AVCJ
ASIAN VENTURE CAPITAL JOURNAL

Asia's Private Equity News Source

avcj.com June 23 2015 Volume 28 Number 23

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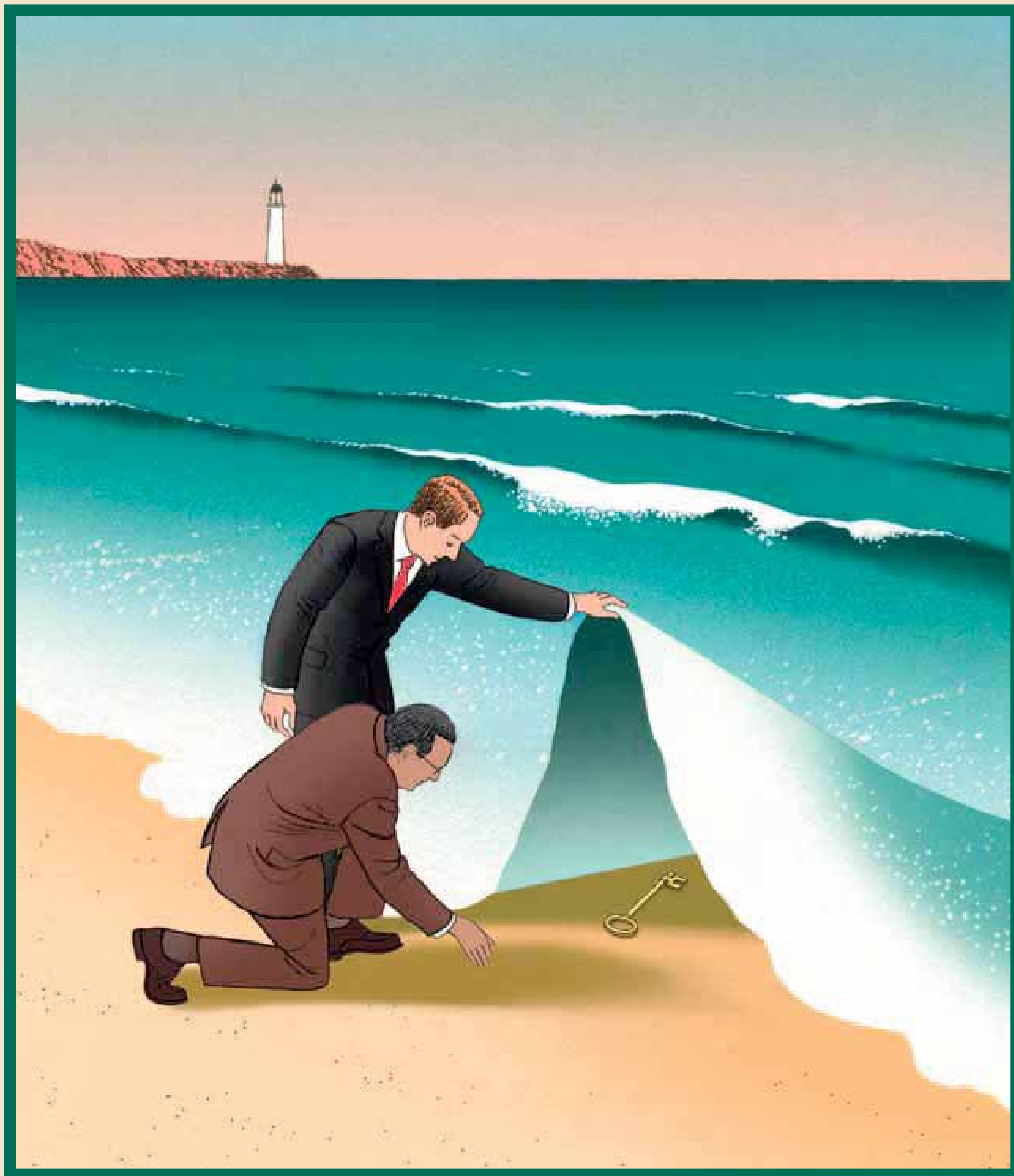

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A team sport

PRIVATE EQUITY IS A PEOPLE BUSINESS – this is an oft-repeated phrase at AVCJ events and certainly one that continues to be relevant.

How many of you have personally out on a limb for the sake of a deal you believed in? Over the years, I have been told of so many deals that were years in making as the GPs cultivated friendships with business owners and showed them how partnerships with private equity could be mutually beneficial. Even in auctions, the relationship between buyer and seller is a crucial factor.

However, it has been observed to me recently that there are fewer "personalities" in the private equity space than before, and that the industry has lost some of its highly opinionated and immensely quotable professionals who are seen at conferences and read about in media. While I don't agree with the first part about personalities, I think there is some truth in the second.

First, many of the more successful private equity firms are much larger nowadays and employ a larger number of staff. Many of these professionals come from other parts of the financial world; parts in people are well-known for keeping things close to the vest. Indeed, in our experience as conference organizers, speakers with such backgrounds are usually very thoughtful and eloquent but rarely delve into the controversial.

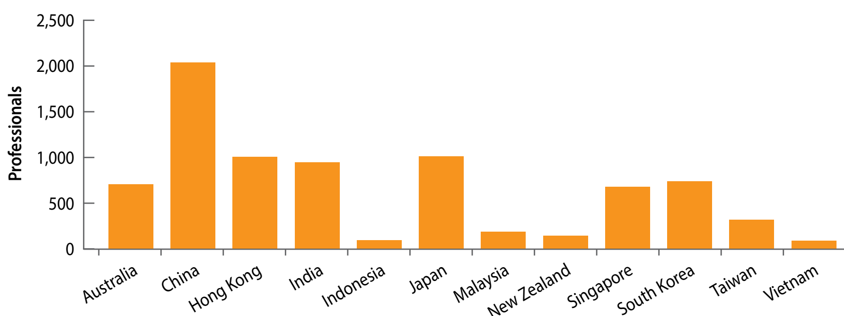
Corporate cultures aside, that's probably the right thing to do in the era of social media where it is all too easy for words to be taken out of context, creating unwanted trouble for employers and employees.

However, what's more interesting – or frustrating – is that some people correlate outward displays of emotion with actual investment success. I would say that is that it certainly much harder now for many to emulate the successes of the past, in particular building firms with their names on the door. But it is by no means the case that the top GPs are less competent or entrepreneurial. Rather, the industry has evolved and the rewards are split more evenly than before, perhaps because there is a much larger pie.

In this sense, comparisons between past and present are unfair. Top firms today are built on teams of professionals that include risk managers, legal counsel, corporate communications executives, and so on – not just investment professionals, although they remain the core to these GPs' success. Yes, private equity is and will continue to be a people's business, but these people aren't by themselves anymore.

Allen Lee
Publishing Director
Asian Venture Capital Journal

Estimated PE professionals in major Asia markets, 2014



Source: AVCJ Research

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ISSN 1817-1648 Copyright © 2015

NEWS

GLOBAL

LPs take over Exhilway emerging markets fund

LPs have assumed control of Exhilway Global Opportunities Fund, apparently following difficulty sourcing deals. The fund launched in 2013 with a target of $2 billion, half of which was supposed to be deployed in India. However, it only managed to raise $203 million.

