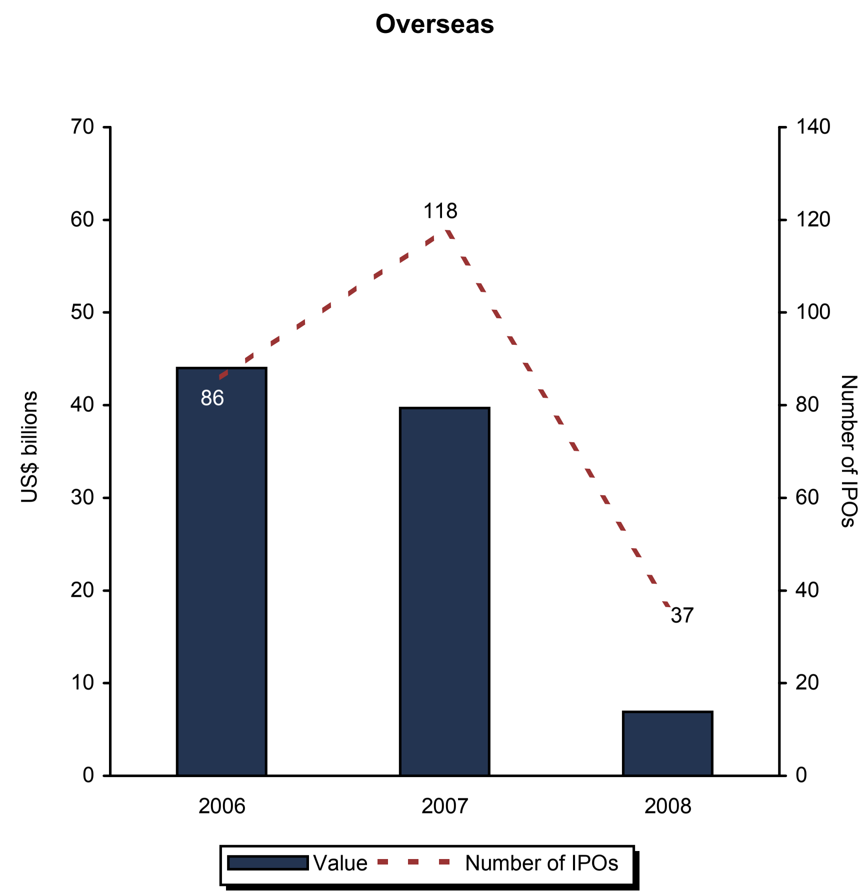
Source: Zero2IPO.

Notes: Private equity includes buyouts, distressed, growth capital, and venture capital. Percentages represent private equity–backed initial public offerings (IPOs) as a percentage of total IPO value.

Exhibit 12

Initial Public Offerings of Chinese Companies





Source: Zero2IPO.