



# The ties that bind

Why Chinese VC spin-outs are staying close to their former parents [Page 9](#)

## EDITOR'S VIEWPOINT

**China's questionable bike-sharing boom**

[Page 3](#)

## NEWS

**Carlyle, CDC, CLSA, EDBI, Formation Group, Hony, IL&FS, MBK, Sequoia, Warburg Pincus, Yunfeng**

[Page 4](#)

## ANALYSIS

**Currency-juggling GPs and conflicts of interest**

[Page 17](#)

## FOCUS

**Regulators restrict China outbound investment**

[Page 20](#)

## INDUSTRY Q&A

**GGV Capital's Jenny Lee**

[Page 23](#)

## AVCJ RESEARCH

**Data file** [Page 27](#)

## FOCUS



# A pending windfall?

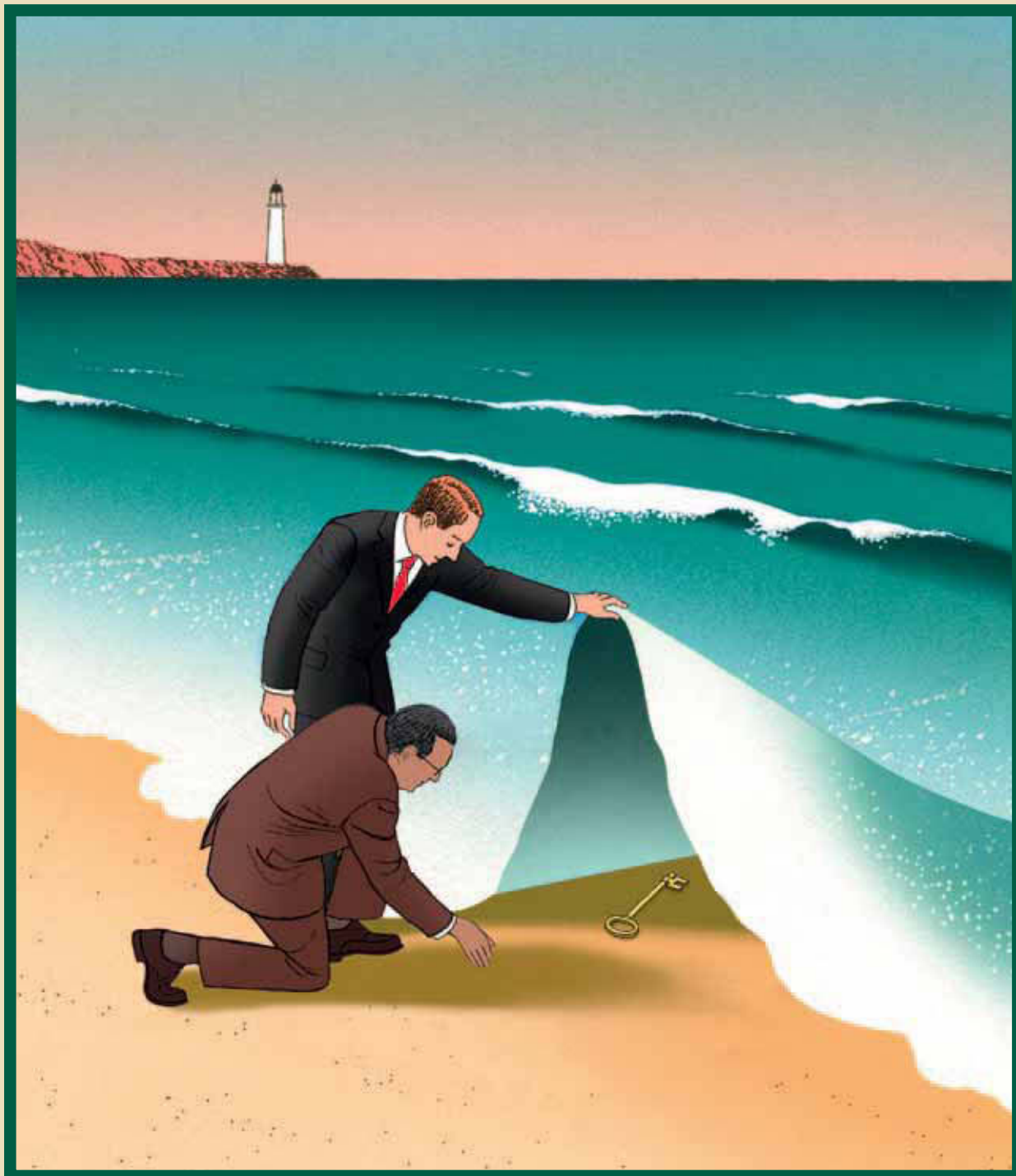
GPs sense a surge in China bad debt sales [Page 13](#)

## FOCUS



# Davids and goliaths

Cloud start-ups press on amongst giants [Page 25](#)



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# Business cycles

## NOTHING SCREAMS SUSTAINABILITY IN A

cut-throat battle for market share like a new PE commitment. This kind of tit-for-tat was apparent in China's ride-hailing app space when Didi Dache and Kuadi Dache (now happily merged as Didi Chuxing) were vying for supremacy. Over the last 12 months it has moved from four wheels to two as private capital fuels the expansion ambitions of bicycle-sharing start-ups.

Towards the end of February, Mobike announced a strategic investment from Singapore's Temasek Holdings and a re-up by Hillhouse Capital. It followed a \$215 million Series D round of funding in January led by Tencent Holdings and Warburg Pincus, and then a commitment from Foxconn Technology Group. Within a week, Ofo confirmed its own Series D round – worth \$450 million and led by DST Global.

The two companies' Series C rounds were also announced within days of each other in October 2016: Ofo received \$130 million across two tranches, one of them led by Didi; and Mobike raised in excess of \$100 million, led by Hillhouse, Warburg Pincus and Tencent.

This all-too-familiar arms race has seen Mobike enter 21 cities, with more than 100,000 bikes in each of Beijing, Shanghai, Guangzhou and Shenzhen. It claims to have served over 10 million users, who have completed in excess of 200 million paid rides. Ofo, meanwhile, now provides over one million bikes across 40 cities in China, Singapore, the UK and the US, with about 20 million registered users.

Comparisons are difficult based on disclosed data, but iResearch Consulting has Mobike as the China market leader, with 5.85 million active users in the first week of 2017, four times more than second-placed Ofo. They are not the only bike-sharing start-ups to receive VC funding. In the past three months the likes of Ubike and Bluegogo have closed funding rounds, but they can't match the big two for scale.

Bike-sharing schemes entered Western markets as government-backed urban

development initiatives and China has seen similar activity: the Hangzhou program is the largest globally, with 66,500 bicycles for hire. However, state-run systems are said to be inefficient and the bicycles often unreliable. This and increasing smart phone penetration have created an opening for start-ups.

There is little differentiation in business models. An app displays each available bicycle in the vicinity of the user and allows a 15-minute pick-up window after booking. A bike is unlocked by scanning its QR code and the app records how far the user has ridden. The service costs RMB1 per half hour, although – much like the subsidies offered to drivers and passengers as inducements to use ride-hailing apps – this fee is reportedly being waived at certain times.

Scale is said to be especially important in the bike-sharing space because in most cities the average frequency of use per vehicle is lower than for ride-hailing. Ofo initially focused on university campuses, where usage density is relatively high, but it remains to be seen if the company can achieve scale and sustainability in other markets – domestically and overseas – where user tastes and habits differ. This question is already being asked in China amid reports of bikes being vandalized, stolen, or simply standing unused. Needless to say, costs of upkeep must also be factored into the equation.

For now, though, profitability doesn't appear to be a priority. Investors are happy to bankroll the battle for market share, presumably in the expectation that a) Mobike and Ofo will eventually merge, creating a single dominant player able to pursue a sustainable economic model; b) these companies will prove they can serve as platforms for a range of other services, thereby achieving critical mass; or c) a bit of both.

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## ASIA PACIFIC

### Formation closes debut US-Asia fund at \$357m

Formation Group, a Silicon Valley and Asia-focused venture capital firm established by Brian Koo, co-founder of Formation 8, has closed its debut fund at \$357 million. The vehicle will invest in a concentrated number of early and growth-stage companies with global ambitions, and seek to play a hands-on role in their development.

### Quona, Accion close \$141m global fintech fund

Quona Capital and emerging markets microfinance group Accion International have closed a \$141 million global venture fund dedicated to financial technology – said to be the first to target unbanked and underserved markets. The Accion Frontier Inclusion Fund will focus in part on India and Southeast Asia.

## GREATER CHINA

### Chauffeured car service Ucar raises \$668m

Chinese chauffeured car service provider Ucar, which is backed by Warburg Pincus and Yunfeng Capital, has raised RMB4.6 billion (\$668 million) through a private placement on the National Equities Exchange and Quotation (NEEQ). Investors included China UnionPay, AXA SPDB Asset Management, Shanghai Goldseed Capital, and CICC Qiyuan National Emerging Industry Venture Capital Fund.

### JD.com spins off VC-backed financial unit

Chinese online retailer JD.com has agreed to sell its entire 68.6% stake in its financial unit JD Finance, which is backed by Chinese investors including Sequoia Capital China, for RMB14.3 billion (\$2.1 billion) in cash. JD.com will take 40% of JD Finance's pre-tax profits once it becomes profitable or it could swap that right for a 40% stake in the business. Richard Liu, CEO of JD.com, will retain a majority voting right.

### China Lodging to acquire Crystal Orange Hotel

China Lodging Group, a US-listed Chinese hotel chain, has agreed to buy Crystal Orange Hotel Holdings, a Chinese boutique operator backed

### HPEF strikes incentive deal with LPs over Asia fund

HPEF Capital Partners – formerly known as Headland Capital Partners – has won LP approval for an incentive scheme that ties in a reconstituted team to manage the existing portfolio, and the principals still hold expectations of raising a successor fund should they achieve their performance target.

