

OBSERVATIONS AND PROSPECTS FOR PRIVATE EQUITY IN CHINA

October 2009

This note presents EMAlternatives' perspective on the development of the private equity market in China, and key considerations for limited partners as they pursue investment strategies in China.

Contents

Executive Summary	2
Evolution of the private equity market in China	5
Legal, regulatory and governance context for private equity in China	9
Private equity fund managers investing in China	13
Routes to liquidity	18
Implications for limited partners	21
Acknowledgement	24
About EMAlternatives	24

For more information, please visit our website at www.emalternatives.com or contact us at one of our offices below:

Leidsevaartweg 99, 6F
2106 AS Heemstede
The Netherlands

T + 31 (0) 23 5100 560
F+ 31 (0) 23 5100 569

1159 Madang Road, 5F
Shanghai 200021
PRC

T +86 21 6135 7208
F +86 21 6135 7207

1010 Wisconsin Avenue, NW
Suite 520
Washington, DC 20007
USA

T +1 202 659 5959
F +1 202 659 5960

This document is provided for informational and discussion purposes only and does not constitute an offer to sell or a solicitation of an offer to purchase any security, nor the provision of any professional advice by EMAlternatives, LLC or its affiliates (EMA) to the recipient. Any such offer of advice or solicitation, if made, will be made only pursuant to a Confidential Private Placement Memorandum or an agreement for the provision of services by EMA. This document may not be reproduced or distributed in any format without the express written approval of EMAlternatives, LLC.

Executive Summary

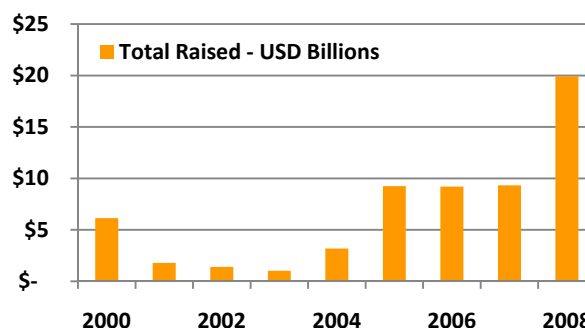
China’s private equity industry is at an inflection point.¹ Among emerging private equity markets, China counts the largest number of fund managers, the largest volume of M&A and IPO activity, and a growing and significant base of domestic limited partners. The market also presents unique challenges created by the role of government in commercial decision-making, extraordinary domestic liquidity, and an evolving regulatory environment that complicates deal-making, exits, and can detract from alignments of interest through separate regimes for on- and off-shore investors.

In light of these developments, limited partners active in emerging markets private equity are right to re-examine their strategies for China, and to recognize that their approach to this market ought to be quite different than their work in other geographies. EMAlternatives (EMA) believes that limited partners interested in China should consider several unique factors in addition to those that form part of their regular due diligence and decision-making processes:

- On the surface, China’s macro story remains compelling: robust domestic growth coupled with relatively strong balance sheets at government, corporate and consumer levels. The country does, however, face deep challenges relating to structural imbalances reflected in its export-oriented industries, fixed asset investment, high personal savings at the expense of domestic consumption, and a state-influenced banking sector. The country also must achieve an annual GDP growth target of at least six percent to generate sufficient new employment for China’s growing labor force and to ease the impact of migration from rural areas.
- In the near term, the government’s response to the recent crisis has supported China’s continued growth, but it also has injected significant liquidity into the market that may be fueling a bubble in financial asset prices, as illustrated by the 63 percent increase in Shanghai’s stock exchange during the first half of 2009.
- China’s private equity industry has developed at a rapid pace over the past decade, and is still evolving across a number of critical areas, with the number of managers growing to 300 and funds raised increasing from \$6 billion in 2000 to \$20 billion in 2008 (Figure 1).² Limited partners should commit capital recognizing that the competition and quality among players in China’s private equity industry will continue to develop, and that this presents both opportunity and risk, particularly where effected by excessive liquidity and governance.

Funds raised grew to \$20 billion in 2008

Figure 1

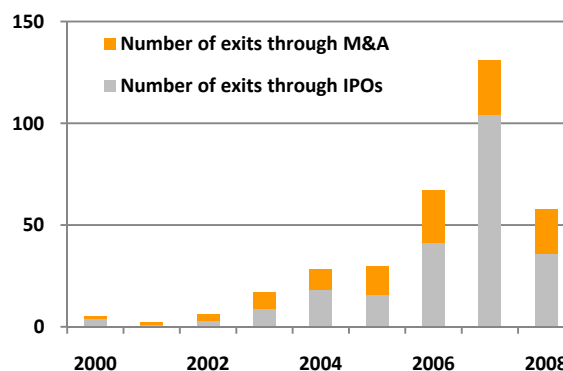


¹ Unless otherwise noted, the use of the term “China” refers to the People’s Republic of China (PRC). The use of the term “private equity” in this note is intended to reflect the full range of alternative investment strategies through which investors commit capital to private companies, including venture capital, growth equity, control buyouts, leveraged buyouts, distressed, mezzanine, and thematic funds, such as in clean energy, healthcare or natural resources.