ASIA PACIFIC

CLSA closes third real estate fund at $1b

CLSA Capital Partners has closed its third Asian real estate fund, Fudo Capital III, at the hard cap of $1 billion, exceeding its initial target of $850 million. Fudo will target investments up to $75 million in assets worth up to $200 million. Investments from the previous fund include Hongjia Tower in Shanghai and Hong Kong's Laguna Plaza shopping center.

AUSTRALASIA

Anacacia takes majority stake in LED business

Anacacia Capital has acquired a majority stake in Australian lighting business LEDified Lighting Corporation for an undisclosed sum. The investment will be used for organic growth and for potential strategic acquisitions. LEDified is Australia's largest LED lighting specialist.

GREATER CHINA

NSSF joins funding round for Ant Financial

The National Council for Social Security Fund (NSSF) has joined a funding round for Ant Financial Services that is said to value the business at more than $40 billion. Other investors include China Development Bank Capital and a company affiliated with Yunfeng Capital co-founder David Yu. Ant Financial is the internet finance affiliate of Alibaba Group.

Shenzhen Fortune invests $48m in Focus Media

Fortune Capital has invested RMB300 million ($48 million) in Focus Media, a Chinese outdoor advertising firm. The company was taken private two years ago by a consortium of PE investors and company management. It has reached an agreement with Shenzhen-listed silicone rubber manufacturer Jiangsu Hongda New Material for a $7.37 billion backdoor listing in Shenzhen.

PE consortium submits Qihoo take-private bid

Chinese internet security software provider Qihoo 360 Technology has received a take-private offer from its chairman and CEO, plus CITIC Securities, China Renaissance Holdings and Sequoia Capital.

The offer values the company at approximately $9.9 billion, based on the number of shares outstanding. The consortium is willing to pay $77.00 per share in cash for all outstanding

American Depository Shares (ADS), according to a filing. This represents a premium of 16.6% to the June 16 closing price.

As with the raft of other US-listed Chinese companies to receive take-private offers in recent weeks, investors are betting on the company achieving a stronger price-to-earnings (P/E) multiple on a domestic bourse. Qihoo's current P/E ratio is around 41. This compares to 82 and 137 for Shenzhen's SME and Chinext boards, respectively. The New Third Board is also gaining traction.

Hongyi Zhou, Qihoo's chairman and CEO, owned a 16.2% stake in the company as of December 2014, while Sequoia had 1.5%.

Founded in 2005, the company was the leading provider of PC internet security and mobile internet security products in China last year. It was also the number one PC browser provider and Android mobile app store operator.

iDreamSky gets take-private offer

VC-backed Chinese mobile game publisher IDreamSky Technology has received a take-private proposal barely 10 months after going public on NASDAQ. Chairman and CEO Michael Chen is offering $14.00 per share for all outstanding American Depository Shares (ADS). The deal values the company at approximately $609 million.

China fully opens e-commerce to foreigners

China's Ministry of Industry and Information Technology has permitted foreign investors to fully own and operate e-commerce companies operating within the country. The new rule went into effect last Friday and is expected to boost competition and promote healthy development within the sector in China.

Dianping leads $30m round for Farmlink

Restaurant supplier platform Farmlinkhas received a $30 million in Series B funding led by listings and group-buying specialist Dianping. Existing investor Sequoia Capital also participated. The new capital will go toward product development, supply chain optimization and geographic expansion.

China financial player Jupai files for US IPO

Chinese wealth-management service provider Jupai has filed for a US IPO. The company will use the new funds to expand its coverage network. Jupai, which provides wealth management products, is backed by an investment unit of online real estate agency E-House and Sina Corp.

IMAX, CMC Capital to launch China film fund

Movie theater operator IMAX Corporation and CMC Capital Partners will launch a fund to bankroll at least 10 Chinese-language movie productions. The fund will have up to $50 million in initial capital and will target productions that can leverage the IMAX brand. It will commit $3-7 million per film.

Everbright mezz fund leads casting investment

China Everbright has invested an undisclosed sum in AVIC Precision Casting Science and Technology via its RMB Mezzanine Fund. The company is an affiliate of Chinese state-owned aerospace and defense company Aviation Industry Corporation of China (AVIC), which invested along with Everbright and COFCO Trust.

This announcement appears as a matter of record only. April 2015

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NEWS

Qiming, Trustbridge back education app developer

Qiming Venture Partners and Trustbridge Partners have committed $50 million in Series B funding to online education app developer Xuebajun. Existing investor Vertex Ventures also participated. Xuebajun will use the funds to develop and promote new products, and to enhance its current offerings.

Legend targets $1.96b Hong Kong IPO

Legend Holdings, sponsor of GPs Hony Capital and Legend Capital, has set a pricing range for its Hong Kong IPO that could raise as much as HK$15.2 billion ($1.96 billion). Legend will sell 352.9 million shares at up to HK$43.00 apiece.

NORTH ASIA

Alibaba, Foxconn invest in SoftBank robotics division

Alibaba Group and Foxconn Technology Group will invest JPY29 billion ($236 million) in SoftBank Robotics Holding Corp (SBRH). The two investors will help launch SoftBank's humanoid robot Pepper in global markets. Alibaba and Foxconn will each receive a 20% stake in SBRH; SoftBank will retain a 60% share.

Japan to lead boom in Asia restructuring activity

A survey by advisory firm AlixPartners indicates that corporate restructuring activity in Japan should increase the number of distress opportunities in Asia. The survey pointed to regulatory change and added pressure from investors as prime causes. Respondents overwhelmingly expected M&A to be the main tactic for restructuring.

SOUTH ASIA

Edelweiss reaches $205m first close on credit fund

India's Edelweiss Alternative Asset Advisors has reached a $205 million first close on its EW Special Opportunities Fund II (ESOF II). The fund will focus on privately-negotiated collateralized credit transactions with risk-adjusted returns. Its LP base includes new and existing institutional investors, such as public pension funds and insurance companies.

Japan's Advantage to launch $400m Asia fund

Japanese mid-market GP Advantage Partners is looking to raise a $400 million fund targeting investment opportunities in Asia outside of Japan. The fund will complement Advantage's flagship fund, Advantage Partners V, which will also be launching shortly. The target amount of the flagship fund has not yet been revealed.

The Asia fund is the GP's first non-Japan vehicle, but Advantage has made four investments overseas. Three of these - Qin Jia Yuan Media Services and Qingdao Hisense

Broadband Multimedia, and ESG, a commercial facilities firm - were in China, while the third, GTA TeleGuam, was in the US territory of Guam.

The last of these was exited to Telkom Indonesia earlier this month for an undisclosed sum. Advantage's last exit prior to TeleGuam was cinema chain United Entertainment to Lawson HMV Entertainment, a unit of Tokyo stock exchange-listed convenience store giant Lawson, in August last year.

Advantage is currently investing out of a $200 million bridge fund which reached a final close in mid-2013. Prior to that, the GP had raised Advantage Partners IV, which launched in 2006 and reached a final close of JPY215 billion ($1.7 billion) in 2007.