The GP was seeking around \$1 billion for its seventh fund, but announced in September 2015 that fundraising had been suspended. At the time Fund VI had about three years to run and



eight portfolio companies. All but three of the original team have departed, while Vincent Low, a General Electric veteran who was most recently head of Actis' value creation team in Southeast Asia, has joined as senior partner and head of portfolio management. There have also been two new hires in Singapore.

Fund VI, which closed in 2008 at \$1.47 billion, is tracking below par. It has generated a 1.6x return on realized investments. The incentive scheme will see the team participate in the fund's upside above an agreed target. CEO Marcus Thompson and Low will also make personal investments in the fund. "If we do a good job with respect to this portfolio the desire is there to raise a new fund," Thompson said.

by The Carlyle Group, for RMB3.65 billion (\$530 million) in cash. Crystal Orange has 100 hotels located in tier one and tier two cities across China, with brands targeting different segments of the market.

### PAG to pay \$612m for Yingde Gases stake

PAG Asia Capital has submitted a cash offer worth HK\$4.7 billion (\$612 million) for a 42.1% stake in Chinese industrial supply company Yingde Gases. The bid – of HK\$6 per share, exceeding an offer made by US-based Air Products in January – is conditional on PAG building up a more than 50%

stake through additional purchases from other shareholders.

### Bike-sharing start-up Ofo raises \$450m

Ofo, a Chinese bike-sharing company, has completed a \$450 million Series D round of funding led by DST Global. Other investors in the round include local ride-hailing app operator Didi Chuxing, CITIC Private Equity, Matrix Partners China, Coatue Management, VC firm Atomico, and Chinese conglomerate Macrolink Group.

### Hosen closes \$440m food and agri fund

China-focused food and agriculture specialist Hosen Capital has closed its third private equity fund at \$440 million after eight months in the market. The target was \$400 million. The vehicle received a \$30 million commitment last year from the International Finance Corporation. Additional LP support came from institutional investors across Asia, the US, Europe and the Middle East.

### Hony healthcare platform launches HK IPO

Hospital Corporation of China (HCC), a hospital group established by Hony Capital, is seeking to raise as much as HK\$500 million (\$64 million) through a Hong Kong IPO. The group currently manages two general hospitals in Shanghai – including Yangsi Hospital, the largest privately-owned hospital in the city – and wants to further consolidate medical resources in the region.

### Foxconn buys into SoftBank investment unit

Taiwan-based Foxconn Technology Group has acquired a 54.5% stake in an investment subsidiary owned by SoftBank Group for \$600 million. SoftBank Group Capital APAC, previously known as SB China Holdings, was set up in 2000 in Singapore. It had assets of \$25 billion as of March 2016, but most of these have been transferred to SoftBank Group, which will retain a 45.5% interest in the unit.

### Partners Group invests in restaurant chain

Partners Group plans to acquire a 30% stake in Affluent Fine, a holding company that operates restaurant chains in China. Affluent Fine owns restaurant chains in China under the Green Tea Restaurant, Play King Pizza and Guan Dong Zao brands.



# First Order of Business: Secondaries

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## Rural e-commerce platform raises \$145m

Maihuolang Information Technology, which operates Chinese agriculture-focused e-commerce platform 51mhl.com, has raised a RMB1 billion (\$145 million) Series A round of funding from investors including Shenzhen New Industry Venture Capital, Shenzhen Weiji Investment and Qianhai Great Wall Fund. The company sells agricultural foods, supplies, farm tools and home appliances via its website, mobile app and WeChat.

## Robotics start-up CloudMinds raises \$100m

CloudMinds, a Chinese cloud-based robotics start-up has closed a \$100 million Series A round of funding from investors including SBCVC, Foxconn Technology Group, Shenzhen Capital Group and Walden International. The company aims to launch a humanoid family service robot by 2025.

## CLSA invests in e-commerce player Azoya

CLSA Capital Partners (CLSA CP) has invested in Chinese cross-border e-commerce solutions provider Azoya. The GP joined several unidentified existing investors as part of the deal. It marks the third round of funding for Azoya, which provides overseas retailers with a platform to sell their goods in China.

## NORTH ASIA

### GPs to exit as Comcast takes 100% of USJ

Goldman Sachs, MBK Partners, Owl Creek Asset Management and PAG Asia Capital will fully exit Universal Studios Japan (USJ) after Comcast NBCUniversal agreed to buy the 49% of the company it doesn't already own for JPY254.8 billion (\$2.3 billion). It values USJ at JPY840 billion, including debt. Comcast paid JPY183 billion for a 51% stake in the theme park operator in 2015.

## SOUTH ASIA

### Alibaba, SAIF invest \$200m in Paytm

Alibaba Group and SAIF Partners have invested \$200 million in the online marketplace unit of Indian online payments platform Paytm

## New GPs will not shake Australia PE dynamic

The Australian PE market has seen the emergence of a number of new GPs but incumbent managers told the AVCJ Australia & New Zealand Forum that they do not expect much change in the competitive landscape.

Odyssey Private Equity, which was set up by former executives from CHAMP Ventures and Quadrant Private Equity, recently closed its debut fund; Pacific Equity Partners (PEP) spin-out Adamantem Capital is currently fundraising; and the likes of Ben Gray and Andrew Gray – previously of TPG Capital and Archer Capital, respectively – are expected to follow suit. There



are also various other investment professionals working on a deal-by-deal basis.

However, both Archer and PEP said it has been at least five years since they went head-to-head against another domestic GP for an asset. "The industry has evolved. We are spending more time and being more proactive on transactions, looking for an angle or an investment thesis that is unique," said Peter Gold, a managing director at Archer. "We are our own biggest competitor."

To a certain extent, the new entrants represent the industry returning to equilibrium following a market shakeout in the wake of the global financial crisis.

at a reported valuation of \$1 billion. Paytm E-Commerce was created last year in an effort by Paytm to differentiate its online marketplace from the better-known electronic wallet, which was incorporated into Paytm Payments Bank.

### IL&FS, Lone Star form distress partnership

India's Infrastructure Leasing & Financial Services (IL&FS) has launched a \$550 million fund to invest in domestic distressed infrastructure assets with US-based GP Lone Star Funds. The fund will buy underperforming assets currently held by other GPs, asset reconstruction companies and banks,

aiming to help these investors recycle capital and reinvest in new projects.

## Providence completes Idea Cellular exit

Providence Equity Partners has exited its remaining 3.3% stake in Indian mobile network operator Idea Cellular for INR12.9 billion (\$193 million). The GP bought a 15% stake in the company for around INR18 billion in 2006 about a year before its IPO and has exited in several tranches, most recently selling a 3.5% stake for INR13.8 billion last June.

## IHH part-exits Apollo Hospitals for \$160m

Integrated Healthcare Holdings (IHH), which is majority-owned by Khazanah Nasional, has sold part of its stake in India's Apollo Hospitals for INR10.7 billion (\$160 million). The government-controlled Malaysian investor retains a 4.8% stake in Apollo.

## CDC, Manipal commit \$20m to iGenetic

Indian healthcare testing business iGenetic Diagnostics has raised INR1.3 billion (\$19.9 million) from UK-based development finance institution (DFI) CDC Group and Indian conglomerate Manipal Education & Medical Group. The bulk of the capital is earmarked for four acquisitions planned for later this year.

## Updater Services gets \$15m from Motilal Oswal

Motilal Oswal Private Equity (MOPE) has invested INR1 billion (\$15 million) for a minority stake in Indian facilities management company Updater Services. The company is of India's top five integrated facilities management service providers with more than 700 clients nationwide.

## SOUTHEAST ASIA

### EDBI, Hewlett Packard back Hedwig's Asia push

Singapore's EDBI and the venture arm of Hewlett Packard's software spin-off HPE have joined a \$21.5 million funding round for an Asian expansion drive by US-based IT company Hedwig. Oman Technology Fund, Atlantic Bridge Ventures, True Ventures and Vertex Ventures also participated. It brings the company's total fundraising to \$52 million since 2012.

*The following appears as a matter of record only*

February 2017

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EXPERTS WITH IMPACT

# Daddy issues

Several managers in the latest generation of China VC spin-outs retain close ties to their former corporate parents. These relationships can deliver great deal flow, but also governance headaches

## SPIN-OUT NUMBER ONE: GENESIS

Capital. After spending seven years as head of M&A at Tencent Holdings, Richard Peng launched his own firm in 2015. Genesis focuses on growth stage investments, leveraging its networks and expertise with a view to helping Chinese internet start-ups achieve critical mass. Peng is said to be on course to beat the \$400 million target for his debut fund, having decided against raising capital from his former parent in order to attract institutional LPs.

Spin-out number two: a consumer fund launched by online-to-offline (O2O) services platform Meituan-Dianping. While professionals have been hired to oversee investments, they are subordinate to the parent's corporate development unit – and the primary objective is to expand its ecosystem through consumer sector deals. The fund, which is targeting \$440 million, has received commitments from the likes of Tencent and New Hope Group, but Meituan-Dianping is the anchor LP.

If Genesis is truly independent and the Meituan-Dianping vehicle isn't even independent in name, then GenBridge Capital sits somewhere in the middle. Two of its three founders worked in M&A at online retailer JD.com, but the GP is wholly-owned by the team, the investment committee is independent, and GIC Private is anchoring the debut fund of up to \$500 million. However, JD.com will contribute capital, people and deal-sourcing capabilities to the fund, and take half of the carried interest.

