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China LP Market and Investment Channel Research Report 2010

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Special Issue

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China's LP Market: Current Status & Investment Channel

China's VC/PE industry is now embracing a new development opportunity, catalyzed by a host of factors such as the race to optimize the policy environment for PE investing, launch of ChiNext in October 2009, rapid expansion of domestic LP group and emergence of domestic brand LPs. The vibrant development of RMB funds has become the highlight of this stage, while the convenient investment circulation mechanism featuring "local fundraising, local investing and local exit" is expected to become a dominant mode in China's VC/PE market. In this context, on one side, fund shortage has bottlenecked the development as many VC/PEs hope to set up RMB-denominated funds; and on the other side, the potential investors in RMB funds such as overseas large institutional investors, domestic banks and insurance companies and wealthy people hold piles of cash but lack suitable investment channels. The poor linkage between investing channels and financing channels has become a significant factor that hinders the development of China's VC/PE market. For this reason, effectively building a communication channel between GPs and LPs is a necessary way for VC/PE institutions to enhance the fundraising efficiency and fulfill common interests of various investors and fundraisers.

The funding source is essential to the financing of all VC/PE funds. The success for the fundraising of a fund directly depends on when a newly established fund wins the recognition and commitment of capital injection from LPs. Therefore, it is very necessary to analyze the current status and trend of China's LP market and understand the status quo of the fundraising for RMB funds in China. According to the present status of the VC/PE market, foreign LPs still come under the strict regulation of China's relevant departments about their investments in RMB funds and cannot initiate investment programs on a large scale, while local LPs are growing rapidly although they are still immature.



This report will first analyze in brief the evolution of the overseas LP markets, and then focus on analyzing the current status and trend of the LP market for RMB funds, and on this basis, examine the fundraising channels of RMB funds in detail.

1.1 Overseas LP Market & Investing Channels

Despite rapid development in recent years, China's local LP market remains at the early stage and is challenged by an array of factors, such as the absence of relevant laws, regulations and policies, monotony of funding sources, immature operating concepts and short supply of relevant professionals. In contrast, the foreign LP markets have grown up after the continuous development for more than three decades. Thus, studying the origin, evolution and investing channel of foreign LP markets will provide an important reference for China's local LPs to grow bigger and stronger in the future.

1.1.1 Overseas LP Markets

The rudiment of LPs could be traced back to the United States in the 1940s, but the LP market in the true sense emerged and grew mature in the late 1970s. The *Employee Retirement Income Security Act* (ERISA) was adopted in 1974, a milestone event that enabled large institutional investors to access a broader autonomy of investments and attracted more idle money in the society to flow into the PE market. Only from 1976 to 1979, the total capital raised by PE funds from pension funds decoupled from US\$5M to US\$50.00M. During that period, to further promote the development of the PE market, the US government granted large institutional investors the green light to invest in PE funds, and also adjusted the tax policy in favor of the PE industry. For example, the upper limit of the capital gain tax was slashed from 49.5% to 20.0% in 1981.

The equity investment was generally conducted by rich families, corporate consortiums and financial institutions in the early period. However, in the 1980s, the investing mode in

the market gradually shifted to the investments dominated by general partners (GPs). Such transition was made happen by the general acceptance of the limited partnership (LP) among the investors. Such innovation of organizational form played an important role in the rapid development of the PE industry in future.

Since the late 20th century, the PE funds in the Untied States stepped into a stage of rapid development. With many cases proving this new investment mode can generate big returns to investors, PE funds have been favored by more and more investors, and gradually become an important financial investment product in the investment portfolios of various investors, in particular large institutional investors.

1.1.2 Current Status & Investing Channels in Overseas LP Market

The PE investment falls into the scope of alternative investment. By alternative investment, it means the investing tools other than traditional investments like stocks, bonds and cash, and mainly embodies PE funds, hedge funds, real estates, infrastructure investment and bulk commodities. According to Russell Survey on Alternative Investment, the LPs of alternative investments chiefly include corporate pensions, DC plans, public pensions, endowment & foundations, insurance firms and others.

Accordina to the Russell data. influenced by the financial crisis. the proportion of the

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