Lafarge buys back Baring Asia's stake in its India unit

French cement maker Lafarge will buy back Baring Private Equity Asia's 14% stake in Lafarge India for EUR270 million ($304 million). The transaction is a precondition to Lafarge's merger with Swiss rival Holcim and will return 100% control of the division to Lafarge. Baring bought its stake in the company in 2013 for $256 million.

Aavishkaar reaches $45m first close on fund

India-based impact investor Aavishkaar has reached a first close of $45 million on its South and Southeast Asia-focused fund. The Aavishkaar Frontier Fund has a full target of $75 million and has raised commitments from several European investors.

FTIL cancels IEX sale, agrees new terms

Financial Technologies India (FTIL) will sell a 16.6% stake in electricity trading platform India Energy Exchange (IEX) to a consortium of investors including Aditya Birla Capital Advisors and DCB Power Ventures for INR3.57 billion ($56.1 million). An earlier arrangement to sell its entire stake to a group led by TVS Capital Funds has been cancelled.

Faering leads $11m Series C for FundsIndia

Faering Capital has led a INR700 million ($11 million) Series C round for online financial services platform FundsIndia. Existing investors Inventus Capital Partners and Foundation Capital also participated in the round.

IFC invests $35m in Indian energy-focused NBFC

The International Finance Corporation (IFC) has committed $35 million to infrastructure finance firm PTC India Financial Services (PFS). PFS will use the new capital to provide long-term financing for wind, solar and other clean energy initiatives. The investment follows a $50 million loan that IFC provided to PFS in 2011.

MyDentist raises $8m Series C round

Indian dental clinic chain MyDentist has raised a INR500 million ($8 million) funding round led by Swiss impact investor LGT Venture Philanthropy. Existing backers Seedfund and Asian Healthcare Fund (AHF) also participated.

SOUTHEAST ASIA

First Reserve subscribes to KrisEnergy rights issue

First Reserve will part-subscribe to a S$169.5 million ($126 million) rights issue by its investee KrisEnergy, an oil and gas exploration and production (E&P) company. The PE firm will subscribe to 87.3 million shares of the planned 440.1 million new issues. They will be priced at S$0.385 apiece.

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Replacement capital?

With Chinese entrepreneurs considering domestic IPOs, foreign VCs face the prospect of having to sell off investments in restricted industries. But the trend can only be sustained as long as valuations remain high

THE PRICE TAG ATTACHED TO FOCUS Media's reverse merger in Shenzhen is RMB45.7 billion ($7.37 billion), more than twice what a consortium of PE investors and management paid to privatize the then-NASDAQ listed business in a deal completed two years ago. These backers might be anticipating a far higher valuation when they eventually make their exit.

Once Focus Media merges into Jiangsu Hongda New Material it will take its place on a bourse that has been trading at an all-time high. The Shenzhen Composite Index has gained nearly 100% in the last six months; the average price-to-earnings (P/E) ratio is 38, compared to 23 for the NASDAQ 100 Index.

The RMB45.7 billion figure is the product of a series of transactions through which ownership of Focus Media was restructured. But one previous complication has been removed. The variable interest entities (VIEs) used to separate offshore investors from assets to which they could not have direct exposure – put in place ahead of Focus Media's 2005 IPO – no longer apply due to a relaxation of foreign investment restrictions in the advertising industry. This means The Carlyle Group, FountainVest Partners, CITIC Capital Partners and Primavera Capital can hold stakes in the listed entity.

It is a regulatory nuance, but a significant one. With China's capital markets in overdrive, local entrepreneurs are now targeting IPOs or reverse mergers on domestic bourses. Not only has there been a surge in take-private bids for US-listed Chinese companies, but unlisted start-ups are also reevaluating their options. Structures set up offshore to facilitate US IPOs are now being replaced by onshore vehicles.

Provided the industry in which a portfolio company operates is not barred to foreign investors, an offshore VC fund can switch their ownership to the onshore entity and look forward to the upside. These are predominantly technology companies, though, and many – but not all – hold internet content provider (ICP) licenses that are off limits to foreign players. An onshore listing can't come with a VIE attached, so in these instances VC firms must sell their positions.

Changing dynamics

The situation represents a potential dilemma for VC investors with US dollar-denominated funds, not only in terms of current portfolio companies but also their ability to secure future investments if entrepreneurs would prefer to get funding onshore and in renminbi. However, questioning the viability of these funds, or the VIE structures they often employ, is premature.

Onshore restructuring is certainly being addressed by investors and entrepreneurs, but as Ron Cao, managing director at Lightspeed China Partners, puts it: "These are real-time discussions over a complex set of issues." They are taking place against a backdrop of uncertainty. While the government has spoken of its desire to see technology companies list domestically, it has yet to put mechanisms in place. And it is unclear whether valuations will remain heady enough to overcome the risk factors.

> "Increasingly, we are seeing NEEQ as a viable fundraising platform – as long as you can raise money at a high valuation"
>
> – J.P. Gan

"It is not just the P/E ratio," says Maurice Hoo, partner and head of the M&A and PE practice at Orrick. "There is currency strength and convertibility, the relative robustness of the US capital markets versus the Chinese capital markets, and the ability to control the timing because listing in China still comes with a high level of uncertainty. In 2008-2009, for example, various people looked at it but not everyone tried to do it."

He is referring to a period after the global financial crisis when the US markets were weak and it was unclear when demand for new listings would bounce back. For about 12 months, a China listing seemed much more appetizing.

Similarly, when a number of accounting scandals involving US-listed Chinese companies in 2011-2012 turned international investors cold on all mid-cap China stocks, there was a spate of privatizations. Founders and their PE backers concluded that the difference between these companies' depressed valuations in the US and what they might trade for back home made action economically justifiable.

The current phase is different in that US markets are not necessarily underperforming. Rather, since the beginning of this year China has outperformed, with the Shanghai A-share market, Chinext and the Shenzhen SME Board reaching record highs in June, alongside the Shenzhen main board. Listings on these bourses are not the only factor. The National Equities Exchange and Quotation (NEEQ), commonly known as the New Third Board, has also been transformed.

"If you asked me a year ago I would have said the New Third Board wasn't an option because there was little fundraising," says J.P. Gan, managing partner at Qiming Venture Partners. "But recently there have been a number of cases in which companies have raised billions of renminbi, which is real money by any measure. Increasingly, we are seeing NEEQ as a viable fundraising platform – as long as you can raise money at a high valuation."

This market, which started as a pilot program enabling high-tech focused small and medium-sized enterprises (SMEs) to raise capital, is an antidote to the long waiting times and strict requirements of the other boards. With participation limited to qualified investors, companies do not have to show two years of profitability to list. Start-ups that had assumed liquidity was years away now have a fast track.

"I have a company that was in the middle of a Taiwan IPO and decided to scrap it and go for the New Third Board," says James Lu, a partner at Cooley. "The record for listing a domestic company is one month but typically it's a three-month process. No wonder everyone is saying, 'Let's do it now.'"

