China—private equity market overview

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Setting the scene

Real GDP growth across the key markets in Asia is forecast to significantly outpace that of the US and Europe. Key elements that support this growth include an expanding middle class, urbanisation, high savings rates and cost-effective work forces.

Forecast Average Real GDP Growth (2011-2015)

Private equity investment as % GDP

Source: AVCJ, Dealogic, Global Insight, January 2011
China’s economic outlook remains positive but inflation risk increases

**UBS sees GDP growth moderating to 9.3% for 2011 mainly due to higher oil price**

**GDP growth rate expected to moderate in 2011**

![GDP Growth Chart](chart1.png)

**Inflation trending higher**

![Inflation Chart](chart2.png)

On Apr 6 2011, marking the 4th rate hike in the past 5 months, PBOC raised one-year yuan lending rate to 6.31% and one-year deposit rate to 3.25%
China market outlook 2011

GDP growth to stay robust despite tighter liquidity management and further rate hikes

Key drivers

1. Robust fixed investment
   - The start of the 12th FYP will support fixed investment despite the property tightening and fading of the stimulus plan

2. Manufacturing sector upgrade
   - More automation, better equipment as well as increased R&D spending
   - Targets for improving energy and emission efficiency, rise in resource taxes and introduction of environmental taxes

3. Develop new strategic industries
   - Seven new strategic industries (energy saving, IT, bio, advanced machines etc.) are expected to reach 8% of GDP by 2015 and 15% by 2020 from current <5%

Key risks

1. Inflation pressure
   - CPI stayed high at 5% (y/y) in 2011 and is expected to climb further, largely driven by food price increase and recovering commodity prices

2. Rate hikes and RMB appreciation
   - We expect 1 more rate hike in Q2 and then followed by another in Q3
   - RMB is expected to appreciate by 5-6% against the USD, which will affect export sector

3. Tightening on property sector
   - The major downside risk is the weakening construction sector with an estimated drop in housing sales and starts of 10% for the overall 2011; to be partially offset by ramp up in social and mass market construction

Source: UBS research

UBS expects a stable outlook for China’s economy driven by proactive fiscal and monetary policies
PE fundraising activity has increased over recent years

Asia has rapidly become a core part of an LP’s overall PE portfolio. This trend has helped fuel a major increase in fundraising activity over recent years.

Pan-Asian funds continue to dominate the league tables in terms of fund size.

The emergence of RMB-denominated funds in China has dramatically shifted the fundraising landscape.

PE fundraising, by country

Selected funds currently in the market

<table>
<thead>
<tr>
<th>Fund</th>
<th>Target Size</th>
<th>Geography</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pacific Alliance Pan-Asia Fund I</td>
<td>US$2,500</td>
<td>Pan-Asia</td>
</tr>
<tr>
<td>Bain Capital Asia (pre-marketing)</td>
<td>US$2,000</td>
<td>Pan-Asia</td>
</tr>
<tr>
<td>AIF Capital Asia IV</td>
<td>US$750</td>
<td>Pan-Asia</td>
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<tr>
<td>Orchid Asia V</td>
<td>US$650</td>
<td>Pan-Asia</td>
</tr>
<tr>
<td>Blackstone Zhonghua Fund</td>
<td>RMB5,000</td>
<td>China</td>
</tr>
<tr>
<td>Carlyle Beijing RMB Fund</td>
<td>RMB5,000</td>
<td>China</td>
</tr>
<tr>
<td>CDH RMB Fund II</td>
<td>RMB10,000</td>
<td>China</td>
</tr>
<tr>
<td>Hony Capital RMB Fund II</td>
<td>RMB10,000</td>
<td>China</td>
</tr>
<tr>
<td>Saratoga Asia III (pre-marketing)</td>
<td>US$400</td>
<td>Indonesia</td>
</tr>
</tbody>
</table>

Source: AVCJ

Source: Preqin Database, AVCJ, PE Asia, market intelligence
Performance in Asia continues to outperform other regions

Over the past several years, PE and VC fund managers in Asia have consistently outperformed their US and European counterparts, as well as key public market indices.

