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European investors' exposure  
to Chinese private equity  
An insider's perspective

White Paper  
in association with  
Zero2IPO

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## Foreword

### Dear readers,

When we initiated the 'China-Europe Private Equity Roundtable' in 2009 we wanted to encourage a regular, transparent and open dialogue between the Chinese and the European venture capital and private equity industry. The initiation of the roundtable forum was a consequence of our observation that, regardless of the fact that the EU 27 member states are the largest trading partners of China, financial markets' relations between China and Europe were still underdeveloped.

Venture capital and private equity companies from the United States were at the forefront of investing in the private sector in China when the Chinese market was opened for foreign capital in early 2000s, while European financial investors were still lagging behind. However, according to Zero2IPO Research statistics, European capital invested in Chinese venture capital and private equity (mainly) via limited partner structures now represents 7% of the overall assets invested.

While the EU 27 members are among the largest foreign investors in China, their investments consist mainly of capital in non-financial businesses. As China is the fastest growing economy and export market, Europe's enterprises have dramatically increased their presence in the country. At the same time, European financial investors were still cautious.

With this study we wanted to provide deeper insights into what European investors are taking into consideration when deciding to carry out Chinese venture capital and private equity investments. Thus, this paper should serve as a building block to a better understanding of the Chinese venture capital and private equity industry on the one hand, but also, on the other hand, address the requirements and expectations of European asset owners and investors wishing to participate in the growth opportunities in China.

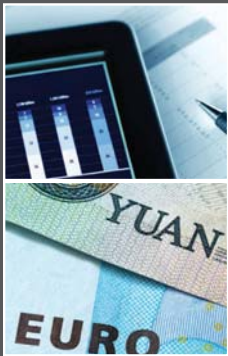
Our roundtable network has enabled us to build a bridge between financial market participants in China and Europe, as well as to get to know new partners and even make new friends.

Therefore, it is a great pleasure for us to have teamed up with the leading venture capital and private equity research and networking platform in China, Zero2IPO. In particular, we are thankful to Gavin Ni, CEO of Zero2IPO, and to his assiduous research team for their contribution to this paper. We would also like to thank Funds@Work, which conducted this study, for its contribution to this paper as well as for opening up its network to us.

Volker Potthoff

Alexander von Preysing

## Introduction



European investors are undoubtedly facing some of the most testing conditions in terms of their investments.

The developments in the US, Europe, and the Arab countries offer both opportunities and challenges, and would appear to encourage tactical portfolio management rather than strategic activities.

When it comes to strategic investments, however, there is a growing feeling that European investors should look more eastwards – specifically to countries such as China – in order to diversify their portfolios and participate in long-term growth.

At present, they predominantly invest through listed equities as well as through bonds and dedicated fund portfolios – frequently in the local currency, especially in emerging Asia.

It is also clear that investors are considering substantially increasing their exposure to countries such as China in the longer term.

A major aim of our paper, therefore, is to provide deep insights into the experiences and perceptions of investors; that is to say, asset managers and asset owners alike who invest in Chinese private equity. This will help to close the information gap that was identified by European investors, and will also assist local Chinese asset managers in better understanding the needs of European investors.

Our interview series with European asset managers and owners, as well as Chinese private equity firms, has revealed important insights which we would like to set out over the following pages, as we take you through a number of key questions and answers.

We are convinced that current as well as future investors in Chinese PE will benefit from these findings.

## Development of venture capital and private equity markets in China

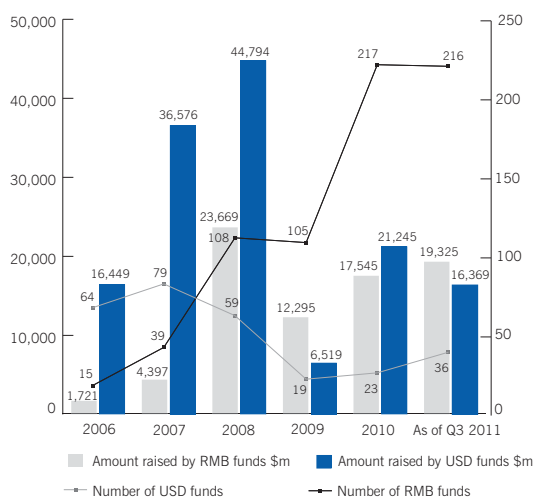
### How the regulations evolved

Venture capital (VC) and private equity (PE) first came to China in the 1990s. Back then, most VC/PE investments were made by foreign firms. The Chinese government published a number of foreign investment regulations in the early 2000s, placing also restrictions on industries and specifying vehicles in which foreign investors could invest. Some of these regulations were later amended to provide a more conducive investment environment for foreign investors.

