Deloitte China Research and Insight Centre
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In conjunction with the Deloitte China 2010 PE Confidence Survey

Measuring Value®
The evolving PE landscape

Introduction

Two developments frame our commentary this year. In the recent 12 months, China has seen continued expansion and diversification of financial players in the marketplace, with a significant part of the domestic capital flows largely unregulated.

The pace of RMB fund growth in the first half of 2010 was approximately three times that of 2009, taking many observers by surprise

Trust companies that behave like RMB private equity (PE) funds have assumed an important role in the marketplace, introducing new financial products that securitise loans from the largest state banks but have only recently come under the scrutiny of regulators.

Secondly, the window is opening wider for foreign financial investors, both through the opening of some previously restricted sectors and the further liberalisation of sectors already open. Several formal pronouncements have fueled this discussion, including the April 2010 circular *(the Several Opinions of the State Council Concerning Further Improving the Work of Utilising Foreign Investment)* from the State Council on improving the use of foreign investment and the "New 36 Measures" document from the State Council in May 2010 which focused on guiding the healthy development of all private investments. But as new sectors open, the actual opportunities they present remain somewhat unclear, pending formal publication of detailed catalogues and the testing out of regulator behaviour.

From both market and regulatory perspectives, the changes underway may mark an inflection point in China's engagement with the global financial system. The recent developments unfolded against the background of intense debate over the post-crisis and post-stimulus role of the State and role of markets in China. And externally, international trade and investment-related disputes are heating up.

Brief comments on the China PE Confidence Survey

Survey respondents this year showed a continued if gradual growth in confidence overall in the Chinese investment environment......

But they also continued to emphasise the challenges in the environment, especially challenges from regulation and competition, consistent with our analysis.

Respondents expected LP interest to grow or remain strong and accordingly for investment activities to continue to grow. They expected deal size to grow modestly. On the other hand, their expectations were not aligned with the government's continue push toward investment in second-tier cities, nor did they expect Chinese targets to improve much in terms of their investment readiness.

Sector interests expressed by respondents were roughly half aligned with government priorities for foreign direct investment (FDI) and private investment, with over 40 percent expecting consumer/retail and mining/power energy to be the sectors of greatest interest.

Government guidelines are focused on FDI that will promote key campaigns, like green growth

Generally, RMB fund activities increased faster than expected, and respondents shared the opinion that RMB fund activities would be the main drivers of investment in the future. A very substantial change occurred in the response to questions about what kind of investors would be most active in the future. In 2009, 36 percent said foreign PE fund managers - this number dropped to 9 percent in 2010, reflecting the surge in domestic investment channels. Linked to this is the expectation, expressed by an overwhelming 94 percent of respondents, that IPOs would be the main mode of exit.

This year's China PE Confidence Survey communicates more clearly than ever the unique opportunities and challenges that China presents global money managers

On one hand, money managers and their LPs are intensely interested and optimistic in noting that China is perhaps one of the very best places to park money today, that investment levels and scales are increasing, and that exit opportunities are improving. On the other hand, they feel the obvious impact of China's development model, which not only assures a major role for the State, including State financed "private" investment, but also includes the particularities of Chinese regulation and administration, the very fast changes and often obscure shifts in market and regulatory direction, and finally the intense, aggressive competition of local investors who move with agility in ways which are sometimes difficult for global money managers to match.

Review of RMB funds, developments and issues

2010 will be remembered as the year that RMB funds found their pace and became the major factor in China's capital landscape. The regulatory framework for foreign-managed RMB funds has taken shape over several years, led by the Pilot Programme of Foreign Capital Participating in RMB Equity Investment, settled in Shanghai and initially launched in Shanghai's Pudong New Area in April 2010. With publication of the long awaited *Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals (Partnership Measures)*, by the State Council, which went into effect on 1 March 2010, the process accelerated. Now, with a number of large municipalities actively competing for RMB funds, new local rules are appearing, differentiating the various opportunities available in cities such as Shanghai Pudong, Beijing, Tianjin, and Chongqing. The yet-to-be explored consistencies and inconsistencies with national partnering, investment, and currency regulations, have made the landscape both confusing and interesting.