These three spin-outs offer a snapshot of how a new generation of venture capital firms in China is emerging. Over the past two years, various teams and individuals have struck out on their own, leaving established VCs or domestic internet giants such as Baidu, Alibaba Group, Tencent and JD.com. But in a competitive investment environment – yet one in which it is increasingly difficult to raise capital – how do these new arrivals convince international LPs that they are worth backing? For those with a corporate heritage, the answer might be not stray too far from their former parents.

"We are open to these corporate-backed venture funds because we do feel that China is a competitive market. If you have some kind of strategic backing and you manage it well, it's a

very powerful weapon. But it's a double-edged sword. You have to get the balance just right because in the US dollar world, investors are more cautious about conflicts of interest," says Doris Guo, a partner at Adams Street Partners.

## VC 3.0

According to Tommy Yip, founder of fund-of-funds Unicorn Capital, which specializes in backing emerging Chinese VC managers, China entered the VC 3.0 phase in 2013. This was when younger professionals increasingly started spinning out from top firms in order to address different kinds of market opportunities. It is distinct from VC 2.0, when GPs would leverage whatever affiliations they could to get started, whether it was a US VC firm or a Chinese corporation like Legend Holdings.

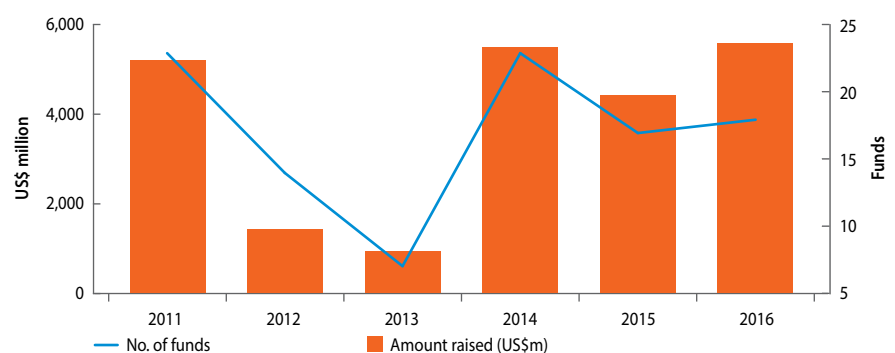
Shunwei Capital Partners and Yunfeng Capital, both founded in 2011, were arguably the progenitors of this trend. The former was set up by Lei Jun, a serial entrepreneur and angel investor best known for smart phone maker

Most of the money went to established names, but there were a couple of fully-fledged spin-outs: Banyan Capital was established by a team from IDG and Source Code was founded by a former executive at Sequoia Capital China.

Starting primarily with commitments from high net worth individuals – including entrepreneurs they had backed while at their previous firms – both GPs quickly gathered momentum and raised successor funds that took them beyond the very early-stage space. For example, Banyan closed its debut fund at \$206 million in early 2014, raised a \$362 million second vehicle 12 months later, and then three months after that received an additional \$100 million for follow-on investments.

The fervor surrounding Alibaba's IPO in late 2014 translated into growing appetite for China VC exposure across the spectrum. More spin-outs followed: Volcanics Venture from IDG, Yunqi Venture from Sequoia, and Blue Lake Ventures and Joy Capital from Legend Capital. Early-stage investment was a common theme.

China VC fundraising: US dollar



Source: AVCJ Research

Xiaomi; the latter is the brainchild of Jack Ma and David Yu, founders of Alibaba and Target Media, respectively, who put assembled a roster of Chinese entrepreneurs as founding partners and Fund I LPs, with a view to leveraging their networks and operational capabilities.

A total of \$5.5 billion was committed to US dollar-denominated China VC funds in 2014, more than for the previous two years combined.

"Senior professionals are seeing new opportunities in the market and they are confident enough to launch their own firms. Sometimes it is because their existing organizations are getting larger and investment strategies are changing. For example, the focus may shift from growth capital investments to larger deals – and because these professionals want to continue doing what they have done

## Private equity spin-outs

The first private equity spin-out in China happened when the industry itself was barely five years old. In 2002, brokerages were barred from owning captive PE units, so a team from China International Capital Corp. (CICC) departed to form CDH Investments. They started out with four LPs and \$100 million in capital.

Other spin-outs have followed at irregular intervals. FountainVest Partners was created in 2007 by a team out of Temasek Holdings, while Fred Hu, formerly Greater China chairman at Goldman Sachs, founded Primavera Capital in 2010. Other firms, such as Boyu Capital, represent amalgamations of executives from several firms. More recently, Forebright Capital and Everbright Reinfore have both come out of China Everbright International. Activity has inevitably been more frenetic among the renminbi-denominated managers.

"Spin-outs happen in China all the time. It's a natural evolution when a market grows and becomes mature. Before 2011, there were managers who spun out from the state-owned enterprises and banks and launched first-time PE funds," says Jun Qian, head of China at global asset manager Adveq. "Between 2014 and 2016, many VC professionals spun out from big names and that caught people's attention."

The headline spin-out for 2017 involves David Liu and Julian Wolhardt, who previously led KKR's private equity business in China. The pair have yet to launch a fund or outline a strategy, but it is suggested in some quarters that they might start by raising renminbi capital for deployment on a deal-by-deal basis so as to avoid conflicts with KKR. Ultimately they must convince LPs that they can be as effective outside a big organization as they have been inside one.

"When managers spin out, especially from brand-name platforms, LPs will ask: Are you able to effectively source deals and add value to the portfolio companies when you're not holding the same business card? How much did the brand contribute to your previous success?" says Chris Lerner, partner and head of Asia at placement agent Eaton Partners.

LPs must provide their own answers to these questions through comprehensive due diligence. In emerging markets like China, global private equity firms enjoy little or no name recognition so they rely heavily on local teams to build out their brands among the founders and owners of local businesses. As a result, the personal touch counts for a lot.

"At the end of the day, private equity is a people business. For a buyout of a family-owned business that is not intermediated, sourcing and execution is often the responsibility of individual managers. If one of these individuals leaves a firm, track records can be verified by speaking to the portfolio company management and to banks that provided financing to the deal," says Niklas Amundsson, managing director at Monument Group.

before, they decide to leave," says Mingchen Xia, a managing director at Hamilton Lane.

Fundraising for US dollar China VC vehicles hit a new high of \$5.6 billion in 2016, as LPs dialed up their exposure to technology, media and telecom (TMT), healthcare and other bastions of the new economy. A growing number of spin-outs from corporates are looking to win their backing.

Ameba Capital, launched for ex-Alibaba executive Andrew Teoh, has scaled up in fund size, Baidu M&A head Hesong Tang established Xianghe Capital, and Peng went to market with Genesis. Other senior alumni of Baidu, Alibaba and Tencent have forged ahead in the angel space, with the likes of Unity Ventures and Crystal Stream Capital.

### Close relations

The sweet spot for corporate spin-outs is growth- to late-stage investments, given where

they tend to have focused in their previous organizations. However, this notion of "more of the same" doesn't resonate with all LPs. When assessing the track record of someone who has come out of a corporate, it is important to note that investments could have been motivated by strategic considerations rather than pure economic rationale. Moreover, it is often hard to tell whether successful deals were driven by the person or the platform.

"When professionals from large TMT companies approach us regarding their new funds, the first question I will ask is: 'Has your strategy changed?'" says Jun Qian, head of China at Swiss asset manager Adveq. "In the past, they might have invested in every single part of the sector in which the corporate operates. If they tell us they backed 300 companies in the space of two years, that's probably not the kind of investment style we like."

On the other hand, a corporate background

and relevant connections can translate into deeper industry insights and better deal flow. Vision Plus Capital, set up by Alibaba co-founder Eddie Wu and James Wang, formerly a principal at Qiming, is a classic example. Based in Hangzhou, not far from the Alibaba headquarters, the GP positions itself as a market-oriented VC that leverages the Alibaba's ecosystem. Having established through research that start-ups are more likely to be successful if they have ex-Alibaba employees on their founding teams, Vision Plus favors with this profile.

"When start-ups raise Series C or D rounds of approximately \$1 billion, they look for Alibaba or Tencent as their strategic investors, whether it's because they want to leverage Alipay's user base or launch a product in partnership with WeChat. We want to invest in those start-ups early on," says Wang. "By being close to Alibaba's headquarters, we quickly find out which employees have left to start their own businesses, and we make a reference call with their respective senior managers and understand more about their personalities and strengths."

Although a close relationship with Alibaba is part of the Vision Plus DNA, Wu and Wang do not want to be beholden to the e-commerce giant. As such, they are open to collaboration with groups such as JD.com and Tencent and half of the firm's investment team previously worked at Temasek Holdings and GGV Capital. According to LP sources, Alibaba doesn't hold a stake in the GP, although Alibaba and several Alibaba executives have also contributed capital to the fund.

From the perspective of an offshore LP, the presence or absence of these fund commitments are indicators of how close a spin-out GP remains to its former parent. Xianghe counts New Enterprise Associates (NEA) as a significant LP, but the family office of Baidu founder Robin Li is also said to be an investor. The implication is that Tang remains plugged into the Baidu network.

Other arrangements are more formal. When Alibaba invested \$100 million to Yunfeng's second fund, the company justified the move in its IPO prospectus by saying the LP tie-up "formalized an institutional relationship" with the GP. The GenBridge-JD.com relationship appears to be forged along similar lines. In addition to the corporate participating in the fund and enjoying a piece of the carried interest, JD.com founder Richard Liu and other management team members will make LP commitments.

If the alliance is too close, however, LPs can get uncomfortable. "Some captive funds handle conflicts of interest very well through a standardized governance structure. They ensure investment decisions are made independently and the team is incentivized by the carry. We prefer the investment team to keep a majority of

the carry. If the parent takes a large portion, the team might separate because they are not fully incentivized," says Hamilton Lane's Xia.