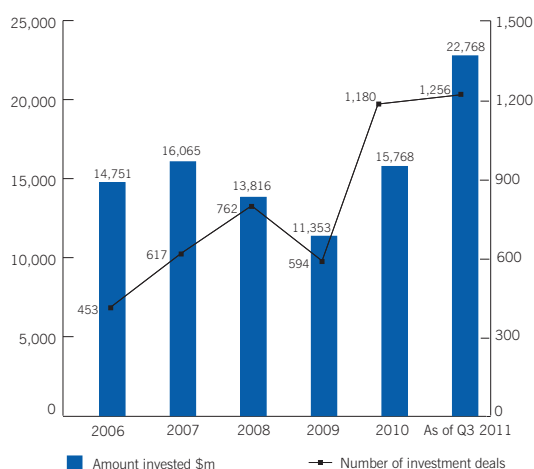
In 2011, Shanghai launched its Qualified Foreign Limited Partners (QFLP) programme, which Beijing and Chongqing then followed. This programme allows QFLPs to allocate a certain USD allowance that can be exchanged into RMB without a deal-by-deal application.

Domestic VC/PE firms and funds were less active before 2007, as most local institutional investors were constrained from investing in the VC/PE market, and exit channels in China were limited. Since 2008, however, China's national social security fund (NSSF), insurance companies and other institutional investors have been permitted to invest in RMB denominated VC/PE funds.

The number of local investment firms and RMB funds has since grown very quickly, as have available exit channels for VC/PE investments in China. IPOs in China were suspended for around a year after the start of the financial crisis in 2008, and recommenced in mid 2009 – the ChiNext market in Shenzhen was launched at the end of the same year. Since then, completed exits in China's VC/PE market have accelerated rapidly, reaching a new high of 555 in 2010, of which 491 were IPOs.

**Chart 1: Fundraising activities in RMB and USD funds**

Source: Zero2IPO Research

**Chart 2: Investment trends in Chinese VC/PE market**

Source: Zero2IPO Research

www.zdbcchina.com

### RMB funds predominate

Prior to 2008, China's VC/PE market was dominated by USD funds. Following the global financial crisis of 2008 foreign firms became less active, while regulations for domestic institutional investors investing in VC/PE funds gradually loosened.

By 2009, RMB funds exceeded foreign currency funds in both numbers and amount. It is worth noting, however, that while the number of RMB funds significantly exceeded foreign currency funds, the size of RMB funds was generally small (see chart 1).

### Deals and amounts invested rise

China's VC/PE market showed a steady increase from 2006 to 2008 in terms of both deals completed and amounts invested. During this time, most deals were solely completed or led by foreign investment firms. In response to the financial crisis the Chinese government introduced a stimulative policy in 2009.

China's VC/PE market then experienced a strong rebound in 2010, when the number of deals reached 1,180, with the amount invested exceeding \$15bn (€10.8bn). Since 2011, VC/PE firms have become even more active. Up to Q3 2011, 1,256 deals had been completed, with \$22.8bn invested (see Chart 2).

### Preferred investment sectors

According to a study by Zero2IPO Research, VC and PE investors in China showed differing sector preferences. From 2006 to 2010, around 60% to 70% of VC deals completed each year focused on bio/healthcare, clean-tech, the internet, IT, electronic equipment and opto-electronics products, as well as the machinery manufacturing sector; while 50% to 60% of PE investments were in the bio/healthcare, clean-tech, consumption, machinery manufacturing, and food and beverages sectors.