Taking action

The restructuring process itself is not overly complex, especially if the target has not yet listed. VC firms invest in an offshore vehicle, which

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holds onshore assets through a wholly foreign-owned enterprise (WFOE). If there are restricted assets, they are placed in a parallel structure owned by one or more Chinese nationals, usually the company founder. The VIE secures the WFOE's interest in the parallel structure.

To take this apart, shares in the offshore entity are cancelled and the WFOE converts to a new structure, perhaps beneath the entity that holds the VIE. If foreign participation is still permitted in a minority capacity the company could become a Sino-foreign joint venture; if not, the investors are cashed out.

There are, however, several issues that could complicate these transactions. First, selling or transferring shares in the offshore entity incurs capital gains tax. Then there may also be a levy arising from changes in the ownership of the WFOE and VIE entities, particularly if the latter takes ownership of the former. Furthermore, the valuations at which these transactions happen may result in larger future tax liabilities.

"Let's give the VIE a nominal valuation of $100. If you spend $90 cashing out the foreign investors and then you invest $10 into the onshore company to get $100 worth of value, the cost base of the onshore company's shares is only $10. If you subsequently sell the company for $100, you are crystallizing a $90 gain in China, which is taxable," says Christopher Xing, a partner at KPMG. "It's a very difficult issue to resolve because there is no cross-recognition cost base under Chinese tax law."

Second, these transactions require financial support. In the case of a privatization or the onshore restructuring of a company operating in a restricted industry – which means the foreign investors have to be taken out – a founder needs capital to buy the shares.

If a company is valued at $1 billion, it would cost around RMB1.2 billion to redeem a shareholder with a 20% stake. Even at half this valuation, few VC firms have renminbi vehicles capable of addressing transactions of this size. Capital flooded into US dollar VC funds last year, with GGV and Qiming raising $620 million and $500 million, respectively. On the renminbi side they are smaller. GGV has raised two local currency funds of RMB600 million and RMB1 billion through an affiliate, while Qiming also has a RMB1 billion vehicle.

It is generally accepted that there will be a spike in renminbi fundraising as investors rush to capitalize on the restructuring opportunity. Sequoia Capital is understood to have teamed up with local brokerage Huatai Securities to raise a RMB10 billion fund and China Renaissance has a similar arrangement with CITIC Securities. Plenty of newcomers to the space are also working with investors on potential deals.

"It would be foolish not to take advantage of this – everybody is doing it," says one of these GPs. He is talking to VC firms that might have to exit positions and estimates that if one can be sourced from each of the top 20 players in China, the restructuring and re-listing process would keep his team busy for two years. "Some might fail; some might have issues during the process. If we complete 10 I would be happy," he adds.

Conflicts of interest

Industry sources say there are GPs restructuring large swathes of their portfolios with a view to transferring investments from US dollar funds to renminbi funds they also manage. However, it is doubtful whether the trend will catch on among the more established US dollar managers that have sophisticated international LPs. This is where third parties hope to come in.

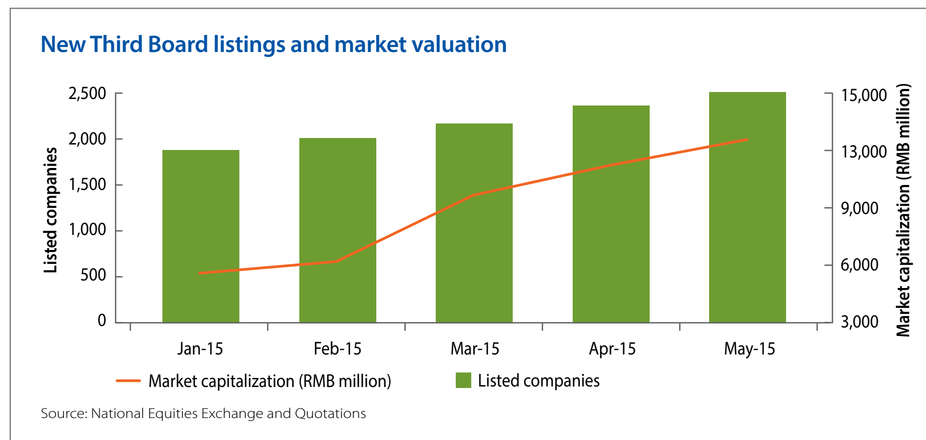
When VC firms started setting up renminbi funds alongside their US dollar vehicles several years ago, there was some disquiet among foreign LPs who were concerned that the local currency funds – in which they were not able to participate – would get preferential treatment in terms of investment allocation. This has arguably held back some firms' renminbi ambitions.

may well be new pools of capital. Partnerships between GPs and brokerages such as Huatai and CITIC Securities are likely to be an enduring theme: the former provide deal flow and transaction expertise, while the latter have plenty of high net worth individuals in their client bases that want access to the private market alpha associated with technology stocks.

Though negotiations are challenging when one group of investors is replacing another, the outcomes are tolerable as long as China's public markets continue to imply that companies can achieve a substantial valuation premium to what is paid to the exiting investors. "Imagine a company is trying to get on NASDAQ at 30x and then all of a sudden there is talk of this mystical 100x on China exchanges," notes Rocky Lee, Asia managing partner at Cadwalader. "There is nothing wrong with a US dollar fund getting 30x return and exiting, provided the companies actually have the ability to cash them out."

There are ways around temporary cash shortfalls. For example, should a company avoid waiting for an IPO by arranging a reverse merger into a listed entity, it can raise capital by issuing shares and use that to redeem investors through a combination of cash and shares. This is of

New Third Board listings and market valuation



Source: National Equities Exchange and Quotations

Transferring assets from one fund to another, therefore, is fraught with potential fiduciary conflicts. How does a GP ensure alignment of interest when it has two funds, with completely different sets of LPs, on either side of a transaction? For many, the answer is to proceed with caution.

"Our renminbi fund, which is run by a separate team, would not provide all the restructuring capital, so we could participate but we would not drive a transaction," says Jixun Foo, managing partner at GGV. "And if it is our own portfolio we would definitely not want to be negotiating with ourselves. We need to be clear where we stand – we are either seller or buyer, we can't be both."

As a result, the drivers of these transactions

course contingent on the company meeting listing requirements – notably the profitability criteria – and not being in an industry where foreign ownership is prohibited.

James Lu, a partner at Cooley, has also seen agreements whereby the buyer settles a portion of the transaction up front in cash and then makes an additional payment if the company reaches a certain valuation on listing.

Echo chamber

Beyond this, the debate descends into a series of ifs and buts. Earlier this month Premier Li Keqiang said the government would promote start-ups with "special ownership structures" to list onshore. In the absence of further detail, rumor is

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occupying the policy vacuum.

Some industry participants predict the creation of a new board on which companies that are already listed overseas can issue Chinese Depository Receipts, enabling local investors to own stock despite the presence of offshore structures and VIEs. This would certainly be quicker than privatizing businesses and re-listing them domestically.

Meanwhile, GGV's Foo is among those who believe that the planned transition from an approvals-based system for IPOs to a disclosure-based model will, ultimately, result in the relaxation of the requirement that companies have been profitable for at least two years. This would open up other markets to start-ups that are currently confined to the New Third Board.