#### Independence day?

For fully captive VC firms, there is also the longer-term question of whether they want to become independent. It is estimated that about 100 funds were launched in 2014 by A-share companies and private enterprises. These could feasibly become the next generation of spin-outs seeking capital from international LPs, but it remains to be seen on what terms this might happen. How will ownership of the GP be structured and the economic interests divided up?

Lilly Asia Ventures (LAV) represents an example of a successful transition to independence, while retaining elements of an alliance with the former parent. Between 2008 and 2010 it was a corporate VC arm under Eli Lilly, and the global pharmaceutical player served as the sole LP in the first two funds raised following the spin-out. From Fund III onwards, LAV has raised capital from a mixture of sovereign wealth funds, fund-of-funds and family offices, while Eli Lilly's contribution has gradually reduced.

Parallels can also be drawn with the financial world and the relationship between global VC firms and their China affiliates. The China team of

Lightspeed Partners went independent in 2012 and received a substantial LP commitment from the parent for its debut fund. More recently, Long Hill Capital and Redpoint China came to similar arrangements with NEA and Redpoint Ventures, respectively.

Spin-outs are likely to continue as China's venture capital market matures, but it remains

Adams Street's Guo. "It is difficult for new firms to establish themselves."

The pressure doesn't necessarily abate once a spin-out raises its first fund. When the GP returns to market, LPs want to see evidence of the investment thesis working in practice and of steps being taken to reach the next level. Banyan started with three founders from IDG but in the

**"If you have some kind of strategic backing and you manage it well, it's a very powerful weapon. But it's a double-edged sword"**

— Doris Guo

to be seen how easily these managers can raise money. Many North American LPs are no longer expanding their portfolios by number of China GP relationships, so a new arrival would have to make a strong case for displacing an incumbent, underpinned by a solid track record. Prospective investee companies would expect to hear an equally convincing argument before taking money from these managers.

"Earlier spin-outs came from a variety of different firms, but now new franchises have to make more successful investments before they are attractive to LPs and entrepreneurs," says

space of three years it has evolved into a team of 30 with financial and operational backgrounds.

"It is challenging to build and develop a new firm from the ground up. Everyone questions whether you can still do well on leaving your old firm, and whether you can attract new talent, cultivate a sustainable corporate culture, and develop a differentiated investment strategy," says Zhen Zhang, co-founder of Banyan. "But when a firm grows to a certain size, the background of the founding partners becomes less important. You then face questions about improving internal systems and strengthening team work." ■

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# Great expectations

Foreign private equity firms are positioning themselves to address an anticipated surge in non-performing loan sales to third-party investors. Will the reality match the hype?

## “I PREVIOUSLY DID NPLS [NON-

performing loans] in Japan and Korea during the Asian financial crisis. In the 20 years since then I’ve been following the China market and thinking about whether this was a scalable opportunity, and every time the answer was no,” says Kei Chua, a managing director with Bain Capital Credit (BCC). “But this time it’s different.”

BCC is a seasoned distressed debt investor globally but it has previously barely touched NPLs in China. Now, though, with the firm looking to raise up to \$1 billion for its first Asia special situations fund, NPLs are expected to account for as much as half of the overall China activity. BCC has 14 people in Asia dedicated to special situations – other professionals in the firm provide support – and there are a dozen more in China through arrangements with asset servicers.

The firm is not alone in wanting to deepen its talent pool. Lone Star, Oaktree Capital Management, Avenue Capital Group, PAG and Goldman Sachs are among those looking at distressed debt with renewed interest. One industry participant – echoing sentiments expressed by several others – says there has been “an open hit out on anybody who has worked at Shoreline Capital,” perhaps the most established China NPL investor.

Two years ago, as it became apparent that casualties from the 2008 credit boom China instigated to minimize the local effects of the global financial crisis were filtering through the system, there was a lot of talk from foreign investors but little action. The recent recruitment drive suggests investors are gearing up for a concerted push into the market.

## Then and now

China’s loan book has quadrupled in size since the mid-2000s when investors last piled into the space only to find that deal flow was not as rich as expected. Assuming the banking industry’s NPL ratio is five times the official estimate of around 1.7%, what Chua currently sees as a \$200 billion opportunity could reach \$1 trillion (other estimates are as much as \$3 trillion, based on a higher perceived NPL ratio). But much rests on the government making banks take action and investors having the right people and processes in place to generate meaningful returns.

“It’s not like the first cycle in 2001-2007

when there was an orchestrated process by the government to sell off the NPLs,” says Ted Osborn, a partner at PwC who focuses on restructuring and NPLs. “This time around there is a lot of musical chairs – banks selling at face value to related companies, talking up securitizations and debt-for-equity swaps – and the problem isn’t being dealt with. Foreign investors will be able to find opportunities if they are persistent, but as to when the market is going to get really big, I don’t see a catalyst for that right now.”

Regardless of skepticism about the government’s willingness to force the issue, there are several structural reasons why NPLs are more accessible than before. First, the quality of the loans is higher. If the last cycle was characterized by portfolios of unsecured NPLs involving state-owned and often largely defunct businesses, the current cycle features private sector companies that are still in operation and more effectively collateralized.

Second, the enforcement infrastructure is much improved. Courts have become increasingly efficient in resolving NPL cases,

banks’ NPLs in the previous cycle have diversified their business lines considerably. The bulk of their income comes from other forms of financing – from direct lending to buying real estate projects to private equity – which means they are incentivized to sell on NPL portfolios as quickly as possible to third parties rather than try to resolve them.

On top of that, the sheer volume of NPLs coming through the system is more than the Big Four can handle, hence the decision to alleviate the bottleneck by awarding licenses to more than 20 new provincial-level AMCs. These groups are looking to build up resolution capabilities and Ben Fanger, who departed Shoreline last year to establish ShoreVest Capital Partners, claims to have been approached by several of these groups with a view to forming partnerships.

## Taking aim

ShoreVest is tracking \$20 billion worth of potential investments and is primed to make acquisitions using capital sourced from a global asset manager. Deals can be as small as \$10

**“Foreign investors will be able to find opportunities if they are persistent, but as to when the market is going to get really big, I don’t see a catalyst for that right now”**

– Ted Osborn

making it easier for investors to predict cash flows. There is also more information to work with thanks to closer scrutiny by the banking regulator and greater transparency in the property market regarding land title ownership and registration of collateral.

“You didn’t really have an active market for selling collateral until the last few years,” says BCC’s Chua. “There are tools that enable you to triage portfolios from your desktop before engaging in deep underwriting. You have good information on buyers, comparable transactions you can look at in order to price effectively, and outlets for marketing properties that are for sale.”

Third, the Big Four asset management corporations (AMCs) established with the sole purpose of resolving the major state-owned

million in size and as large as \$300 million, with an average of \$30-50 million. BCC is seeing opportunities in a similar range: RMB200-300 million (\$30-44 million) investments in portfolios with original principal balances (OPB) of anything from RMB600 million to RMB2.5 billion.

PAG bought its first portfolio last year, which had an OPB of RMB10 billion. It was an auction process run by an AMC, as required by the regulator, but essentially a bilateral deal negotiated with a bank; the AMC received an intermediary fee. In these situations, the buyer approaches the bank early on and might get two months to conduct due diligence. The portfolio is then opened up for general bidding, but with a one-week turnaround – generally insufficient time for rival bidders to firm up the pricing.

"It wasn't long before we started receiving calls from local guys who wanted to buy some of the loans," says Eddie Hui, a managing partner in PAG's absolute returns division. "You never know why they are interested. We did our own due diligence, but the one thing they can usually quantify is the personal guarantee: they might be able to leverage their local knowledge to collect money from borrowers in situations where the collateral value doesn't look good."

In a portfolio of this size comprising approximately 40 borrowers – and more than one loan per borrower – packaging up portions for sale to third parties is not unusual. For

to a local guy. It was a \$30 million deal, sizeable for a local player, so it was broken up into pieces. While a \$100 million deal would be unusual, the numbers are creeping up."

## Domestic rivals

Local capital has poured into the space over the last 18 months, much of it from high net worth individuals (HNWIs), traditional private equity firms, and vehicles backed by listed companies. Pricing has adjusted accordingly. "The prices in recent transactions have been pushed to levels that are difficult to justify from Shoreline's perspective. In our view, the market will cool

proposition is based on detailed knowledge of a handful of borrowers and relationships with regulators and legal officials within specific geographic areas. Executing the same strategy with several hundred borrowers on a nationwide basis is a substantial undertaking.

Shoreline, for example, has a team of more than 40 people in China and claims to have signed agreements with over 50 servicers across the country over the last few months. In addition, the firm is considering opening offices in different provinces that would serve as points of contact for servicers and outposts for gathering information on what local banks and AMCs have in the pipeline. "The NPL business is a very local business, and first-hand information from the market will help us to better serve the clients – banks and AMCs – as well as our servicers" says Tony Liu, COO at Shoreline.

In this context, scale is also a concern for any foreign investor addressing the China market. More advanced industry infrastructure means foreign distress specialists can introduce global best practices and technology, allowing them to track portfolios more systematically, but they still need bodies on the ground to service and enforce on loans.