### How the market will develop from here

Since 2011, China's VC/PE industry has entered its market selection stage, and supervision has been tightened. From 2015 onwards, the market will face its adjustment stage, where the number of active VC/PE firms in China is expected to decrease, as the market approaches its peak. By this time, China's VC/PE market will have a sound supervision system in place with clear behavioural guidelines, which should augur well for the next development stage.

## Executive summary

Though still lagging behind, investing in Chinese private equity is certainly gaining traction among European investors, whether they are asset owners such as family offices, pension entities and insurance companies, or asset managers who manage a fund of funds or single fund structures.

In their view China has made considerable progress over the past decade, in terms of developing a more robust governance framework, which in turn has provided greater certainty for investors.

This white paper looks at a variety of factors driving European investors' allocations to Chinese private equity (PE). In particular, it elicits their views on the challenges and risks perceived, selection processes when determining potential targets, and on any recommendations for future investors. It also examines two other themes, namely: exit options and how investors can ensure access to the best deals.

### The European dimension

Having initially identified around 40 private equity companies of European origin that have dedicated Chinese PE exposure and numerous other asset owners who are already invested or are considering investing in this area, we carried out 11 detailed interviews with selected investors in order to discuss at length a number of common themes.

### The local perspective

To complement our European investors' views, we also sought the opinions of local Chinese private equity firms throughout our interview series in order to garner different perspectives. This, we believe, has greatly enhanced the quality of the insights.

This paper does not claim to be perfectly generalisable, but it will provide a solid overview of the perceptions of very experienced people who have had many years of exposure to the Chinese private equity market.

China's long-term attractiveness for PE investments is clearly highlighted in our findings. But some investors

suggest that "a lot of money is chasing the opportunities these days", partly on account of the increased attention of local Chinese funds, but also because it is now "very difficult to identify cheap targets due to high valuations", which some people are already reporting at 20-40 times earnings. This leads a number of investors to view China as an exit market in the short term, despite the strong medium-to-long-term potential and their general willingness to increase investments in the country.

In what follows we provide you with a bullet point precis of our findings:

### The China opportunity

- China is one of the fastest growing economies in the world. Simultaneously, private sector businesses are increasingly becoming a major driver of economic growth.
- The PE industry is playing a vital role in speeding up the privatisation of the government led Chinese economy. Apart from substantial capital investments, the PE companies are providing international know-how and appropriate access to vital networks.

### Major challenges and perceived risks

- A lot of money chasing the available opportunities makes it difficult to identify cheap targets, due to high valuations and competitive noise. This means working harder to find solid investments.
- Political and regulatory risks. Although private equity is part of the Chinese five-year plan and therefore seen to have wind in its sails, one should remain alert for sudden changes in the legal environment.
- Lack of corporate governance. This makes it imperative to have either strong social networks locally and/or develop mechanisms to control investments – for example by tracing historical accounts and doing forensic research.
- Thorough due diligence of companies and target funds is seen as very important, as the perception is that numbers are systematically inflated. High turnover of employees among local funds and companies investors are exposed to is a real concern, as it leads to strategy changes.



#### What investors look for when selecting targets

- An important element in selecting local companies and target funds is, undoubtedly, the people and the trust in those who manage the entity.
- Investors greatly value the track record and experience of companies they work with, especially given the amount of new funds that have entered the market recently.
- Strategic and operative competence in managing firms are seen as real assets and important selection criteria when choosing a local manager.
- Having local people or a competent local partner with offices on the ground, and being part of the local ecosystem, are seen as crucial for success.
- Establishing well functioning control mechanisms is seen as critical; for example through a presence in the governing bodies of the target companies.

#### Exit options

- IPOs are the main exit option for Chinese PE investors. Chinese stock exchanges, due to the considerable liquidity in the market and the high multiples currently on offer, are seen as the preferred exit route for companies with lower international ambitions. A second exit option likely to gain in attraction over the coming years is trade sale. However, those who are looking for an internationalisation of their business and a diversification of their

investor base are tending to prefer an international listing venue.