Even on VIEs, there is hope of reform. The Ministry of Industry and Information Technology (MIIT) recently announced that foreign investors would be able to fully own and operate e-commerce companies. Coming a few months after the publication of the draft Foreign Investment Law – which proposes that VIEs only be permitted if the associated operating company is controlled by Chinese nationals – it is reassuring. The move may even point to a more flexible attitude towards foreign ownership of ICP licenses in certain areas.

"They will probably limit foreign ownership of ICP licenses to pure transaction-based companies such as e-commerce, which has nothing to do with more sensitive areas like content and video-sharing," says Qiming's Gan. "It makes sense because China has already opened up to foreign investment in offline retail."

It is important to note that, even where industry participants see movement, they are reluctant to offer opinions as to when reforms might come to fruition. Indeed, there is no real consensus as to what constitutes "short term" in a China regulatory context. Sentiment is therefore divided between those who see the government's words of support as an irrevocable catalyst and those who are more wary.

Cadwaladar's Lee, for his part, is skeptical about change full stop. His takeaway from meetings with regulators is that they think the market is too hot, would like to see a reduction in the irrational exuberance, and generally do not favor a surge in new listings by companies that have little substance. He also sees little likelihood of new development on VIEs.

The broader question is what this means for US dollar investors. Any one of the reforms listed above might facilitate their participation in domestic capital markets – by effectively blurring the line between onshore and offshore – but right now the momentum is with renminbi funds. If a company is in a restricted industry, is there any point setting up an offshore structure that might just end up being unwound?

"There appears to have been a slowdown in US dollar fundraising recently, while on the renminbi side it is growing exponentially," says Cooley's Lu. "The New Third Board craze has put US dollar funds in a difficult position. A lot of smaller companies only agreed to VIE structures to get access to funding. Now that the government is opening up the capital markets for smaller companies, they may not need to do this any longer."

Here to stay?

It remains to be seen whether the current dynamic is sustainable. There are still plenty of investments offshore VC investors can make that do not fall in restricted areas, including the fast-growing hardware space. Start-ups may also seek out US dollar funding from brand-name VC firms because of the credibility it brings. They can achieve scale with the support of a Sequoia or a SAIF Partners and an onshore restructuring might make sense at a later date.

Then there are companies that have already gained traction with substantial amounts of offshore VC backing. Opinion is divided as to whether the likes of Didi Dache and Kuaidi Dache, the recently-merged taxi-booking platforms that have between them raised in excess of $1 billion, will pursue a domestic listing.

"You are going to be surprised at the number of companies that are going to at least attempt to do this in the next six months, and the size of those companies," says one lawyer. Others question whether the New Third Board can accommodate companies of this size.

Another option is to list overseas in anticipation of the government creating a mechanism for companies to sell shares back home, which is likely what most of the well-established US-traded China technology stocks are waiting for.

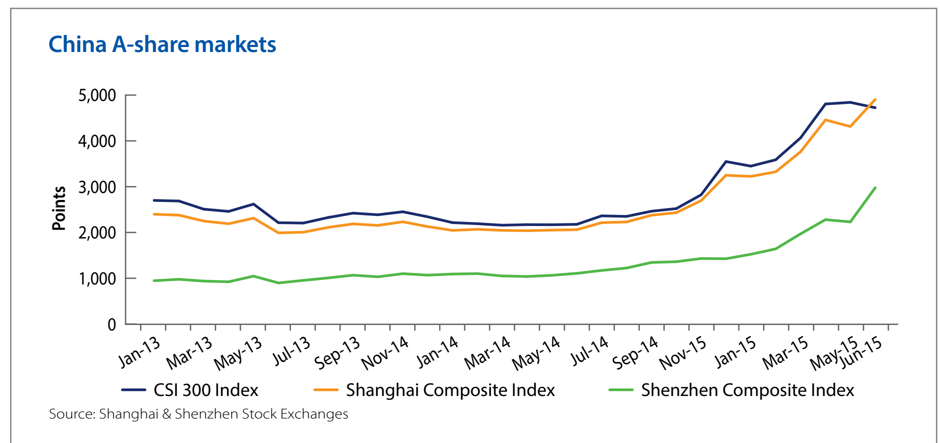
Finally, there remains the issue of valuations. After peaking on June 12, the Shanghai Composite Index dropped 13.3% last week – the worst five-day performance since 2008 – and other bourses saw similar declines. The New Third Board did not suffer so greatly, losing 2.17%, but a prolonged deterioration in the main markets would not help matters.

These movements may or may not represent the first salvos in a rebalancing, but China's public markets have been volatile in the past and will likely be so again. Venture capital investors managing predominantly US dollar funds are taking a longer-term view.

"If you ask me where the market is today, there is a natural arbitrage opportunity on the renminbi side – the sky-high valuations on domestic stock exchanges are attracting a lot of entrepreneurs and the government is encouraging offshore-structured technology companies to relocate onshore," says GGV's Foo. "However, as more companies list domestically and the liquidity gets soaked up and monetary policy changes, you will see valuations come back down. It will reach equilibrium."

Those with existing portfolios are also enthused by the growing array of exit options presented by these developments, even though onshore restructurings may force the sale of certain positions. Public markets in the US and China are now viable liquidity channels and there is more activity on the M&A front, particularly from listed Chinese companies that want to tap the technology space.

"I have never seen a market so vibrant in my 15-year career and we have never been so busy," adds Qiming's Gan. "We recently announced the sale of one of our portfolio companies, a mobile advertising platform called Domob. We considered a VIE restructuring but then an A-share company decided to acquire the business outright. The buyer is Blue Focus, which was in the first batch of Chinext listings."



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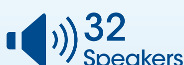
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An underpenetrated market

Plenty of Chinese high net worth individuals want to sell LP interests in renminbi funds. Local and foreign secondaries managers would like to take advantage, but they are held back by an immature market

GOPHER ASSET MANAGEMENT, THE PE arm of NASDAQ-listed Noah Holdings, closed its debut renminbi-denominated secondaries fund-of-funds at RMB600 million ($97 million) in 2013. The timing was good: LPs' exit options were limited amidst the domestic IPO drought and the fund was fully deployed within one year.

When China's securities regulator resumed IPOs and promised to introduce a more transparent listing process, investors' hopes were revived. However, the lengthy reform process left more than 900 companies awaiting approval to list, and so the secondary market remained a tempting alternative source of liquidity. Last December, Gopher duly closed its second secondaries fund at RMB1.3 billion.

"With China's public markets trading so high recently, many opportunistic domestic investors want to sell their shares in illiquid private equity funds and shift the money into the stock market. This will lead to increasing PE secondary transactions for us," says Chun Zeng, managing partner at Gopher.

In the past few years, a huge number of Chinese high net worth individuals (HNWIs) and small companies have sunk capital into PE funds, and as these funds near the end of their lives, GPs need to return capital to LPs. Engineering a secondary sale is one way of doing this. However, it isn't easy for secondary fund managers to structure deals when their own HNWI LPs are not experienced in the asset class.