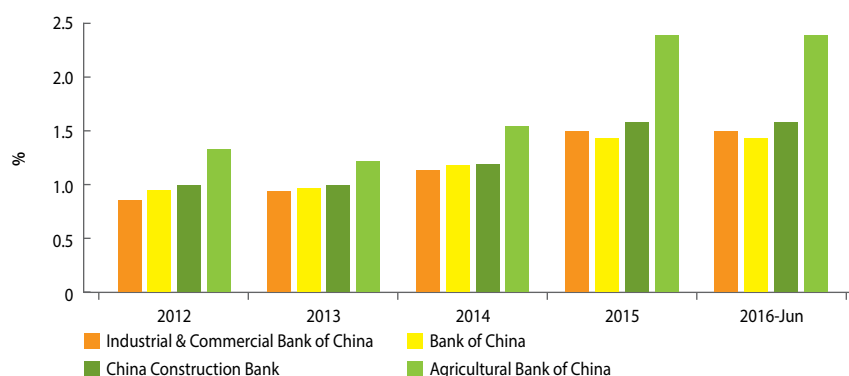
Local servicing platform Gao Fei employs about 50 people and is increasing headcount by nearly 10% a month as it takes on more jobs from domestic and offshore groups. Phil Groves, founder and president of DAC Management, Gao Fei's parent, observes that there is "a lot of fear" among foreign investors about going into China without the a partner that has the full set of licenses. But should an investor maintain a skeleton staff in Hong Kong and rely on outsourcing or build up an in-house team?

Hui describes PAG's model as a combination of the two. The firm currently has six people dedicated to China NPLs, four of whom are in Shanghai working on the portfolio acquired last year. The plan is to increase headcount with each additional purchase. "Maybe there will be 10-15 when we reach a meaningful size," Hui says. "We will still use servicers. We are more hands-on than some people, but we can't do anything like the US and Europe, building a 100-person servicing team."

## Complexity counts

Not all investors consider the investment to be worth it. Edwin Wong took part in the first China NPL transaction to feature foreign investors in 2002 while at Lehman Brothers. SSG Capital Partners, a spin-out from Lehman's Asia special situations business, has "strategic plans" for the space, but it does not believe the returns are at present commensurate with what its LPs expect. Wong cites local competition and a shortage of

NPL ratios of China's Big Four state-owned banks



Source: Company reports

example, an investor might identify 50 loans in a portfolio of 200 where the seller hasn't priced in full value and by resolving those situations alone it can more than cover the reserve price. Those NPLs warrant active management, but the rest do not, so they are offloaded to other investors who think they can extract value.

The question for foreign investors targeting the NPL space is the extent to which these local players are emerging as genuine competitors as opposed to just downstream buyers. While renminbi-denominated investors tend to occupy the sub-RMB200 million space, which means there is minimal overlap with their offshore peers, there are reports of domestic firms with resources to address RMB500 million transactions. AMCs are also tailoring transactions to suit the smaller end of the market.

"The AMCs want to deal with local people because there are fewer approvals and less scrutiny of the transactions than if they were to sell to a foreigner," says PwC's Osborn. "We lined up a deal for a foreign investor but the AMC got tired waiting for a decision and said, 'If you don't get back to us by this date we're going to sell locally because these guys are ready to go.' We didn't get back to them in time and so they sold

down because it is important to have the right disposition capabilities and capital structure," says Xiaolin Zhang, co-founder and managing partner at Shoreline.

According to multiple industry participants, the structures are often far from healthy. A lot of the capital comes from HNWI's who participate in expectation of a 2-3 year holding period, far shorter than traditional NPL funds. Structures are also highly levered, with a senior debt tranche provided by banks at high cost or through products sold to retail investors – in some cases online peer-to-peer lending networks have been used – on the understanding of a guaranteed return.

"If it is two-year money targeted at a couple of portfolios, they then need to be resolved, pay cash interest and pay capital to investors. The return is the spread between that high net worth money and what you think you can resolve on the loans – and when bidding so high for small portfolios there is a real risk of not achieving those returns," says BCC's Chua. "The whole concept behind a portfolio is the diversification it provides and the ability to scale up."

Scale is something local players understandably struggle to achieve. Their value

sizeable portfolios as the primary obstacles.

These conditions can leave investors in a bind: it is unclear how big the China NPL opportunity will be in this cycle or how long it will last, but if they do not properly engage at the local level they will be left scratching the surface. While the improvements in loan quality and the enforcement regime are helpful, they are also a leveler. A portfolio of 10 loans pledged by real estate assets in Shanghai will be heavily contested by investors, pushing the pricing up and the profit margin down.

ShoreVest's Fanger prefers portfolios that comprise more than 30 loans, so there is a greater scope to take advantage of information asymmetries. He compares the current scenario to the previous cycle, when a number of global investors arrived with mandates to acquire concentrated, highly secured portfolios. They ended up paying \$0.30-0.40 on the dollar, leaving little margin for error if it turned out that a few assets were not as secured as previously thought. Around the same time, Shoreline faced zero competition in buying a portfolio of more than 1,000 loans for \$0.02 on the dollar.

"Many investors assumed that anything under \$0.05 was garbage. There's a fundamental flaw in thinking that a portfolio with fewer loans that are senior secured has to be a lot safer than one

that's harder to understand, has more loans, and some of them have problems," Fanger says. "This business requires a commitment to building a local platform and having decision makers who can communicate in a seller's native language

a helpful proxy for the broader distressed investment opportunity. Yields are lower than the interest developers are paying on their bank loans, but as long as asset prices keep rising, the market is unconcerned. The question

## "This business requires a commitment to building a local platform and having decision makers who can communicate in a seller's native language"

— Ben Fanger

in order to create relationships for sourcing and managing deals."

Should more substantive deal flow emerge, more foreign investors might be willing to make this commitment – although it follows that local competition would intensify as well, ultimately to the point where there is more institutional participation. As it stands, though, initiatives such as NPL securitization are seen as symptomatic of a tendency to play for time: securitization removes NPLs from a bank's balance sheet but they are still under its management and they still have to be resolved at some point.

PAG's Hui sees commercial real estate as

then becomes: How low would yields have to fall before banks recognize the loans as non-performing and start to foreclose?

"Eventually, they will have to deal with this problem," Hui says. "If the government admits it has a 10% NPL ratio and wants to clean everything up in three years, we would have three years of great deal flow and not much after that. If they say the ratio is 2% and will stay that way for 10 years, it's a softer landing, but on one hand they are selling NPLs and on the other they are creating more every year. We don't know how aggressive the government is willing to be on this" ■

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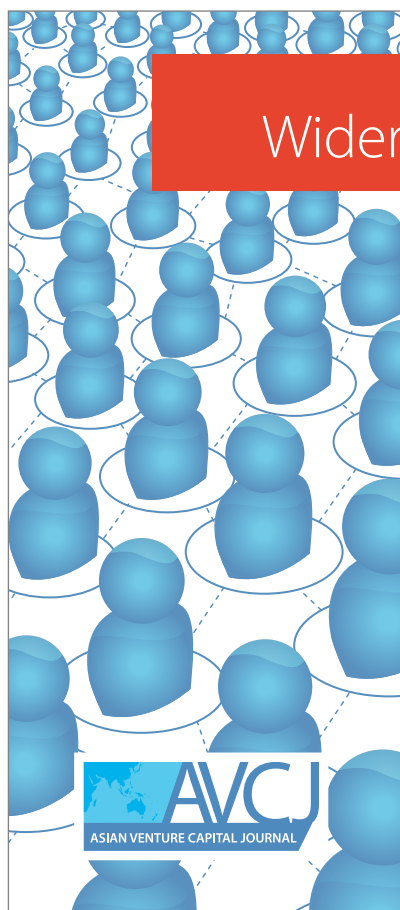
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# Servant of two masters

A resurgence in renminbi fundraising has prompted GPs best known for US dollar funds to enter the local currency market. Addressing conflicts of interest in an increasingly complex industry will prove difficult

## SAIF PARTNERS LAUNCHED ITS FIFTH

Greater China fund more than 12 months ago, seeking \$800 million. There has been no word of a first close. Several sources in the LP community say there was little appetite for the vehicle and that the GP has been forced to regroup. But that's not to say SAIF has no capital to deploy: it has more than RMB6 billion (\$870 million) under management across a dozen renminbi-denominated funds.

SAIF made its name in the US dollar space. Having begun life as the \$404 million SoftBank Asia Infrastructure Fund in 2001 – SoftBank Group was the GP and Cisco Systems the sole LP – the firm went independent in 2004 and prospered, largely on the back of pre-IPO technology deals. Fund IV closed at \$1.3 billion in 2010, with commitments from the likes of California Public Employees' Retirement System (CalPERS). The India team spun out in 2011 and has since raised two funds.

When the Chinese government started making concerted efforts to develop a domestic private equity industry in 2006, SAIF was a willing partner. Between 2008 and 2009, it launched three renminbi funds in conjunction with the Tianjin, Heilongjiang and Changzhou governments, raising a combined RMB3 billion. Performance is cited as one reason why LPs are reluctant to support another US dollar fundraise; the risk that SAIF might be distracted by the scope of its local currency interests is another.

A number of GPs essentially went native in 2006-2008, riding on a wave of capital from government-backed guidance funds. The phenomenon is now being repeated, particularly in the VC segment, as an even greater quantum of state-driven capital enters the asset class. Raising renminbi has arguably never been so easy, and several traditionally US dollar managers are enlarging their local currency pools. Offshore LPs are inevitably asking questions about conflicts of interest – is there a reasonable answer?