- European investors would welcome exchanges such as Deutsche Börse becoming a preferred exit option. They particularly value its stringent listing procedure and high corporate governance standards.
- Germany, regarded as the central gateway to Europe and as a global market leader in clean technology, engineering, high end manufacturing, chemicals and automotives, is seen as an ideal listing location by the respective companies.
- European investors should become more familiar with the situation in China, as there is less analyst coverage and less liquidity in their markets. Better intermediation from banks, lawyers, and their advisers could help bridge this knowledge gap.

#### Conclusions

- With the amount of assets managed and investment funds available steadily increasing as well as consolidation of the VC/PE-industry to be expected, asset managers have to carefully scrutinise fund managers and select the most suitable partners in terms of risk-return opportunities.
- As an inside market view is key, investors have to build trustworthy relationships through suitable networking platforms.

## The China opportunity

- On the back of the positive macro economic and regulatory development, Chinese private equity investments are set to grow in popularity over the longer term. Most of our interviewees planned to increase their existing commitments. European investors' time horizon for investing in Chinese PE is at least 10 years, shorter than for European PE engagements. This is because companies grow faster in China and thus investments and exits are made more quickly.
- Private equity investments can provide exposure to the huge potential of the local consumer market as well as to the development of value-added technologies and applications in interesting sectors of the economy. The export sector is generally not the priority of investments.
- One reason for European investors to invest in China is the continuing strength of the yuan, which they expect to give them extra returns in their home currency.



## Major challenges and perceived risks

You will notice opposite that we have used a network chart to visualise the main answers (blue squares) we received from investors (circles).

For the purposes of our analysis we shall from now on treat the interviewees in an anonymous way by using proxies such as “Chinese Investor (orange circles)” or “European investor (green circles)”. At the centre of these answers you can see the investors’ concern about the fact that “a lot of money is chasing the opportunities these days (due also to local RMB funds)”.

### Fear of a bubble

We can identify, for example, that the major concern about a bubble emerging is being predominantly raised by local Chinese investors who, one could of course argue, have their ears closer to the ground. This view correlates with the statement that it is “difficult to identify cheap targets and that valuations are high”; but also with the idea that investors “need to work harder to find a solid target”, with two European investors explicitly stating that this year could be used for an exit.

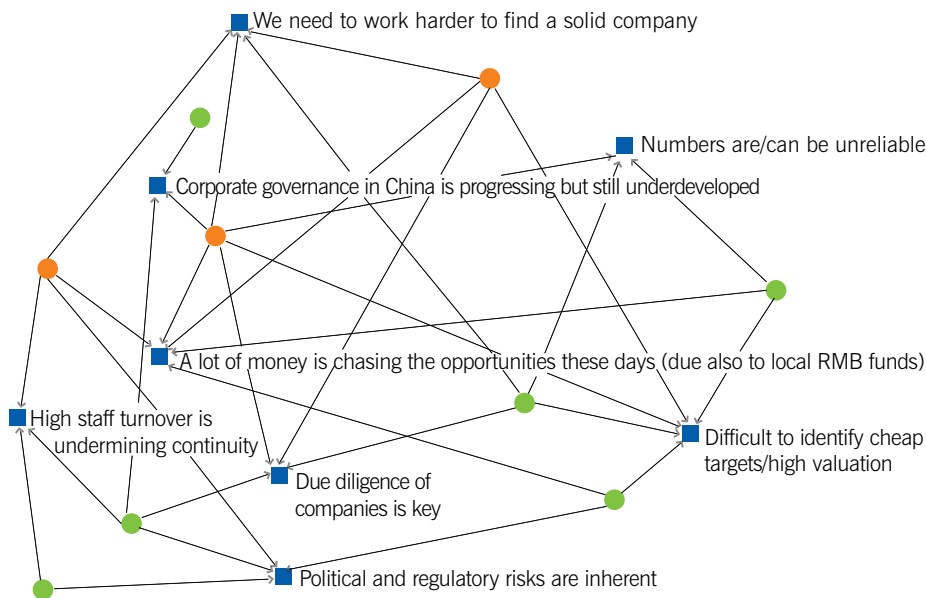
### Minimising staff turnover

A common theme that we see across industries in China and also in the PE sector is turnover of employees and the need for employers to retain their people within their organisation. Whether single fund investors who invest in companies directly or funds of funds which invest in target funds, turnover among team members and thus strategy changes at the fund or company level are seen as a growing concern.