In the first half of 2010, 32 new PE funds were set up, 26 of which were RMB-denominated, with US$4.5 billion worth of capital raised. The 100 plus RMB funds in existence have so far raised US$9.13 billion this year, making up 77 percent by value of all China-focused PE funds raised in 2010 to date. Yuan-denominated private equity funds have taken the lead since 2009, with deals worth at least US$3.6 billion since the beginning of 2009, while non-yuan funds have done US$2.8 billion in deals.

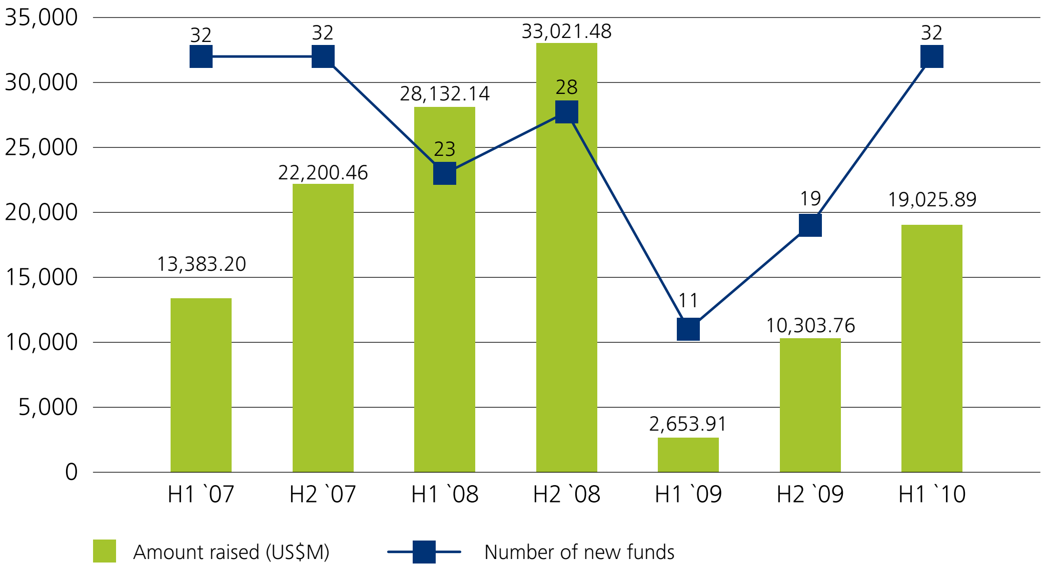
As of June 2010, 18 funds have been marketed to investors with an aggregated value of RMB85.3 billion (US$12.5 billion), a 67.9 percent increase on the 12 funds out in the market at the start of 2010 valued at RMB50.8 billion (US$7.5 billion), according to data provided by Preqin.

Foreign funds have encountered regulatory and market challenges in meeting their RMB funding goals. Nonetheless, foreign-run RMB funds have raised a disclosed RMB23.8 billion (US$3.5 billion) to date. Of this, RMB15.1 billion (US$2.22 billion) was raised in 2010. This means 64 percent of all foreign-managed RMB funds raised to date were raised in the first three quarters of 2010. The pace is clearly accelerating, but challenges remain.

There are many different kinds of RMB funds, and those managed by global fund managers are significantly different in many respects from the burgeoning purely domestic funds