"Of more than 15,000 PE funds in China, the majority are renminbi-denominated," says Jun Qian, head of China for Swiss asset manager Adveq. "For the time being, renminbi funds and US dollar funds are competing in different parts of the market, but one day – maybe in the next 3-5 years – the two pools of capital will merge

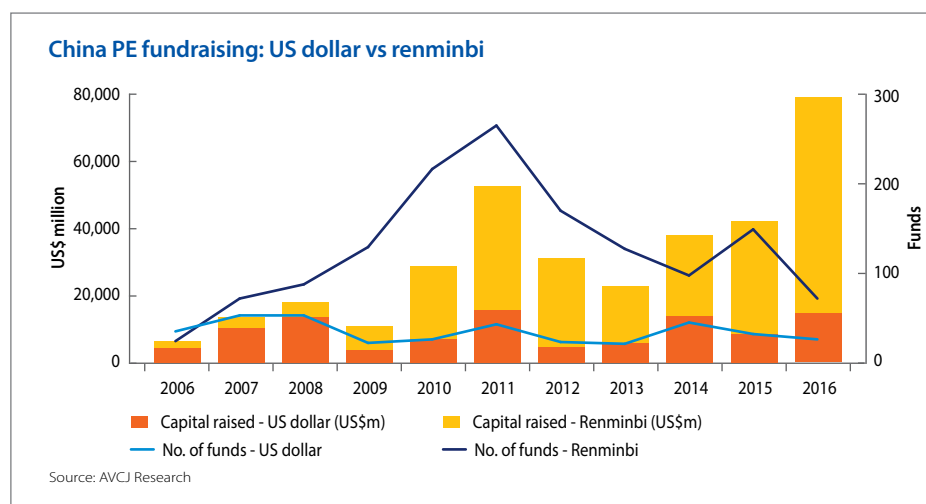
and there will be no currency convertibility issues any more. If you believe that, you should look closely at renminbi activity when evaluating the entire Chinese GP landscape."

## Deeper pockets

China private equity fundraising has seen two peaks. The first came in 2011, when \$52.8 billion poured into the asset class, 70% of it entering renminbi funds as high net worth individuals (HNWIs) pursued pre-IPO opportunities. The second arrived last year: \$79.7 billion was raised, 80% of it going into renminbi funds. In the absence of meaningful HNWI activity, the government role has been magnified. Three state-sponsored renminbi funds together received around \$39 billion, including RMB40 billion for the National Venture Investment

Over half of the commitments in the \$674 million dual-currency fund raised by last year by Sinovation Venture (formerly Innovation Works) came from renminbi investors including government-backed VC funds. The RMB2.5 billion renminbi portion is five times larger than that of its predecessor. Sequoia Capital China raised RMB10 billion for its latest renminbi vehicle, exceeding the combined total of \$1.45 billion the GP received for its venture and growth funds last year.

"For a GP that has not raised a renminbi fund before but is raising one now, a natural question to ask is: 'Why now?' It could be about navigating a competitive VC environment: we have seen US dollar GPs commit renminbi to lock in a deal and convert to US dollars later on for timing reasons," says Jireh Li, chief Asia representative at



Guiding Fund for Emerging Industries launched by the State Council.

Following a fund-of-funds model, the vehicle will provide seed capital to professional managers which will then raise more money from independent sources. It sits at the top end of burgeoning segment that is estimated to contain around 1,000 renminbi fund-of-funds with total assets of RMB1.5 trillion. About 60% of them have central or local government support. The net impact is that more capital is available from an increasingly sophisticated set of LPs – and this is not lost on GPs best known for US dollar funds.

Commonfund Capital. "Other questions would include: How do you manage your time across the two vehicles? What differences are there in strategy or return expectations? How will you manage potential conflicts? It would be a major concern if a GP has not thought through such issues and is looking to raise a renminbi fund only because their neighbors are doing so."

The restrictions placed by the Chinese government on foreign investors, streamlined approvals processes for local currency deals, and higher valuations when listing companies onshore rather than offshore have long been cited as justification for simultaneously managing

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US dollar and renminbi funds.

In 2009, when for the first time more capital entered renminbi funds than China-focused US dollar vehicles, the Limited Partners Association of China (LPACN) published a study on the potential conflicts arising from such an operational model. Although GPs have employed different mechanisms to try and minimize the risks, some remain.

The biggest concern is that a majority of Chinese GPs use the same team to manage both currencies. When individual investments vary – for example, renminbi funds tend to invest in growth and later-stage deals, while dollar funds go earlier with longer time horizons – or investment allocations diverge between the two funds, the amount of time spent by senior partners on each vehicle is diluted. For GPs that raise new renminbi funds during the investment period of an existing dollar fund, additional challenges arise.

With greater amounts of renminbi capital flowing into the system from increasingly sophisticated LPs, GPs could become even more distracted. “What has changed in the renminbi market is the maturation of the LPs,” says Niklas Amundsson, managing director at placement agent Monument Group. “Five years ago they were passive. Today, renminbi LPs are more institutionalized and they are also hungry to co-invest into deals, just like international LPs. Structuring this type of deal will take up more of a GP’s time, and so they may become more focused on the renminbi vehicles. International LPs might start worrying about that.”

James Wang, investment funds partner at Han Kun Law Office, echoes this view. He adds that some renminbi LPs are conducting even deeper due diligence on GPs than their foreign counterparts, investigating carried interest plans, allocation of the responsibility within management teams, and GP succession planning. In certain cases, requests have been made for a share of carried interest at the GP management company level.

“If renminbi LPs find that some current status of a GP isn’t consistent with what they see as the ideal arrangement, they will ask for further assessment, which is really aggressive and almost unheard from the US dollar LP community,” Wang adds.

It is also not unusual for private equity firms to feel obliged to make larger GP commitments to renminbi funds than to their US dollar vehicles in order to convince big name domestic LPs to invest. This kind of arrangement can make offshore LPs feel uncomfortable. If the economic terms are structured differently between the two funds, or one vehicle is performing considerably better than the other, the GP will be incentivized

to allocate better deals and more resources to the fund that can generate earlier and larger carried interest payments.

To assuage these concerns, some GPs are constructing diversified investor bases that includes different independent LPs, so as to avoid perceptions of overdependence on government-guided funds. They might also be conservative in increasing their renminbi fund size despite the large amount of capital flowing to the market. Qiming Venture Partners has deliberately kept its US dollar funds three times larger than its renminbi funds over the past three vintages. The firm’s latest US dollar fund closed at \$648 million in 2016, followed by RMB1.5 billion for a local currency fund one month later.

“We won’t push entrepreneurs to accept either pool of capital. Often they choose which currency to take. Some have already established offshore vehicles so they prefer US dollar funds with a long holding period,” says

are treated equally. “For example, for investments where both currencies can invest, the GP will invest from both. For deals which are appropriate for one pool of capital only, the best approach is for the GP to share information on the legal or structuring reasons behind the decision,” says Haide Lui, a principal at HarbourVest Partners.

While troublesome, this may be regarded as essential to deploying capital effectively in a market where high quality deals are said to be relatively few in number. Just as traditional US dollar GPs are looking to raise renminbi funds, GPs that made their name with local currency vehicles want dollar-denominated pools of capital as well. Less than half of the approximately 4,000 independent renminbi managers have proven track records with institutional investors, so offshore commitments are hard to win.

Principle Capital and Maison Capital have both managed to attract international LPs into

## “Five years ago they were passive. Today, renminbi LPs are more institutionalized and they are also hungry to co-invest into deals”

– Niklas Amundsson

Janet Yu, a partner at Qiming. “When a deal can be accommodated by both funds, with the entrepreneur’s permission, we commit capital from the renminbi fund and US dollar fund on a proportional basis.”

### Parallel plans

But there is still an issue if dollar and renminbi funds operated by the same managers have invested in different sets of deals, resulting in different performance. As such, larger managers such as CITIC Capital and Hony Capital have devised parallel fund structures in an attempt to invest in the same assets on a pro rata basis. There is some skepticism as to whether this can work in practice.

When CDH Investments launched its mid-market fund in the summer of 2015, it wanted to have the two currency tranches operating in tandem. However, China then tightened controls on capital outflows while proposals to relax the approvals process for foreign investment have yet to come to fruition as originally envisaged. CDH ended up with \$800 million, split 60-40 between renminbi and dollars, but co-investment in every single deal was no longer seen as a practical goal.

If a GP does want to build an overlapping portfolio, it is essential that communication with offshore LPs is transparent and that processes are in place to ensure different pools of capital

their debut dollar funds, although they have yet to achieve final closes. Principle is targeting a \$300 million parallel fund that will only invest in areas where foreign capital is permitted, so as to maximize the overlap. The dollar portion is intended to be three times the size of the renminbi portion because Principle wants to build long-term relationships with offshore investors and ensure they have exposure to deals.

In the absence of full currency convertibility, this balance is likely to become ever more difficult to strike, regardless of whether a GP has made its name on the dollar side or the renminbi side. As the market matures and Chinese LPs grow in sophistication, their demands will begin to match those of their foreign counterparts, making it harder to please all parties concerned. Caught in this bind, private equity firms would have to make careful strategic decisions about which path to take.

“Going forward, more US dollar GPs will focus on the renminbi market, making investments through increasingly streamlined procedures and establishing relationships with emerging Chinese institutional LPs,” says Chun Zeng, a partner at Gopher Asset Management. “But every US dollar GP is developing its renminbi fund strategy at a different pace, depending on individual strategies that are in part driven by what kind of Chinese LPs they want to capture.” ▀

# Time will tell

Restrictions on outbound investment have China's investor community scrambling to adapt, but devising a proper response depends on future decisions from notoriously opaque regulatory agencies

## CHINA'S RECENT CURBS ON OUTBOUND

investment have given rise to familiar complaints among investors. "In general, the problem of the Chinese policymakers is they almost never make things clear," says Lin Feng, founder and CEO of advisory firm Dealglobe. "What's happening now is there are so many rumors from here and there, but the government has not been coordinated. The only thing they've said is that they continue to support outbound investment, and in the meantime they want to keep foreign exchange rates stable."

Feng's frustration is echoed by others who were largely taken aback by the rollout of the

Swiss seed and agrochemicals player Syngenta by China National Chemical Corporation – but both figures were higher for every month of 2016 than the year before.

While Chinese buyers were racking up deals, the country's banking system was hearing alarm bells. Because most of the outbound deals required conversion of renminbi to foreign currency, the foreign exchange reserves were dipping to what regulators considered dangerously low levels – from nearly \$4 trillion in 2014 to less than \$3 trillion at the end of last year.