### Maximising due diligence

In addition, political and regulatory risks are identified as a particular bugbear for European investors. Corpo-

### Highlighted concerns of interviewees investing in PE in China



Source: Funds@Work AG, blue squares = main answers from investors, green circles = statements by European investors, orange circles = statements by Chinese investors

rate governance related issues calling for a thorough due diligence of the related companies are also mentioned, particularly as there is a view that numbers get inflated and investors need to protect themselves through robust due diligence, but also by structuring contracts in a way that serves their purposes. Owing social security or tax payments and lack of documentation of property rights are mentioned as major issues, factors which make conducting a forensic due diligence necessary.

Many Chinese seem to believe that PE is a way of making lots of money, which is also reflected in the fact that there may be between 5,000 and 20,000 local PE managers present, making the selection process far

more difficult for established companies, given the abundance of new market entrants.

This goes hand in hand with the view that there are a few well-established asset managers with the necessary track record and professionalism that investors would look for, and that getting the right information and access have become more crucial factors than ever before.

One has to be aware that the specific risk parameters in China are different from those investors are familiar with in other parts of the world; outstanding tax or social security payments, for example, are not seen as a major risk in China due to a lack of enforcement.

## What do investors look for when selecting targets?

An important element in the selection process is the people involved and, more precisely, the trust in those who run the respective company or single fund.

“Strategic and operative competence in managing firms” are seen as real assets and important selection criteria when opting for a local manager. In this context, track record and experience are vital, especially given the number of new funds that have joined the market recently, following the appreciable boom in PE investments locally.

This increased noise in the market has made selection even tougher for investors. Typically, they might look at 30-40 times more organisations than they invest in, spending considerable resources on forensic research of companies' accounts or portfolios of single funds to find out whether their assets are what they purport to be. As one European investor wryly notes: “One can easily

get cheated in China”, but as potential returns outweigh potential risks in the long term, at least from the current perspective, you need to face this downside.

A key finding for Chinese PE managers, such as those who serve European fund of funds' managers or even asset owners directly, is to adopt European governance standards and a more Western orientation in order to attract more financial resources.

Evidence suggests that the more solid the governance process is, the higher the potential to attract money from European investors. Therefore, it seems inevitable that there will, in future, be a stronger convergence between European investors' corporate governance expectations and what their local fund managers in China are willing and able to do to meet those needs.

### Factors determining selection of targets for investors in Chinese PE



Source: Funds@Work AG, blue squares = main answers from investors, green circles = statements by European investors, orange circles = statements by Chinese investors

## How can European investors access the best deals?

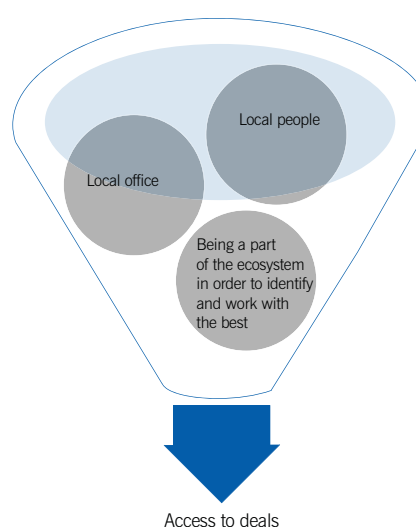
The most important requirements to ensure access to the best deals seem to be straightforward: namely, having a local office in China with local people and being part of the local ecosystem.

According to one of the investors we interviewed, China is a vitamin B society where networks still predominate and not just the rule of law. In line with the Chinese concept of *guanxi*, what matters most are the relationships that people need to foster in order to achieve better insights and access to investment targets.

### Developing local contacts

This situation is no doubt similar in many developing markets, but it does make it imperative to be present locally or at least to have a competent local partner, particularly if one is looking to pick the best fruit rather than simply generating a market return through a broad investment such as a fund of funds.