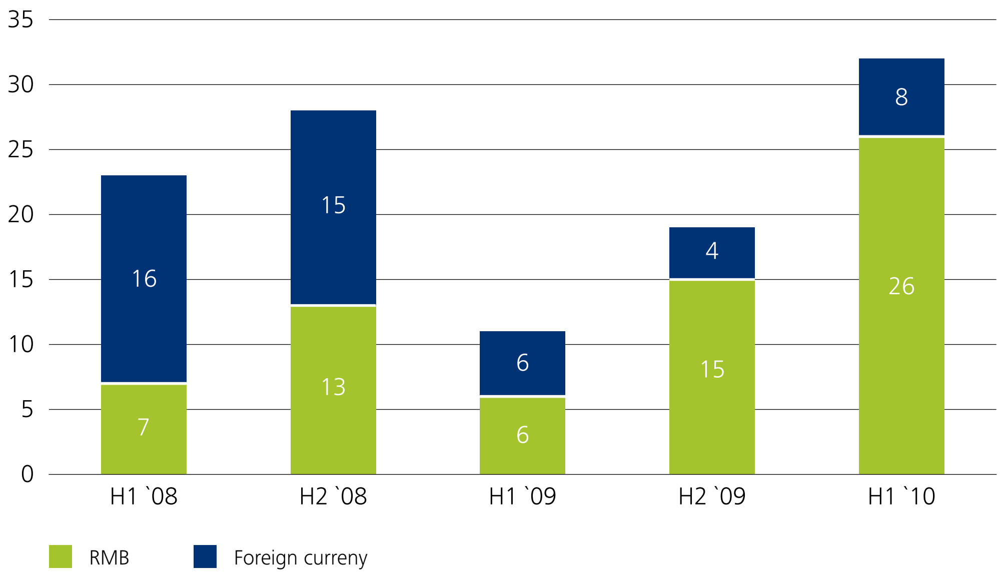
The domestic playbook calls for fast action, shorter diligence, simple documentation, and reliability of commitment that is more relationship-based than the legal framework familiar to globally managed RMB funds. Foreign funds are adopting various approaches, with some focusing on a single location and single RMB funds, others on multiple locations with strong local partnerships. In addition to reflecting the very strong growth in the number of new RMB funds and their aggregate capital, both charts below show that the scale of new funds is decreasing, a result of the large numbers of new, domestic players entering the playing field.

Chart 1: Comparison of aggregate fundraising amounts of PE investment funds between H1 `07 - H1`10



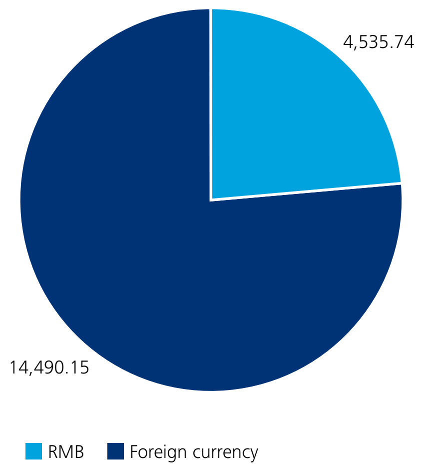
Source: Zero2IPO Research Center 2010.07 (www.zero2ipo.com.cn)

Chart 2: Comparison of new PE funds newly released between H1`08 - H1`10 by currency (by number of funds established)



Source: Zero2IPO Research Center 2010.07 (www.zero2ipo.com.cn)

Chart 3: Comparison of new PE funds released between H1 `08 - H1`10 by currency (By amount raised, US$M)



Source: Zero2IPO Research Center 2010.07 (www.zero2ipo.com.cn)

The trust model

A PE strategy in China cannot be considered comprehensive without at least an understanding of the recently proliferating trust model. Trusts are as old as China's reform itself, dating back to the establishment of China International Trust and Investment Corporation (CITIC) in 1979. After nearly three decades of rather tumultuous ups and downs and regulatory shuffling, China's current trust model was established under the regulatory authority of the Chinese Banking Regulatory Commission (CBRC) in 2007.

Trusts were under intense scrutiny beginning about the time China joined the WTO and intensifying in 2004. The major new regulatory framework implemented in 2007 both tightened regulatory oversight and expanded the activities of trusts, creating a uniquely Chinese financial services player that combines several functions of wealth management, banking, and private equity.

After three decades of liberal oversight, the CBRC has recently undertaken a closer look at their performance and risks

By design, the parties permitted to participate in funding trusts are high net worth individuals and corporations. Trusts are limited to participation of no more than 50 high net worth individuals, but are unlimited with respect to the number of corporate participants.