"Last year was quite interesting, because the outbound volume was just amazing – not just

Limiting capital outflows might be an understandable goal for China's financial regulators, particularly given fears of protectionist measures from the US and other key trading partners. But the method for achieving the desired cutbacks has created a high degree of uncertainty in the investment community, with no way to know how strict the new measures will become or how long they will last.

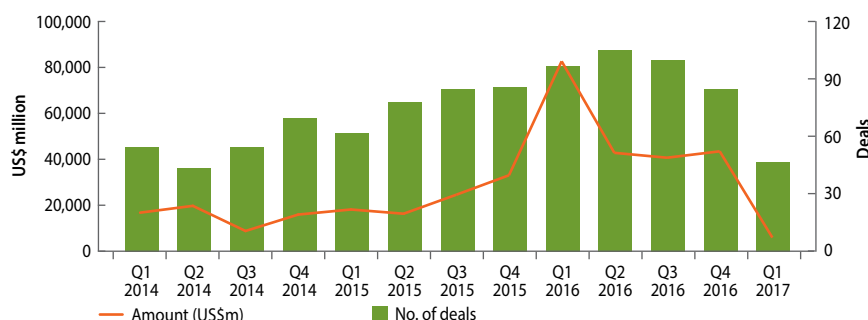
"When the Chinese government issues things I think they don't want to give a very negative message to the market, given China just joined the IMF and they have made a commitment to further open up the Chinese economy to global competition," says John Gu, head of private equity for KPMG China. "They're hoping that more foreign capital will come in to China to counter the effect of the capital going out. But how long it will take to balance the outflow, we don't know."

So far the curbs have not included an outright halt on outbound investment. Instead, the slowdown has been achieved through measures from a number of agencies, including the People's Bank of China (PBoC), the National Development & Reform Commission (NDRC), the Ministry of Commerce (MofCom), and the State Administration of Foreign Exchange (SAFE) aimed at increasing the scrutiny of investors who seek to exchange renminbi for foreign currency.

Deals coming in for a closer look include large investments outside the Chinese investors' main line of business; transactions in sectors such as real estate, hotels and cinemas; and investments by limited partnerships. Each agency has implemented its own requirements: NDRC and MofCom have substantially increased the supporting documents required for deal approval, while PBOC and SAFE have strengthened reporting requirements among local banks for proposed foreign exchange transactions for as little as \$5 million.

Though all of the new restrictions ramp up the difficulty of outbound investment, the banking regulators' moves have prompted the most debate given their lack of transparency. SAFE and PBOC communicated the new requirements via verbal "window guidance" rather than formal regulations, leaving it up to individual banks to work out their own interpretation. This has meant that in practical

China outbound M&A transactions



Source: MergerMarket

new measures last year and the limited warning they were given. While most industry participants say they understand the reasoning behind the restrictions, having so little time to adapt puts them in a difficult position.

Much about China's regulatory environment remains in flux for the time being. Those facing immediate impact may try creative foreign exchange approaches to keep their plans moving forward, but the industry's ultimate fate may be out of the community's hands.

The regulatory moves, which started in the last quarter of 2016, followed a surge in outbound M&A transactions: data from MergerMarket show more than \$208 billion was invested across the 383 transactions announced last year, compared to \$92 billion across 307 deals in 2015. February 2016 saw a particularly large spike in deal size with nearly \$60 million in 31 deals – including the \$47 billion acquisition of

among private equity funds, but also Chinese investors generally," says Nanda Lau, a partner in the Shanghai office at Herbert Smith Freehills (HSF). "So I suspect that the government felt it had no choice but to issue interim measures to try and stabilize this fund flow and the RMB exchange rate."

## Down trend

Though regulators' heightened scrutiny has only been in effect a few months, they appear to have had an arresting effect on outbound deals. While 33 transactions were completed in January, more than the preceding year, the amount invested fell to \$5 billion from \$11 billion in 2016. In February the drop was even more precipitous, with just 13 deals for \$1.1 billion. Although there is still one month to go, it is unlikely the current total of \$6 billion will approach the \$82 billion from the first three months of 2016.

terms, gaining approval for transactions has become much tougher.

"We've heard a number of banks saying they want to err on the side of caution and not take risks themselves, because ultimately they have to report back to PBOC and SAFE," says HSF's Lau. "So I think a lot of situations are being interpreted very cautiously on a local basis, because everyone's trying to minimize their own risk."

It is important to note that outbound investment itself is not being targeted, but only certain transactions that might deplete the country's foreign exchange reserves. Deals that support the government's policy agenda are considered easier sells than those which are based more on speculation.

KPMG's Gu gives the example of a strategic investor looking to buy a foreign company with proprietary technology that it can bring to China. The value to China's economy in this case is likely to justify the currency outflow required in the eyes of regulators. "As long as you can prove that there is such a value proposition, then such applications are likely to be granted foreign exchange approval," he says.

In addition, GPs with existing US dollar assets remain free to invest in outbound transactions, while domestic-focused renminbi funds have no need for currency exchange.

For Qiming Venture Partners, the effect of the regulatory moves has been negligible so far. While in the last year the firm has seen renminbi funds begin to angle for the same group of offshore-incorporated Chinese companies that Qiming targets with its US dollar fund, the new regulations have put a lid on those GPs, at least for the time being. "Their impact actually was very small to begin with, and now it's been shut out, so it doesn't really make much difference," says J.P. Gan, managing partner at Qiming.

## Exit angst

But depending on the longevity of the restrictions, US dollar investors could still be impacted – not at the time of investment, but at the time of exit. A number of industry professionals say they have already seen managers struggle to reassure potential overseas backers that they will be able to return capital. Even though returns should not be affected, it is a measure of the uncertainty surrounding the measures that investors feel the need for clarity.

"One of our private equity clients is raising funds, and they actually do receive questions from LPs who are really concerned about capital controls in China, and want to find ways of getting around that," says Judie Ng Shortell, a partner at Paul Weiss. "Unfortunately there aren't

many ways that can be done. The only comfort that people can take is that hopefully these measures aren't permanent."

Efforts to adapt to the new measures are underway. In some cases GPs go to banks with which they have a good relationship in the hope of receiving assistance in streamlining their foreign exchange requests. Others have tried to be more creative. For example, by depositing the purchase price for a deal in a domestic bank, the bank's foreign branch can then loan the GP's offshore special purpose vehicle the required amount in foreign currency.

Central to the industry's response is the belief that this strict approach is only temporary and that by the end of this year regulators will ease off. Otherwise they risk long-term damage to the prospects of Chinese investors among owners of offshore assets, who are already beginning to require higher break fees for potential Chinese buyers or refusing to meet with them altogether until the currency issues are resolved.

"Life cannot be this way forever. I think the expectation is that while there won't be the same freedom as we've seen before, once the pressure on the currency is reduced the government will slowly normalize the regime, and there will actually be some regulation," says Shortell. "Unpredictability is always bad for the market." ▀

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\*Based on a review of various venture capital fund agreements drafted by our primary competitors conducted January 2014.

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# Small world

Jenny Lee, managing partner at Sino-US VC firm GGV Capital, discusses supporting start-ups from early through later-stage rounds, and why technology players increasingly need to think internationally

*The following is taken from an interview for AVCJ TV conducted late last year*

**Q: GGV's most recent fund comprises multiple vehicles with different strategies. Why is this?**

**A:** Our latest fund is structured as an early-stage fund – the discovery fund – which allows us to invest in entrepreneurs very early on, and then a later-stage fund, which is our main fund, and allows us to continue to help companies as they grow from Series A onward, even up to IPO. The reason we did this is that we want the fund to cater to the entrepreneur. So if you're an entrepreneur who is starting to think about who you want to talk to, the opportunity to find investors who can come in earlier and understand the risks you are taking is very important.

**Q: Do you need additional internal resources to execute this strategy?**

**A:** If we have one fund with 40 portfolio companies, all around late Series A or Series B, then obviously we don't need to offer a lot more support. But with the discovery fund, we do expect to be engaging with CEOs at different stages of development. To support them, GGV has over the last two to three years built up what we call a portfolio services support team, which covers functions like legal, finance, PR, marketing, even government relations. If you are a two-person start-up at seed or early Series A stage, you aren't going to need a lot of strategic advice. It's more on the level of hiring the right management team, and we can get our HR

recruitment team to help on this. As companies grow, their needs may grow. So if they want to expand from China to the US or from China to Southeast Asia, a PR or marketing team can also be of assistance there.

**Q: How has GGV's cross-border strategy evolved?**

**A:** When we first started I would say that most entrepreneurs and companies were more local. US companies focused just on addressing the US market, Chinese companies said let's win the China market first. The mobile internet is bringing global markets closer together with technology. And because of that we are now seeing start-ups actually think a lot more about being global from day one. I wouldn't say that 100% of companies think about being global, but of the ones we're meeting, at least 30-40% think that way. Increasingly the world is becoming more integrated and technology platforms are becoming more standardized, which means that companies will have to thinking global earlier on. Uber should have thought about ride-sharing globally first. The fact that the company came to China late meant it gave Chinese players a chance to do it locally.

**Q: What must a US start-up do to be successful in China?**

**A:** While the products and services may look similar it's actually very important for US companies to realize that the target audience is different. You may be catering to a US consumer group with a particular product, but the Chinese consumer might not react in the same way as a US



**“The world is becoming more integrated and technology platforms are becoming more standardized, which means that companies have to start thinking global earlier on”**

consumer, even though the technology stack may be the same. First of all, US companies need to understand that the consumer market is actually different, they need to be ready to localize their product, even change features to address local conditions. Second, the Chinese market is not just another city in the US. It's a completely different country with a different regulatory framework and a different history in terms of the last 15 years of technology growth. And so you definitely have to respect the market

and work with the local players and regulators, and if need be consider a completely separate team who can run autonomously in the China market.