Limited deal flow

The drop in renminbi fundraising seen over the past two years is indicative of how investor sentiment has turned. After $35 billion went into 272 vehicles in 2011, the annual totals have declined: $26 billion in 2012 and $17 billion in 2013 respectively, although the market rebounded to $22 billion last year.

With LPs defaulting on fund commitments, the government has set up secondaries trading platforms in Shanghai and Beijing. However, transactions are limited. "It's difficult to transfer LP interests through those platforms because they aren't market-driven. Transactions tend to be based on private negotiations between LPs, rather than working through an established system," says Vincent Wang, managing partner at consultancy Promise Advisors.

In addition, renminbi GPs are reluctant to share information on their portfolios, complicating any attempts to set valuations.

Although Gopher focuses on buying LPs interests, deals usually come via GPs with which the firm has established relationships from previous primary fund-of-funds investments. To date, the firm has acquired positions in nearly 30 renminbi funds. As individual LP interests in each fund tend to be very small, Gopher conducts due diligence to identify "high quality HNWIs," so designated because they have exposure to multiple funds. This presents the opportunity for bulk deals, with pricing based on the quality of the portfolios to which these LPs have exposure.

"Another group of LPs willing to sell are those who invested in multiple local government-backed funds a few years ago, which are quite sizeable. The GPs at that time guaranteed to return principal or a minimum return to investors within 4-5 years through share buy-backs. As time goes by, GPs may not have enough cash to buy back these interests but LPs want a way out. We might be a solution," Zeng says.

> "It's difficult to transfer LP interests through those platforms because they aren't market-driven" – Vincent Wang

The irony is that many of the market characteristics that facilitate Gopher's deal-sourcing – HNWIs who did not fully understand the asset class rushing into funds and now wanting to get out – also shape its fundraising efforts. Gopher relies on Noah's network of wealth management clients to raise capital. Although the LP base has become more institutionalized, most investors are still HNWIs.

To ensure that its funds remain stable, the firm has to be careful in how it deals with these LPs.

"Over the past 3-5 years, Chinese HNWIs have come to understand that it is normal for a private equity fund to have a life of 7+3 years. Since we're secondaries, our fund life is 7+2 years," Zeng says. "Investors should consider carefully whether they have sufficient cash flows during this period when making commitments to our funds." Breaking agreements can result in legal penalties.

US dollar issues

Most of the secondary activity in China happens at the LP interest level; there are no renminbi funds focusing on direct secondaries or portfolios restructuring, as some of their US dollar counterparts do. NewQuest Capital Partners has looked at working with domestic partners, but nothing has materialized to date. A major hurdle is structuring transactions.

"We can buy renminbi portfolios as a US dollar fund, but it makes the transaction more complex. The company must be a foreign-invested entity or be willing to become one, and that entails changing the format of the investment entity," says Bonnie Lo, a partner at NewQuest. "Also the renminbi investments we have looked at tend to be small. Those not linked to official funds tend to be held by special purpose vehicles backed by a string of individual investors."

One possible solution is to raise a renminbi vehicle to execute onshore deals. However, the fundamental issue is that China has yet to achieve a critical mass of institutionalized local LPs. Although long-term players such as insurance companies and the National Council for Social Security Fund are now present onshore, it is unclear when and to what extent they would want to participate in the secondaries market.

"They're new in the market and secondaries might be a bit advanced for them. They may enter the secondaries market they may back global secondaries funds operating in the US and Europe. As we focus on direct secondaries, we are probably too niche, but I think they will expand their programs eventually," Lo adds.

On the other hand, given the Chinese government is taking steps to loosen capital controls, foreign investors may not have to enter the market through renminbi funds.

"It's a while since we have looked at the technicalities of coming onshore," says Jason Sambanju, head of Asia secondaries at Deutsche Investment Management. "But given the trend towards loosening capital controls in China, especially in the past 12-24 months, the regulatory environment is becoming a bit more conducive towards offshore funds coming onshore."

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Shoreline rides the China credit cycle

BEN FANGER, CO-FOUNDER AND managing director at China distress specialist Shoreline Capital, divides credit cycles into four phases: a credit boom or misallocated lending; decelerating growth or credit tightening; the recognition that someone has to take a loss; and the release of NPLs into the market.

China is currently entering the fourth phase and it is against this backdrop that Shoreline has closed its third fund at $500 million – compared to $303 million for Fund II. The GP has also reached a first close of a $115 million on an overflow vehicle that is expected to reach its $200 million target within a month.

Shoreline: NPL opportunity

"What was in question a year ago but no longer is in question is whether Chinese banks would recognize and sell their NPLs en masse," says Fanger. "In December we did our first deal, buying several hundred NPLs for more than $150 million. It was the beginning of a series of very large deals for Shoreline."

About 70% of the Fund III corpus has already been called, the vast majority of it for NPL transactions – in contrast to Fund II, which focused on special situations. There are two main reasons for the switch. First, Fund II launched in 2011, so it fell in between China's two most recent credit cycles. Second, the current cycle is fundamentally different to the previous one – in a good way for NPL investors.

Foreign investors were first drawn to China NPLs a little over 10 years ago. The government wanted to shore up the Big Four state-owned banks and so a swathe of NPLs were transferred off their books – most at 100 cents on the dollar – to asset management corporations (AMCs). However, the AMCs were not mandated to sell off a certain number of NPLs and so there was often a mismatch between the quality and pricing of the loans put up for auction. Many foreign investors went away disappointed.

Phase one of the current cycle started in 2009 with the credit boom introduced in the wake of the global financial crisis. As growth has slowed in the last few years, NPLs have emerged – but this time the banks are under pressure to recognize bad debts honestly. They are therefore incentivized to sell at a suitably competitive price.

Shoreline's 40-strong team scours the country for investment opportunities, dealing with an array of regional branches rather than just the four original AMCs. Indeed, the AMCs now sometimes partner the GP on deals. Loan quality has also improved. In the previous cycle, less than one third of the NPLs Shoreline purchased were secured by assets that could be liquidated, and they often involved state-owned enterprises or companies that had ceased operating.

"The portfolios we are seeing now are much more highly secured, 60-85%, and 100% of the loans we bought this year were to privately owned companies, not SOEs," Fanger explains, while stressing that positions can still carry significant risk. "Many of the borrowers are still operating, they just couldn't pay their loan back for a period of time."

InnoSpring's cross-border bridges

SAN FRANCISCO'S ARTISAN STATE FACED the classic start-up dilemma: a great idea with no way to make it happen. The firm knew there was demand for professional-quality photo books at affordable prices, but it didn't have the facilities to produce them. Outsourcing to China was an option, but Artisan State had no contacts there.

Silicon-Valley based technology incubator InnoSpring stepped in with a seed investment out of its first China-US fund and desperately-needed China expertise. Now, with a fresh $5 million for its second fund in the bank, InnoSpring plans to help more start-ups both in the US and in China secure those all-important cross-border ties.

"When we started there had been a lot of exchange of talent, capital and partnerships between the US and China, but there wasn't a professionally-run platform that went a step further, bridging two markets that are very different culturally and very different in terms of a running business," says Xiao Wang, CEO of the InnoSpring Seed Fund.