### Essential deal-making components in China



Source: Funds@Work AG

### Selected European PE investors (asset managers) with exposure to China

Adveq, Zurich	RWB AG, Oberhaching
Capital Dynamics, Zug	Actis Capital, London
Capvent AG, Zurich	Adams Street, London
Capvis, Zurich	EQT, Guernsey
LGT Capital Partners, Zurich	APAX, London
Partners Group, Baar-Zug	Pantheon Ventures, London
Pictet Asset Management, Geneva	Permira, London
Robeco SAM Private Equity, Zurich	SVG Capital and SVG Advisers, London
SCM Strategic Capital Management, Zurich	AXA Private Equity, Paris
Taishan Invest AG, St Gallen	Cel Partners, Paris
UBS, Zurich	Private Equity Partners, Milan
Unigestion, Geneva	AlpInvest, Amsterdam
Auda Private Equity, Bad Homburg	CVC Capital Partners, Luxembourg
DB Private Equity, Frankfurt	Nokia Growth Partners, Helsinki

## Exit options

IPOs are the main exit route for Chinese PE investors, and also the most favoured option. The Chinese stock exchanges are particularly attracting IPOs. This is because of the liquidity attainable through domestic exchanges and also the high multiples on offer. This is certainly true for Shanghai and Shenzhen, but also for Hong Kong, the special administrative region. However, one should point out that this situation could change based on a substantial correction in the Chinese local market.

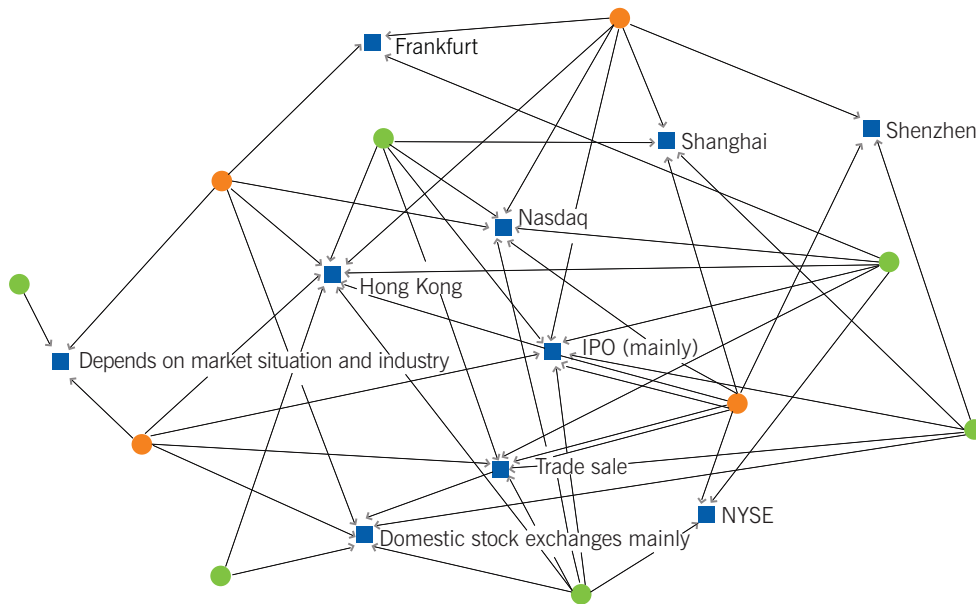
The decision to go with either Shenzhen or Shanghai is often linked to the size and sector of the organisation involved, but also to cultural factors and geographic proximity, issues which were highlighted when compar-

ing exits in other international markets such as Nasdaq, NYSE or Germany's Deutsche Börse.

When deciding on a particular stock exchange bankers play a significant role, especially because of the substantial underwriting fees they accrue. Generally speaking, Anglo-Saxon representatives tend to go with those stock exchanges they are already familiar with, or those which represent a good fit for the sector of the company to be listed – Nasdaq or NYSE for technology-related listings, for example.