**Q: What do you see as the next big tech sector development?**

**A:** When PC internet first started, it was all about horizontal players. You had the Alibaba doing e-commerce, Baidu doing search, Tencent doing social. They were able to take on a huge horizontal need in the market. As the PC became more mature, you started to see the internet becoming more vertical. There was a Ctrip or Qunar for travel, Shanda, Perfect World and Netease for gaming, and 51job for HR. We have seen more verticalization and specific services that grow from the internet, and we think the same thing is going to happen with mobile internet. Mobile internet has now gone beyond just a reading device or a dashboard. We now use it as a tool to actually get access to services: to order your rides, to get your food delivered, to get information about buying your next house. Mobile is now an enabling device to get you better services in your daily life. And with the very personalized data you collect, you can start to have very good recommendations. When people talk about learning technology or artificial intelligence, the concept may be huge, but actually it's about giving you what you need at the time you need it. To do that you require data, and because you carry your smart phone with you all the time that level of data enables a lot better and more personalized services. ▀

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# Billowing forth

China's nascent cloud computing industry appears set to replicate a US-style growth trajectory. Venture investment, however, may play a larger role due to a range of cultural and economic differences

## ALIBABA GROUP MAY BE A MINOR CLOUD

computing player from a global perspective, but its stirrings make noticeable waves in China, where it is by far the biggest operator. The latest news from the company's small but promising cloud division highlights a doubling of data storage and processing power in Hong Kong as well as a 115% year-on-year revenue surge during the December quarter.

The industry has digested this eruption in two ways. On one level, it is seen as a sign of increasing regional demand for the big data number crunching capacity that underpins cloud business models. More incisively, it implies China's internet heavyweights are bound to dominate the emerging local market in much the same way that the likes of Amazon and Google have in the US.

VC firms in China, however, point to a parallel momentum among smaller local companies as evidence that a more inclusive investment landscape is possible. This potential is rooted in a number of variables unique to the Chinese market, including an awkward combination of reliable national internet infrastructure and widespread shortcomings in corporate IT competence.

"As venture capitalists, we're never afraid of the giants because an elephant walks and turns slowly, but we can run and turn fast," says Chris Pu, head of Greater China at Telstra Ventures. "This is a turning point for enterprises in China to leverage the higher penetration of smart phones at the front end while upgrading their IT capabilities on the back end."

## Transition time

The essential play for venture investors in China is to service the migration of small and medium-sized enterprises (SME) from traditional IT infrastructure platforms to cloud-based systems. China is better positioned than the US to seize this opportunity in part because the lack of in-house IT support compels local companies to outsource expensive technical operations to relatively cheap clouds.

Government imperatives to secure sensitive cloud-processed data and the prevalence of state-owned enterprises present another potential advantage for start-ups. Although Alibaba has made a few forays into private

cloud infrastructure services, it remains largely associated with public platforms and therefore considered off limits to many banks, insurance companies and government agencies. This was part of the rationale for Lightspeed China Partners' investment in private storage company QingCloud.

"The China market will eventually be just as big if not bigger than the US market," says James Mi, co-founder and managing director at Lightspeed. "In the past year, a lot of companies in China have started very actively thinking about

teams have sales experience in whatever specific niche of the value chain is being targeted. The idea is to bypass a common cloud company imbalance between technical knowhow and customer service ability.

"If you're targeting the security industry, your best practice will be completely different than if you're targeting the telecom industry because the terms and the people and the needs are all different," Zhu adds. "Cloud is not as light as people assume, and customers are not going to be able to use your API [application

**"A lot of companies in China have started very actively thinking about using cloud services because labor costs are really growing"**

— James Mi

using cloud services because labor costs are really growing and they need to invest in IT to improve productivity."

China's immaturity in the cloud space, however, also presents an important limitation. The massive collections of unstructured data that drive much of the cloud computing business opportunity are still relatively rare assets in the country, controlled by large players with little incentive to share. VCs will always find cracks in a conglomerate-dominated cloud market because small software developers tend to avoid major infrastructure platforms in order to protect proprietary source code. But at this point in China's development curve, it is still not advised to rely too heavily on doing business with the minnows.

"It's definitely a good time to start investing, but in China, you've got to talk to the big customers instead of the small enterprises because even though a lot of Chinese SMEs don't have an IT staff, they don't have the budget to pay for a move to the cloud either," says Michael Zhu, managing partner at Gobi Partners. "Eventually, I truly believe that SMEs in China will be big enough to pay for cloud but who knows how long that is going to take."

Gobi has made more than 10 cloud company investments in China across the past six years using this evaluation approach in combination with a strong focus on making sure portfolio

programming interface] without any education or outside service. Not every team in China really understands that."

## Open source

The importance of providing adequate technical support in cloud computing is compounded by the fact that many of the industry's basic components are based on open source code. Enterprise-grade software-as-a-service (SaaS) offerings are therefore under added pressure to demonstrate that a differentiated product will be provided on top of the readily available infrastructure.

Marketing plays a big role in this effort but it can also represent a pitfall for interested investors. As the hype curve runs its course in the Chinese cloud space, VCs will need to be able to recognize when companies with no competitive edge are posturing themselves as something innovative.

"In cloud computing, there are a lot of technology buzzwords like 'containers' and 'open stacks'. The key for start-ups is not just becoming one of the providers in those areas but developing differentiated products and services based on those topics," says Telstra's Pu. "At the end of the day, SaaS is a subscription model, so if there's no differentiation, it becomes sort of like a utility – and that would be bad because it's getting very competitive." ▀



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### Investment Breakdown by Country From January to February 2017

| Country     | Deal Amount (\$mln) | No. of Deals | No. of Disclosed Deals | No. of Investee |
|-------------|---------------------|--------------|------------------------|-----------------|
| China (PRC) | \$7,742.3           | 171          | 161                    | 171             |
| Japan       | \$2,359.4           | 60           | 50                     | 60              |
| South Korea | \$2,178.2           | 25           | 23                     | 25              |
| Australia   | \$1,639.4           | 15           | 12                     | 15              |
| India       | \$1,260.2           | 93           | 61                     | 92              |
| Singapore   | \$467.2             | 5            | 5                      | 5               |
| Malaysia    | \$126.3             | 5            | 5                      | 5               |
| Bangladesh  | \$55.0              | 1            | 1                      | 1               |
| Taiwan      | \$33.9              | 1            | 1                      | 1               |
| New Zealand | \$32.1              | 3            | 3                      | 3               |
| Indonesia   | \$10.0              | 6            | 4                      | 6               |
| Hong Kong   | \$5.0               | 2            | 1                      | 2               |
| Thailand    | \$4.5               | 2            | 2                      | 2               |
| Vietnam     | \$4.0               | 3            | 1                      | 3               |
| Cambodia    | \$0.7               | 1            | 1                      | 1               |
| Philippines | -                   | 2            | 0                      | 2               |
| Pakistan    | -                   | 1            | 0                      | 1               |

## FUND-RAISING MONITOR

### CLOSED FUND

|                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Location:</b>             | India                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Fund Name:</b>            | ChrysCapital VII, LLC                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Closing Amount:</b>       | US\$600 million (final close)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Launch Date:</b>          | December 2015                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Fund Manager/Advisor:</b> | Nuvo Chryscapital Advisors Pvt. Ltd. (ChrysCapital)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>Stage Focus:</b>          | Buy-outs (MBO/MBI/LBO), Expansion/ Growth Capital, Mezzanine/ Pre-IPO                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Industry Focus:</b>       | Consumer products/services, Financial services, Information technology, Medical                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Geographical Focus:</b>   | India                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Contact:</b>              | Ashley Menezes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| <b>Phone:</b>                | (91) 11-4129-1000                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| <b>Email:</b>                | ashley@chryscapital.com                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Website:</b>              | www.chryscapital.com                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>Update:</b>               | ChrysCapital has closed its seventh India fund with more than \$600 million, beating its target. ChrysCapital VII will focus on the business services, financial services, healthcare, consumer and manufacturing sectors, and will comprise minority growth and select control deals. Limited Partners in ChrysCapital VII include both new and existing investors, with insurance companies, university endowments, family offices and global fund-of-funds represented. Returning LPs include Singapore's sovereign wealth fund GIC and Harvard Management Company. |

### NEW FUNDS

|                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Location:</b>             | Australia                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Fund Name:</b>            | Odyssey Private Equity Fund                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| <b>Target Amount:</b>        | A\$200 million (closed at A\$275 million)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Launch Date:</b>          | February 2017                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| <b>Fund Manager/Advisor:</b> | Odyssey Private Equity Pty Ltd.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Stage Focus:</b>          | Buy-outs (MBO/MBI/LBO), Expansion/ Growth Capital, Turnaround/ Restructuring                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| <b>Industry Focus:</b>       | Consumer products/services, Electronics, Financial services, Manufacturing - Heavy, Manufacturing - Light, Medical, Retail Wholesale, Services - Non-Financial                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Geographical Focus:</b>   | Australia, New Zealand                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>Contact:</b>              | George Penklis                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Phone:</b>                | (61) 2-8880-7000                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| <b>Email:</b>                | george@odysseype.com.au                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Website:</b>              | www.odysseype.com.au                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <b>Update:</b>               | Odyssey Private Equity has closed its debut fund at A\$275 million. The fund will invest in profitable, mid-sized, growing businesses in Australian and New Zealand, to fund organic expansion, acquisitions, management buyouts/buy-ins and shareholder restructures. It will invest in both control and minority equity positions across a broad range of industry sectors, including consumer products, retail, financial services, industrial products and services, equipment rental, distribution, aged care, manufacturing and building products. |



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