The policy interest is clearly focused on improving the professional investment channels for investable corporate assets

In the third quarter of 2007, the CBRC issued regulations explicitly permitting foreign investment in trusts, up to anything under 20 percent. In that respect, foreign investment in trusts mirrors that in banks, but unlike banks, there is no limit to the total equity that can be owned by multiple foreign investors. Foreign investors are, however, limited to investments in no more than two trusts, and they must certify assets of at least US$1 billion to participate. The first such foreign investment occurred in 2007, and since 2008 the number has expanded significantly.

In our classification of PE fund types in China, trusts are most like foreign invested RMB funds, in that they can move quickly without the State Administration of Foreign Exchange (SAFE) process burdens and entrain local investment capital in their projects, either as direct investors in the trust or co-investors with the trust. But in some respects they are more flexible, because they have access to sectors that are open to trusts but may be closed to PE funds, foreign and domestic. These include several types of financial services and real estate. Trusts can sell financial products, make loans, make direct investments, fund leases, and underwrite securities.

The tangled history of trusts in China invites close regulatory oversight, and there is clearly concern about the relatively liberal market space given to them. Entering the second half of 2010, as China tried to tighten lending to the property development sector, commercial banks have decreased their lending, but trusts have not. In the first half of the year, trusts issued RMB66.7 billion in real estate products, 65 percent more than that in all of 2009. The CBRC, perceiving the large exposure to a potential real estate downturn, has urged the trusts to undergo stress tests of their real estate exposure. In a more recent regulatory move, the CBRC has scrutinised the securitisation of commercial bank loans, which are being sold to investors through trusts, a practice which potentially moves high risk loans off the banks' balance sheets.

Like RMB funds under management of foreign PE firms, the direction in which foreign-invested and wholly domestic trusts will develop is as yet unclear. But they are likely to be important channels for cash-rich state-owned enterprises (SOEs) in particular, to diversify their asset management, reduce exposure to highly volatile sectors, and improve returns. Serving that function, they are likely to continue to grow in their role, with unavoidable regulatory ups and downs. During the early years of development, they may offer truly unique opportunities for foreign funds to gain access to some of the more attractive yet elusive corners of China's economy. At the same time, the 20 percent investment ceiling limits the degree of control over the activities of the trust a foreign investor might exercise through legal right, and that invites careful consideration of the relationships among the owning parties.

Classifying RMB fund types

Given the complexity and ambiguity of the various investment vehicles mentioned in the above discussion, the table below is an attempt to categorise active RMB fund types in China that either behave like private equity funds or compete with them. In the fast changing channels of capital, the boundaries of many of these investor types are vague at best, but the chart may help investors understand some of the inner workings of this complex market in the coming years.

Local PE type	Characteristics	Trends	Outlook
Traditional PE	• Both USD & RMB funds • Locally managed • International background investment team • Active market player	• Hybrid with international PE to enlarge relationship • Club investment	Market leader
Securities firms' direct investment Co	• "Sponsoring & Direct equity investment" in pre-IPO deals • Relatively strong network for deal sourcing	• Few large securities firms with sizable capital funds become market leaders • But face stricter regulatory monitoring	Independent PE
Insurance AM	• Relatively new entry to the market • Great demand for higher returns on large assets from active investment	• Subsidiaries set up to invest in PE and real estate although not officially allowed by the China Insurance Regulatory Commission	Fund of Fund (FOF)
SOE backed investment fund	• Strong relationship with governments & SOEs • More chances to conduct majority stake acquisition, especially for SOEs	• To diversify business lines when reaching mature stage • But likely to focus on core business in the future	FOF
Municipal/Provincial fund	• Include Industrial Investment Fund, Venture Investment Guide Fund etc • Emerging fast • Investment restriction on geographic range and industry	• New funds continue to be set up as they have support from various levels of government • Learning to more effectively position and manage the funds	?

FDI windows of opportunity

The Ministry of Commerce (MOFCOM) has announced plans to update the catalogue detailing foreign investment rules for various sectors. This document has existed since the mid 1980s and was last updated in 2007, prior to the financial crisis.