Frankfurt, Singapore, Sydney, and Toronto were considered peripheral exchanges because it was felt that

### Preferred exit strategies of investors in Chinese PE and exchanges used



Source: Funds@Work AG, blue squares = main answers from investors, green circles = statements by European investors, orange circles = statements by Chinese investors

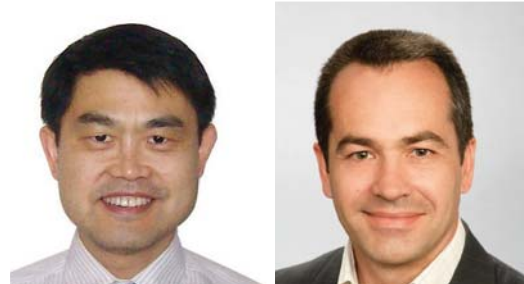
valuations were comparatively low in terms of what could be achieved in the Chinese Stock Exchanges and specialised to sectors which fit the company.

European investors, however, would generally welcome stock exchanges like Deutsche Börse becoming a preferred exit option, especially for companies in sectors such as clean tech, engineering, high end manufacturing, chemicals and automotives, where Germany is perceived as being a global market leader.

As Michka Kovats, chief investment officer of a single family office in Switzerland, notes: investors value the stringent listing requirements of an exchange such as Deutsche Börse because it raises the bar for corporate governance. The stricter the listing requirements, the more of a unique selling proposition for investors, particularly for stocks that are less well-known to European investors.

Furthermore, Bin Sun, vice president of CICC Private Equity in China, observes that Europeans might be less familiar with the situation in China, because there is less analyst coverage and less liquidity in their markets. He suggests it would be beneficial if there were more knowledgeable intermediary agents, such as investment banks, lawyers, and advisers providing the necessary coverage and intermediation.

Bin Sun, vice president of CICC Private Equity in China and Michka Kovats, chief investment officer of a single family office in Switzerland



In the future a second exit option expected to gain in importance is trade sale. So far it has not been very popular because of the cultural aspect involved in a trade sale, since the entrepreneurs who created the company can also keep their legacy when the organisation is listed on an exchange, whereas this is not necessarily the case when a company is sold.

As more and more entrepreneurs begin to look beyond IPOs, however, this situation is likely to change.



## Conclusions

When it comes to the lessons learned by European investors, an important point to mention is the huge discipline that a very high valuation environment such as Chinese PE now requires from investors. In this respect reliable information and deeper insights, as provided by papers such as this, for example, play an increasingly important role.

As Frankie Fang, partner at LGT Capital Partners, says: “You need to look beyond the surface to the core of the story that you are investing in.” This requires thorough due diligence – characterised by forensic research and a detailed understanding of the country, ideally coupled with a local team or trustworthy local partners.

Take your time and be highly selective, even if the external pressure to commit is considerable. The bubble-like period that investors are currently going through inevitably increases the pressure to make a quick decision, but this also heightens the risk factor.

One also needs to be humble enough to concede that not everything will work out perfectly. A point noted by Hans Peter Bader, managing director at Unigestion, who said that even the best funds have exposure to companies where they don't necessarily understand everything.

China is here to stay and Chinese private equity likewise. It is not China's export orientation that interests European investors, but rather the fledgling domestic market, which they see as growing significantly over the coming years.

It has also become clear that private equity in China is seen as a way of focusing specifically on the entrepreneurs rather than state-owned entities.

As the evolution of local investments seems to show, it is now time to move away from those companies under state control, concentrating instead on those which have strong business propositions and deserve the capital

Helge Müller (top left), CIO Equities at a German single family office; Frankie Fang, partner at LGT Capital Partners; and Hans Peter Bader (right), managing director at Unigestion



allocated – making them also far less dependent on state-controlled banks.

As Helge Müller, CIO equities at a German single family office, observes: “The market works mainly with little or no leverage.”

With European investors increasingly avoiding highly geared investments, Chinese private equity would seem to be a good way of adding value without exposing oneself to unnecessary risk.

We hope that these insights have been valuable to all those considering investing in Chinese private equity. We also hope that Chinese asset managers will have gained a greater understanding of what makes European investors tick.

As Chinese asset managers devote more attention to European investors, this white paper will serve as a useful starting point to connect both regions and, we trust, also foster greater transparency.



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