² “Report on China’s Venture Capital and Private Equity Fundraisings 2008,” *China Venture*. Data represents final fund closings.

- The regulatory environment for private equity in China has effectively created two markets: one domestic and the other offshore. At present, these markets have distinctly different limited partners and exit routes, even if they sometimes involve the same fund managers and/or portfolio companies. These conditions create the potential for conflicts for managers who invest via different structures on behalf of both domestic and offshore limited partners. Over time, currency controls and other restrictions that cause offshore investors to invest through a foreign direct investment regime may ease, and these differences may be resolved. A practical resolution, however, appears some years away and the risks posed by these distinctions may increase as domestic limited partners become more active investors in private equity.
- A consequence of rapid development is immaturity – a combination of ambition, nimbleness and inexperience – that is present across private equity teams, their portfolios and track records. Few managers have managed funds through full fund cycles, and only a few have returned all invested capital back to their limited partners. As is customary in China, most managers have invested in minority positions, with sometimes impractical conditions attached to exit rights. Enthusiasm for the promising records associated with a handful of deals and managers should be tempered by recognition that strong realized records of funds launched prior to 2005 benefited from an unparalleled exit window in 2006 and 2007 (Figure 2).³ Careful evaluation of unrealized portfolios for progress and prospects for liquidity is therefore critical.

Exits have grown, but peaked in 2006 and 2007
Figure 2



- The number of fund managers active in China has grown substantially, creating a logistical challenge for those institutional investors who lack sufficient resources to track their development, or to prioritize their evaluation. Consequently, institutional investors must ensure alignment between their over-arching investment objectives, and the resources they can dedicate to sourcing, evaluating and managing their program in China.
- Distinctions among fund managers active in China have up to now been less focused on specific geographies or industries as is common in the United States and Western Europe, and more linked to differences in personnel, sourcing and executing capabilities, transaction size, and portfolio company maturity. As a result, limited partners will find it challenging to create a portfolio within China that provides targeted coverage of specific geographies or industries. China’s private equity industry is developing rapidly, however, and funds providing exposure to particular regions or sectors are emerging, as illustrated by an increasing number of venture and thematic funds now active in China.
- The development of an active domestic limited partner community within China presents both positive and, potentially, negative implications to international limited partners that invest in offshore funds. On the one hand, domestic sources of limited partner capital should present fund managers a solid base from which to establish their investment records without having to manage

³ “Report on China’s Venture Capital and Private Equity Fundraisings 2008,” *China Venture*.

fundraising through the cycles with which international capital ebbs and flows. On the other hand, domestic limited partners – who are newer to the private equity asset class than the fund managers themselves – may not see immediate alignments of interest with international limited partners and may as a result be less willing to pursue common agendas, such as the recently endorsed terms advocated by the International Limited Partners Association (ILPA).⁴

In sum, the private equity market within China shows considerable progress and promise, and has earned an appropriate allocation within limited partners' portfolios. Given the rapid development of the market in China, however, investing is not without risks and limited partners should take care either to educate themselves when acting directly, or to invest alongside third-party advisors with appropriate expertise.

⁴ See, *Private Equity Principles*, International Limited Partners Association.
<http://www.ilpa.org/files/ILPA%20Private%20Equity%20Principles.pdf>

Acknowledgement

EMAlternatives thanks [Ying White](#), who leads the China funds practice in the Beijing office of [Akin Gump Strauss Hauer & Feld LLP](#), for her advice and input in the regulatory section of this note.

About EMAlternatives

EMAlternatives, LLC (“EMAlternatives” or “EMA”) is a private equity fund investor that focuses exclusively on global emerging markets. EMAlternatives provides discretionary and non-discretionary services to sophisticated institutional investors seeking exposure to private equity outside traditional markets in North America and Western Europe. By customizing funds for clients, EMAlternatives constructs portfolios that reflect clients' existing relationships, unique preferences for geography and strategy, and other investment objectives.

For more information about EMAlternatives, please contact us at one of our offices below.

Leidsevaartweg 99, 6F
2106 AS Heemstede
The Netherlands

T + 31 (0) 23 5100 560
F+ 31 (0) 23 5100 569

1159 Madang Road, 5F
Shanghai 200021
PRC

T +86 21 6135 7208
F +86 21 6135 7207

1010 Wisconsin Avenue, NW
Suite 520
Washington, DC 20007
USA

T +1 202 659 5959
F +1 202 659 5960

www.emalternatives.com