The general direction of the changes will be to encourage FDI in higher value added activities that support China's urgent campaigns, including the achievement of green growth objectives and the harmonious society

These steps illustrate the tension between long-standing programmes like indigenous innovation and urgent pressures to achieve progress on favoured projects like electrically motivated transport and renewable energy.

Piecing together what can be gleaned about the new catalogue, along with the information filtering out on the 12th Five-year Plan, we expect important opportunities to emerge in:

- Optical-Electromechanical Integration
- Geospace and Ocean
- Electronic Information
- Aeronautics and Astronautics
- Biomedicine and Medical Equipment
- Software
- Environmental Protection
- New Materials
- New Energy Resources and Effective Energy Conservation
- Modern Agriculture

However, even if it is published in 2010, we expect the new catalogue and the implementation of new guidelines to remain somewhat unclear and continue to leave considerable leeway for interpretation by central and local regulators

The give-and-take nature of FDI regulations is reflected in the table below. An additional level of uncertainty resides with potential World Trade Organisation actions threatened by key trading partners in some service sectors, like IT VAS, basic telecom services, and media.

Sector	Previously	Now	Going forward
Agriculture & Forestry	Highly restricted	Highly restricted	May ease somewhat in processing, production of biofuels and crops, R&D.
Business Services	Moderately restricted	Lightly restricted	Will remain lightly restricted or continue to ease slightly.
Construction	Lightly restricted	Moderately restricted	Will become more restricted as government cracks down on industries that are over-capacity, or are low end/ highly polluting.
Distribution & Logistics	Highly restricted	Moderately restricted	Government seeks to guide investment into logistics and e-commerce but this remains a sensitive/strategic sector - will probably remain moderately restricted.
Electricity	Highly restricted	Less highly restricted	Restrictions will ease with government focus on high-end sectors, and energy, energy efficiency, new energy technologies.
Energy	Highly restricted	Moderately restricted	This is a sector poised for major easing of restrictions - government focus on high-end sectors, and energy, energy efficiency, new energy technologies.
Financial Services	Highly restricted	Even more highly restricted	Focus on strengthening domestic financial service providers does not leave much room for foreign firms.
Hospitality	Lightly restricted	Moderately restricted	Not a particular focus area.
Manufacturing	Moderately restricted	Lightly restricted (except in key sectors: Auto, Chemical, etc)	Although restrictions have continuously eased, they look to tighten again as government emphasises high-tech and high-end sectors, and cracks down on over-capacity, polluting, or energy-intensive sectors.
Media	Completely/highly restricted	Highly restricted	Probably remain highly restricted.
Real Estate	Moderately restricted	Lightly restricted	Possibly in jeopardy as government tightens on sectors over capacity.
Resources	Highly restricted	Highly restricted	Sensitive/strategic sector but possible opening with focus on new energy & energy efficiency.
Social (Med, Edu, Culture)	Moderately restricted	Moderately restricted	Government hopes to develop by channeling investment in.

Not restricted (approaching 0%)	Lightly restricted	Moderately restricted	Highly restricted	Completely restricted (approaching 100%)

Sector	Previously	Now	Going forward
Telecom	Highly restricted	Completely/highly restricted	Sensitive/strategic sector and not a major focus for upcoming regulatory changes.
Transport & Infrastructure	Highly restricted	Even more highly restricted	Sensitive/strategic sector (esp in transport of certain goods like autos, chemicals, veg oils) but may get a boost under some of the upcoming provisions for energy-saving/environmental protection sectors.

Not restricted (approaching 0%)	Lightly restricted	Moderately restricted	Highly restricted	Completely restricted (approaching 100%)

Looking ahead

In China's current business environment, the central and local leadership exerts influence through two major channels. One is obviously through regulation and the implementation of regulation, extending from licensing business scope to setting tax and benefit levels to setting pricing along the supply chain. The other is non-regulatory, with what we call "opportunity management," through the agency of a number of players working directly or indirectly with public resources to shape the investment and operating environment.