Performance benchmarks, median net IRR (%)

Performance benchmarks, upper quartile net IRR (%)

Source: Cambridge Associates Index and Benchmark Statistics, September 2010
Note: US PE and VC data only available separately; Asia PE and VC data only available combined
Increasing LP interest in Asia

LP’s planned changes to their emerging markets PE investment strategy over the next 2 years

Approximately 44% of LPs surveyed expect to increase their allocations to China

Source: Coller Capital and EMPEA, Emerging Markets Private Equity Survey, 2010
Recent “notable” PE transactions in China

<table>
<thead>
<tr>
<th>Deal</th>
<th>Sponsor(s)</th>
<th>Country</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments</td>
<td>TPG, KKR, existing CICC shareholders (34% stake)</td>
<td>China</td>
<td>Dec-10</td>
</tr>
<tr>
<td></td>
<td>Goldman Sachs (12% stake)</td>
<td>China</td>
<td>Apr-11</td>
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<tr>
<td></td>
<td>TPG, CDH</td>
<td>China</td>
<td>May-11</td>
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<tr>
<td></td>
<td>Primavera Capital</td>
<td>China</td>
<td>May-11</td>
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<tr>
<td></td>
<td>Bain Capital Asia</td>
<td>China</td>
<td>May-11</td>
</tr>
<tr>
<td>Divestments</td>
<td>Carlyle Asia</td>
<td>China</td>
<td>Dec-10</td>
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<td></td>
<td>TPG Asia</td>
<td>China</td>
<td>Apr-11</td>
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<tr>
<td></td>
<td>Morgan Stanley PE, Headland Capital, IFC</td>
<td>China</td>
<td>May-11</td>
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<tr>
<td></td>
<td>Affinity Equity Partners, Unitas Capital</td>
<td>China</td>
<td>Jun-11</td>
</tr>
</tbody>
</table>

Source: AVCJ, PEI Asia, Private Equity Analyst, Private Equity Review, market intelligence, and other publicly available information; may differ from actual data.
China PE framework

Rules and restrictions
- Number of regulatory restrictions, including:
  - Conversion of foreign currency to RMB and vice versa (i.e. as a means both to invest and to exit from investments)
  - Sectors foreign investors are allowed to invest in (government approval on a deal-by-deal basis through a time-consuming process)
  - China State Council national security concerns for merger/M&A review (February 2011)
- No nationwide legal framework that concretely regulates P/E industry

Foreign currency funds
- Typically invested into China via offshore structures
- Growth of RMB-denominated funds provide some additional ways for foreign GPs and LPs

RMB funds and sources of capital
- Usual partnering of local GPs with local LPs
- Changing regulatory environment in recent times has:
  - Allowed funds to tap a mix of both foreign and local LPs
  - Fostered foreign GPs’ ability to engage with local LPs
Key market trends and developments

The Chinese government is increasingly supportive of local private equity...

**Increasingly supportive regulatory landscape**

- Since 2009, foreign firms allowed to register domestic entities to raise and manage RMB private equity funds
- Decentralized approach MofCom: approval authority for “FIVCIEs” with registered capital <$100 million on provincial level
- Local regulations and rules that are supportive of private equity funds formation
  - Tax incentives, seed money for funds registered locally, reduced regulatory filing requirements
  - Beijing, Shanghai, Tianjin, Chongqing, Suzhou, Hangzhou, Shenzhen
- Competition amongst various local jurisdictions, policy development in support of RMB funds at central government level
- March 2010: Chinese central government new measures pertaining onshore foreign-invested RMB funds, known as Foreign Invested Partnerships or “FIPs”

**Improving regulatory framework**

- NDRC (February 2011): all China-focused PE firms with AuM over RMB500 million (~US$76 million) will be required to register with NDRC and provide regular updates
- Annual reviews of such registered PE firms
  - Beijing, Shanghai, Tianjin, Jiangsu, Zhejiang and Hubei (includes foreign GPs)
  - only raise capital from sufficiently sophisticated LPs
  - cleared for due diligence by NSSF
- CSRC may allow select brokerages to set up PE funds within their asset management divisions by 2011-2012. Currently drafting new regulations
  - In 2007, pilot program for CITIC Securities and CICC to invest in unlisted companies. Similar now for Huatai Securities, Guosen Securities and Haitong Securities
  - In 2008, CSRC condition: up to 15% net worth, through a separate company
Key market trends and developments

... and RMB Funds have received increasing amounts of attention

Primary sources of Chinese institutional capital include NSSF, state-owned enterprises and wealthy individuals.