InnoSpring's funds are primarily raised from venture capital backers. The first fund was supported by KPCB, Northern Light Venture Capital, GSR Ventures, China Broadband Capital, and the TEEC Angel Fund. Northern Light also features in the second, alongside IDG Capital Partners, Legend Capital, Legend Star, SoftBank, the Chinese Software Development Network, and executives from Tencent Holdings.

Investees not only receive seed capital of around $30,000 per company, but also access to other InnoSpring start-ups and companies in the portfolios of these VC firms. This base of experience and knowledge can help newcomers trying to break into an unfamiliar market, whether in China or the US.

InnoSpring: $5m for Fund II

Part of InnoSpring's role is to convince investees, most of which are based in the US, that China is relevant to them. This can be challenging, because awareness is still quite low among most US start-ups. "Even though Alibaba Group has gone public, most of my friends who are really tech-savvy don't know Alibaba's business model," says Wang. "I've been giving talks at Stanford a lot, and most of the people sitting in the audience have no clue as to how Baidu, Alibaba or Tencent generate their revenue."

Companies that take Innospring's advice on board have seen success. Artisan State, which now produces photo books and frames in China, is projected to post $25 million in revenue this year, while consumer-focused mobile security company Trustgo was acquired by Baidu eight months after Innospring's 2013 investment.

InnoSpring is now looking to expand its China presence, having recently set up a renminbi-denominated fund, which will support Chinese and US companies. "We need capital to support these companies that are on the ground in China. We can't just leave them alone," Wang says. "We're going to set up a bigger China fund, and that will be our complete pipeline to provide continuous support."

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Qiming sees Tuhu as agent of disruption

WHEN IT COMES TO USING TECHNOLOGY to disrupt China's auto industry, private equity and venture capital funding appears to have targeted almost every corner of the space. In addition to start-ups that connect drivers with potential passengers, online and mobile businesses extend into second-hand car sales and helping drivers find the best place to get a vehicle check-up or an oil change.

Tuhu Yangche falls into the latter category. It is a platform through which car owners can identify offline after-sales services providers, using the website or mobile app to purchase goods or make appointments.

"It is classic disruption," says J.P. Gan, managing partner at Qiming Venture Partners. "The major competitors are the offline dealerships. They want to do after-sales services for their customers but prices can be twice the factory cost. They try to maintain a high profit margin because they have an exclusive dealership but consumers can buy through Tuhu at a price that is 30-40% lower."

Tuhu was founded in 2011 and Qiming has supported the company through three rounds of funding. The most recent of these saw Hong Kong-listed leasing business Far East Horizon, Legend Capital, Joy Capital (formed following a spin-out from Legend Capital) and Qiming commit $100 million. This round is said to have valued the company at less than $500 million.

There are other mobile players in the market – in the last six months, GGV Capital has led a Series B round for Yangche Diandian while Lightspeed China Partners provided Series A funding to Yikuaixiu – but they can't match Tuhu for size. The company claims to be the largest automobile after-sales e-commerce platform in China, with a network of 1,200 third-party repair shops that spans 266 cities in 19 provinces.

Tuhu: Service solution

Tuhu has also set up a number of wholly-owned service centers in key cities from which coordinates same-day delivery of products to consumers. Sales are said to have reached RMB300 million ($48.3 million) in 2014 and the target for this year is RMB1.5 billion.

The customer base and service functions are different to the auto-trading platforms that attracted so much private equity backing. However, Gan does not rule out consolidation within the broader automobile services market.

Indeed, last year when Warburg Pincus invested in Uxin, the auction company best known for B2B platform Youxinpai, there was talk of the company building itself in the image of Manheim. This company dominates the US used-car auction space and has also grown vertically to incorporate all kinds of financing, recovery, repair and information sharing components.

"It is not unusual for Chinese companies to try and enter new areas quickly and grab market share," Gan observes, although he notes that the priorities for Tuhu are customer acquisition and geographic expansion. "These businesses are all about cutting out the middle man and I can see why people talk about vertical integration. But it will take some time."

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The knead for change

By undercutting its competition, massage salon Riraku was able access a broader segment of the domestic market. But achieving growth on a national scale required support from Advantage Partners

JAPANESE EMPLOYEES ARE NOTORIOUSLY hard working. According to data compiled by the government, around 22% of the country's workforce admits to putting in more than 49 hours a week. This compares to just 16% in US and 11% in Germany.

Overtime at the office is therefore not only common in Japan, but in many cases expected – by clocking off on time a worker runs the risk of being seen lazy, or even disloyal. Holidays don't come easy either. In 2013, the Labor Ministry reported that on average workers only took nine of the 18.5 days off to which they are entitled. It is little wonder that Japanese have a word for death from overwork: karoushi.

Inevitably, industries that provide stress-relief to the overworked masses have seen steady growth. This is particularly true of the quick massage and reflexology market. The most recent report offering insight on the size of this space was published by the Yano Research Institute in late 2013. It found the market to be worth JPY105.5 billion ($853 million) – up 10.5% from 2009 – and growing on average 3.3% a year.

However, the space is highly fragmented, with most chain operators holding no more than 40-50 stores apiece. Meanwhile, the few people who stand to benefit from such services rarely have the time or the money to enjoy them. For a company like Riraku, an affordable quick-service massage salon chain set up in 2008, these dynamics represent a market opportunity.

Established in Osaka as a small chain of outlets offering back and shoulder massage, Riraku – which takes its name from "rirakkusu," the Japanese borrowed word meaning "relax"– aggressively targets overworked, cash-strapped patrons with the tag-line: "Riraku, popular and affordable relaxation for salarymen, office ladies (OLs), and housewives."

The company now provides a range of service offers including traditional "hogushi" body massage and foot massage. Sessions start at JPY900 for 15 minutes and go up to JPY9,900 for 180 minutes.

"Normally, one would have to pay approximately JPY6,000 per hour for this type of service in Japan. We were able to develop a business model whereby we could provide a similar service for JPY2,980 per hour – so that is about JPY500 for 10 minutes," explains Yukihiro Takenouchi, co-founder and director of Riraku.

"By doing so we were able to make this service accessible to a larger group of potential customers at a lower price point, which turned out to be a very attractive business model targeting a broader age group."

It was this potential that eventually led mid-market GP Advantage Partners to invest in the company. Takenouchi explains that he and co-founder and CEO Satoshi Koizumi were looking transition the business into professional management with a view to driving growth, while retaining an interest in it themselves. The priority was to achieve scale: given Riraku's low price points, the company needed to open new stores at a much faster rate.

"We had to keep opening new stores but to do that we needed capital. Cash flow management was a big issue and always needing cash was a challenge," says Takenouchi. "We were originally looking for candidates to whom we could exit the business through a private process. We ended up meeting, and being impressed with Advantage, and so we decided to sell."

The private equity firm acquired a 90% stake in August 2013, with Takenouchi and Koizumi retaining a 10% interest. Although financial details of the deal were not disclosed, Advantage typically targets companies with an enterprise of between $40 million and $100 million, paying a valuation multiple of 4-7x EBITDA. The investment came out of the firm's bridge fund, which reached a hard cap of JPY20 billion earlier that month.

