105 RMB Funds Complete Fundraising in 2009 for a Total of US$ 12.30B

Zero2IPO Research Center

According to the statistics on the development trend of China's Private Equity (PE)[1] market from Zero2IPO Research Center, 105 RMB funds completed fundraising with a total of US$12.30B in 2009. The number and amount raised of new funds accounted for 84.7% and 65.4% of the total of the year respectively. RMB funds, for the first time, took a dominant position on the market in terms of the amount raised. From the perspective of investment, the number of investment deals conducted by RMB-dominated funds amounted to 328, contributing a combined amount of US$2.92B. In spite of still being far behind their foreign-currency peers in investment scale, RMB funds were more brisk in investment, which has become an undoubted fact. In this connection, RMB funds, as an emerging force in PE fund market, have all but outshone the others in both fundraising and investment, as well as had a brighter prospect.

Despite that the economies worldwide were struck by financial crisis and China's PE market fell down, RMB funds bucked the trend to prompt another round of liftup. Since 2009, the central and local governments have made unremitting efforts to stage new policies in succession, in a bid to remove the legal barriers to the development of RMB funds. Meanwhile, the government finance represented by government guidance funds at all levels has led the PE investment to a big extent, the large institutional investors represented by national social security funds have increased the proportion of investment in PE funds in their asset allocation, and the re-start of IPOs on the SMEB and the launch of ChiNext have established channels for domestic exits of RMB funds.

Chart 1 Year-on-year Comparison of Fundraising of RMB Funds and Foreign Currency Funds on Chinese Market between 2006-2009

Chart 2 Year-on-year Comparison of Investment of RMB Funds and Foreign Currency Funds on Chinese Market between 2006-2009

Note [1] The Private Equity Fund referred in this article is defined in a broad sense, which makes direct equity or quasi-equity investment in all enterprises before or after their IPOs (i.e. PIPE), including seed-stage, early-stage, expansion-stage and late-stage enterprises.

The Zero2IPO Research Center believes RMB funds will confront both challenges and opportunities in the future, and the challenges RMB fund will face during its development on China's PE market in 2010 are as follows:

I. Foreign Currency Funds Are Expected to Stop Decline and Gradually Go Up in 2010; Percentage of Fundraising and Investment of RMB Funds May Decrease.

Affected by the financial crisis, the global PE market went into downturn last year. Foreign institutional investors, in particular, have to review the potential risks of investment in this field and adjust their proportion of asset allocation in PE investment, due to assets contraction. Even emerging markets that develop very fast, for example China, also reduced, postponed, or even suspended investment in local PE funds. However, it is expected that institutional investors only adopted the measure of reducing alternative investment as an expedient. We believe the total funding injected by foreign institutional investors to Chinese PE market will go up in 2010, especially under the attraction of its ultra-high return on investment. As a result, the percentage of fundraising and investment of RMB funds is likely to decrease in 2010. In brief, the dominant position of RMB funds is not stable yet. The sizes of RMB funds and foreign currency funds will experience some fluctuations with the development of the industry in the next three to five years. Therefore, it is of high possibility that foreign currency funds may surpass RMB funds again.

II. Smaller Sizes of RMB Funds Lead to the Restrictions to Investment Strategy and Stage.

According to the statistics of Zero2IPO Research Center, in terms of fundraising, although the quantity of newly raised RMB funds on China's PE market exceeded that of foreign currency funds greatly in 2009, the sizes of RMB funds were only one third of that of foreign currency funds on average. From the prospective of investment, the quantity of investment deals completed by RMB funds in 2009 was 1.7 times of foreign currency funds. However, in terms of investment amount, RMB funds invested US$2.92B, while foreign currency funds contributed a collective of US$8.43B or 74.2% of the total in investment amount and took lead on the market. As a result of the small sizes of RMB fundraising and investment, investment stage and strategy of the funds will be subject to some restrictions, and the investment concepts and styles of RMB funds will also get affected to some extent. In 2010, RMB funds may see difficulties in its development on China's increasingly diversified PE market.

III. Participation of Large Institutional Investors Is Restricted by Current

Regulations; Development of RMB Fund May Face Barriers.

At present, RMB fund are mainly invested by the government finance (government guidance funds), national social security funds and private capital (private enterprises/rich individuals). Moreover, RMB funds' funding resources seems somewhat simple, and their structure has ample room for improvement. Meanwhile, RMB funds are restricted by the characteristics of capital sources to various extents. For example, government capital usually makes the fund involved with some political affairs, thus slowing down the decision-making efficiency of their investment. Private capital focuses more on short-term income and is no good for the long-term and stable development of the funds, due to its small size, frequent changes and less durability. Currently, for the reason of existing policy restrictions, large institutional investors that possess bigger funding amount and investment ability, such as local annuity, enterprise pension, commercial bank, insurance company and trust company, have not participated in RMB fundraising yet.

Looking at the development experience of mature foreign market, such as the US market, we can notice that its LP market has experienced over 30 years of development. Although the embryonic form of the LPs appeared in the 1940s, it was in the late 1970s that the LP market really started to turn from inception to mature. The pass of the *Employee Retirement Income Security Act* of 1974 marked as a milestone, which gave greater freedom to large institutional investors and enabled more leisure social capital to enter into the PE market. The growing experience of American PE market shows that active participation of large institutional investors plays a vital role in the development of the industry. In other words, the lack of large institutional investors in China's PE market may cause unconquerable barriers to the development of RMB funds.

IV. Mature LPs Are Rather Limited; GPs for Brand RMB Funds Fall Short.

Now, the number of LPs of RMB funds is rather limited, because large foreign institutional investors are strictly regulated by domestic departments and cannot make large investment yet. Mature domestic institutional investors, such as national social security funds, are very few. The existing domestic LPs have not formed mature risk consciousness, evaluation system and understandings on investment of RMB fund. The low level of psychological quality and risk tolerance cannot meet the requirements of domestic PE fund investment, which is reflected in two aspects. (i). Local LPs require for a quite short duration of return on fund, and focus more on short-term income, i.e. the phenomenon of "achieving long-term return with short-term investment". (ii). Some of domestic LPs interfere with the operation of fund too much, set many restrictions to fund investment, and even force fund management institutions to invest in some projects, which result in the confusion of management roles and non-clear-cut of responsibilities and affect the investment decision-making efficiency of fund management institutions seriously.

On the other hand, GPs of RMB funds are mainly domestic institutions now. The ranking result of VC and PE industry in 2009 from Zero2IPO Research Center shows that domestic fund management institutions developed rapidly, and the number of institutions on the ranking list increased year by year at a faster speed. However, having just experienced a ten-year history, China's PE market is large in quantity of PE investment institutions but unbalanced in management capabilities. The number of brand fund management institutions that possess excellent performance, good market comments and high credit is still very few. Meanwhile, the new industrial model of "domestic fundraising, domestic investment and domestic exit" is still under confirmation. The return on investment of RMB funds in the next few years is to be examined by the market.