- September 2010: CIRC implementation rules permitting Chinese insurance companies to invest in RMB funds.
  - Up to 5% of total assets in PE products (including RMB funds) and 10% in real estate.
- October 2010: Shanghai’s pilot program involving Qualified Foreign Limited Partners (“QFLP“) (foreign-funded GPs and LPs can convert foreign capital into RMB).
- January 2011: Shanghai government new implementation measures for foreign institutional investors to invest in RMB funds, convert foreign currency to RMB. QFPLs may still be subject to sector restrictions. Specific quota on foreign currency to be converted alongside domestic LPs.
- RMB-denominated fund of funds (“FoFs“) have typically been managed by local governments to support policy-driven agendas, but there has also been gradual development in the RMB FoF space.

RMB funds: number and capital raised

- In 2010, amount of capital raised by China-focused PE funds more than doubled from 2009, with number of RMB-denominated funds exceeding number of USD-denominated funds.
  - 86% of private equity funds investing in China were RMB-funds (71 RMB funds were raised vs. 11 USD funds investing in China)¹.
  - Under 40% raised in RMB ($6.94 billion RMB-funds vs. $10.68 billion USD-funds) in 2010¹.
- In 2009, amount of capital raised through RMB funds exceeded the commitments of USD-denominated funds.
  - 67% were raised in RMB ($8.73 billion RMB-funds vs. $4.23 billion USD-funds)¹.
  - 70% of private equity funds investing in China were RMB-funds (21 RMB funds were raised vs. 9 USD funds investing in China)¹.

Note:
¹ Zero2IPO Research Centre; this excludes the amount raised by venture capital funds.
Overview of RMB private equity funds

**Domestic-invested RMB Funds**
- Entirely domestically funded, which excludes all foreign capital, no currency conversion-related issues
- Not subject to any sector restrictions
- Typically structured as a domestic limited partnership

**Foreign-invested RMB Funds**
- Restrictions under Foreign Investment Industry Guidance Catalogue
- Foreign Invested Venture Capital Investment Enterprise (“FIVCIE”) and, more recently, the Foreign Invested Partnership (“FIP”)
- Advantages vis-à-vis foreign currency funds:
  - **Faster execution**: more expedient deal execution via a more streamlined regulatory approval process
  - **Large potential pool of LP capital**: raise capital from domestic investors and local government bodies (in addition to having access to offshore LPs)
  - **Domestic listing** as an exit strategy: buoyant domestic IPO market can potentially facilitate exits at attractive valuations
  - **Increasing clarity** with respect to the regulatory environment
Overview of RMB private equity funds

**Qualified Foreign Limited Partners ("QFLPs")**

- Shanghai Trial Plan approved in October 2010
- Specific rules published in January 2011, permitting select firms to convert foreign capital into RMB
  - Aggregate quota for foreign exchange convertible into RMB not to exceed 50% of the fund, quota for GP not to exceed 5%
  - If only foreign source of capital from GP, no MofCom approval required for investment
  - Still subject to “foreign-invested enterprises” regulations
  - 3 stages of distribution for a quota of $3 billion: first round of approvals quota of $300 million in total, second round $1.5 billion across approximately 15 firms
  - 5 firms approved as QFLPs, including Blackstone, Carlyle, DT Capital Partners, First Eastern Investment Group and a joint venture between CLSA and Shanghai Guosheng Company
- The Chongqing government has also, as of May 2011, approved 7 firms as QFLPs with a quota of $100 m to $500 m for currency conversion

**Outward-bound RMB Funds**

- Restrictions on foreign currency conversions work both ways
- Recent developments to facilitate the investing of Chinese capital abroad
  - Beijing Municipal Bureau of Financial Work and A-Capital
  - RIT Capital and Beijing-based Creat Group to launch $750 million RMB-funded vehicle targeting minority stakes in Western companies operating in sectors where China does not have a competitive advantage (e.g. luxury goods, clean technology etc.)
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