For example, a strategic or financial investor that is State-owned and with access to public funds can impact the transaction price of an enterprise that is targeted by a PE institute or impact the land transfer price targeted by a private developer in municipal auctions, as has happened recently with startling upside impact.

In China's socialist market model, State-owned or influenced investors participate as market players, but in certain investments their goals may be more aligned with policy interests than with commercial interests

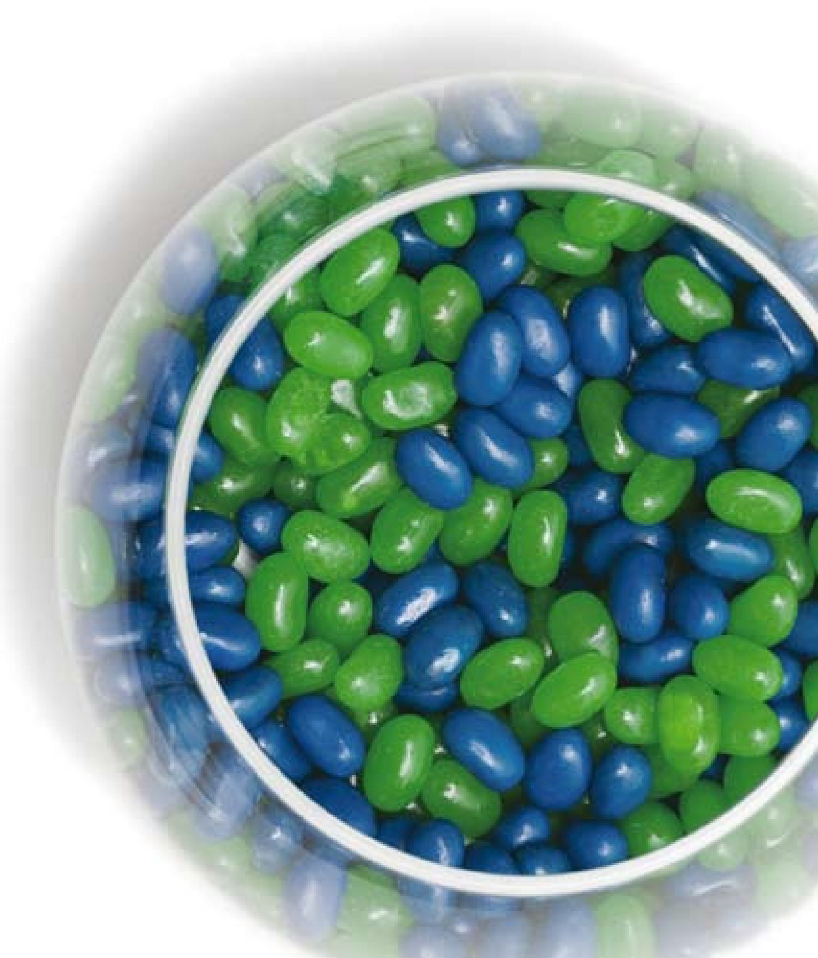
They might prefer investments to support sectors financially, in what could fairly be called rescue operations, or support pricing in others, in what could fairly be considered protectionist action.

In approaching an investment, both foreign and domestic investors should understand the chains of capital in the sector as a whole, as well as the typical diligence issues associated with a specific target.

Increasingly, investors and dealmakers need to consider the adaptation necessary in order to compete in China, including empowerment of local teams to accelerate the management and closing of good deals

In that way, the competition can be met, while risks of non-commercial pressures distorting the pricing and post-deal operation of the target can be identified and appropriate provisions made.

The diversification of investors in China's booming financial services sector, including an increasing number and variety of PE and trust investors, could be seen as liberalising in some instances but not in others. Not all players competing as financial investors operate under the same commercial imperatives and toward the same market goals, bringing to financial services in China what has been true for decades for competition in industrial sectors. The expansion of the FDI catalogue, similarly, will have an upside and downside, as the State refines its interests and significantly improves its technical skills in reaching its development goals.



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