Daisuke Murakami, a director with Advantage, explains that the GP had been not been targeting the salon segment specifically. Rather, this investment came as a result of coverage of the broader consumer services industry.

"We learned about this opportunity through an advisor working with the founders. It was a succession deal involving Mr. Takenouchi and Mr. Koizumi, two of the three founders that established the business," says Murakami. "It was also kind of a management buyout-type of deal, given the two founders re-invested with us, and the third left the company to start another venture."

> "We wanted to open the stores at as low a cost as possible, so former convenience store locations have been a huge opportunity for us," says Murakami. "If we get any information that a store has closed we look at the possibility of opening a Riraku"
>
> – Daisuke Murakami

Expansion strategy

Once Advantage came in, financing was no longer an issue. With the help of its new investors, the company – which opened around 200 stores by that point – was able to develop a plan for systematically evaluating and selecting store locations, targeting around 75-100 new outlets a year.

"The first thing we wanted Advantage to do was to come in and do a qualitative analysis of our business activities," says Takenouchi. "Advantage has been able to provide that analysis and also bring in a world of networks and contacts that Riraku could leverage to continue to grow the business."

The company's business model is comparable to that of QB House, a Japanese hair salon chain that offers 10-minute haircuts at a much lower price than its competitors. As is the case with QB House, part of Riraku's strength lies in its training program, which means newly-hired therapists can be brought up to speed and deployed within the store network in accordance with expansion requirements.

The2013 Yano Research report notes that one the major problems facing new and existing massage salons is a lack of qualified therapists. It

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results in many outlets closing despite good sales performance.

Another similarity between QB House and Riraku is that both depend on heavy foot-fall, although when it comes to locations their strategies is slightly different. Whereas QB House likes to be based near train stations, Riraku favors roadside locations, often in suburban areas.

Murakami observes that, while this is Advantage's first investment in the massage salon space, another portfolio company that shares a number of characteristics with Riraku is Komeda Coffee. This is a Nagoya-based restaurant and coffee shop chain in which the private equity firm acquired a 78% stake for JPY15 billion in 2008. It expanded the business domestically and exited five years later to North Asia-focused buyout firm MBK Partners for an estimated JPY40 billion, generating a 7x return.

"Like Riraku it targeted the lower end of the market, at a much lower price point with greater value for money, and it also favored roadside locations," says Murakami.

As with Komeda, which focused on opening stores swiftly in response to customer demand, much of Riraku's success is expected to be predicated on its ability to grow its footprint. However, Takenouchi notes that the biggest challenge for the company has been determining which locations are most optimal for opening new stores.

In terms of geography, Riraku has traditionally been focused on Kansai, the western region including cities such as Osaka and Kyoto. Therefore, the company first concentrated on expansion into Tokyo and then turned its attentions nationwide. This has involved targeting more remote prefectures like Hokkaido in the north and Okinawa in the south, where the company now has 14 and four stores, respectively.

Riraku does not follow a franchise model, preferring to rent and operates each stores directly. The typical outlet is around 120-180 square meters in size and can hold 10-15 beds. The company particularly likes former convenience store premises that offer parking spaces and smaller urban locations within larger buildings.

"We wanted to open the stores at as low a cost as possible, so former convenience store locations have been a huge opportunity for us," says Murakami. "If we get any information that a store has closed we look at the possibility of opening a Riraku."

To make this process more efficient, Advantage had helped set up a store development team of eight professionals. Over the last two years the team has seen number of outlets expand by around a 100 per year, which equates to seven per month. Riraku now has 400 stores.

Well-oiled operations

Beyond expanding the company's footprint, Takenouchi says Advantage has also helped improve efficiencies in terms of operations and decision-making. He notes that prior to the investment, the founders took full responsibility for all major management decisions. Advantage led the establishment of more structured and organized processes involving a larger number of senior management.

"One area where Advantage was particularly helpful was with compliance," he says. "Previously, when I was making compliance-related decisions, it was basically me operating on my own, and there was a risk I could have made the wrong decision. Now there are several people in the process, so it is more transparent and thorough. In that respect, things are moving in a better direction."

Another key area of improvement has been the company's IT infrastructure. Accelerating expansion meant that Riraku required a system that could collect and analyze information from a large number of stores and customers, and then feed that into strategic decision-making.

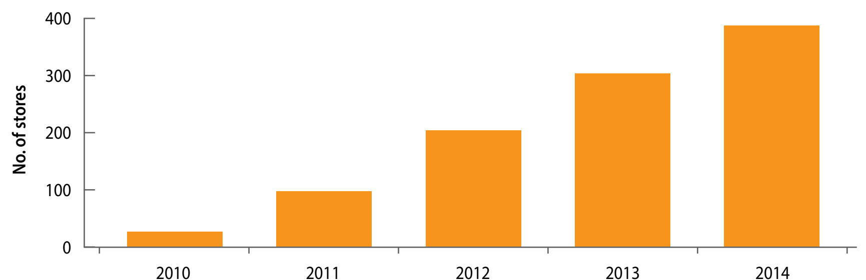
"Prior to the investment, each store was managed manually so a daily report would be faxed to headquarters and accounting staff had to input the numbers," Murakami explains. "With the roll-out of the new IT system into all our stores we can now operate more efficiently, analyze sales and customer data and develop marketing activities. We started to roll out the system from April of this year."

As to Riraku's longer-term objectives, Takenouchi identifies continued domestic expansion. While overseas expansion is being considered, he believes there is still room for further penetration of the home market.

At the same time, there are plans to diversify the menu of services on the menu. A recent example of this has been Riraku's core stretch offering, a so-called "fitness and body maintenance-focused" service, which involves a sports massage, starting at JPY3,600 for 30 minutes and running to JPY9,700 for 90 minutes.

"We expect the relaxation industry will keep on growing steadily. Even small franchise operators are able to make money," says Murakami. "Demand is very strong and we don't see any other big massage relaxation salon operators at this price point. We think this demand won't lose momentum for some time, so we are putting the company on track to reach 1,000 stores over the next several years."

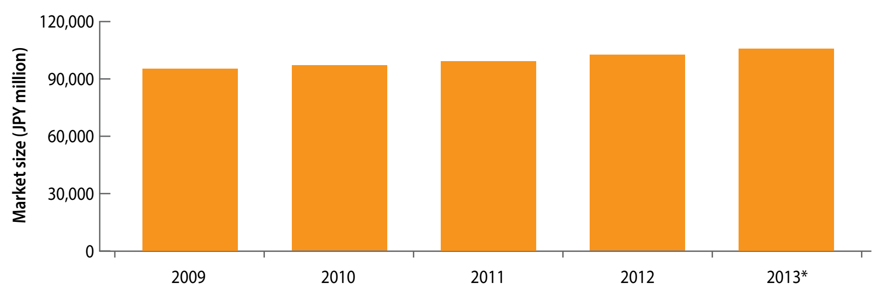
Riraku new store openings



Source: Riraku

Note: 408 stores have opened as of May 2015

Growth of the quick massage and reflexology market in Japan



Source: Yano Research Institute

* Estimate based on 2013 figures

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