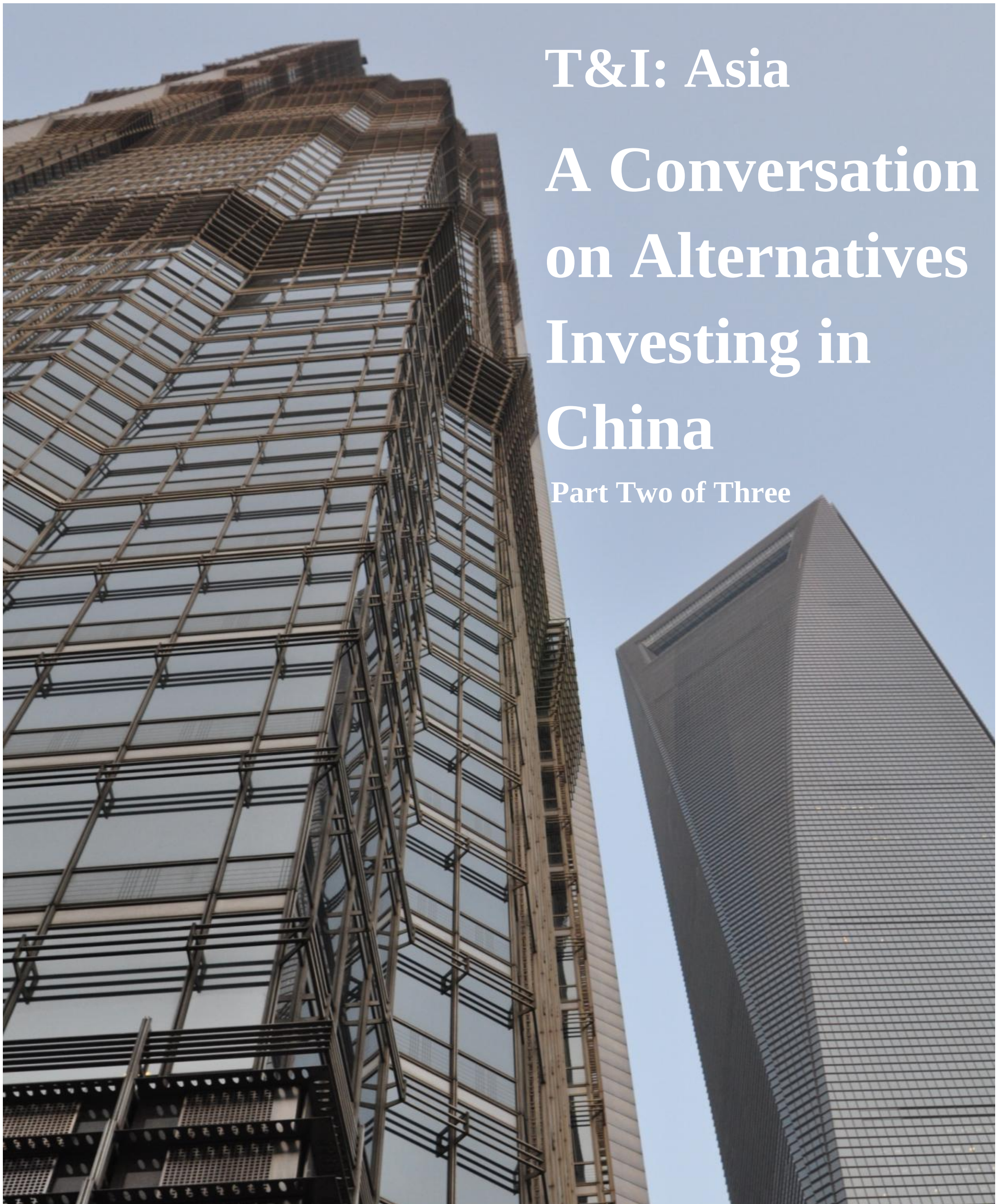

T&I: Asia

A Conversation on Alternatives Investing in China

Part Two of Three

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Judie Feng, Capital YuanTao (**JF**): Some of you may recall that at this time last year, I was representing American Securities/Hamilton Lane China, but during the summer we changed our name and brand here, because the length of the name was unwieldy, but more importantly, people had so many questions when they heard the name. They saw us as a US firm or they saw us as a broker that could help them pick stocks, because of the word securities, so as part of our preparations for fund raising, we decided to develop a Chinese name. Yuan and Tao in Chinese means long term and this reflects our long term approach

JF…SOME LPs TOLD GPs, DON'T CALL CAPITAL. IF YOU DO…

to investing. It also emphasizes our China focus, our desire to help local GPs and our outlook as a fund of funds, in long-term investments in China. We began investing in 2007, committing to three small to mid-sized funds in China, but this year we're cautious, only committing to one fund, New Horizon Private Equity. In thinking about private equity and events in China over the last year since we met last, here in Shanghai, I think that the GPs have felt the pressure from the financial crisis over the intervening period. The result has been that the private equity market has been fairly quiet. We've seen fewer deals primarily for two reasons; First, GPs were unsure about how deeply the economy was going to decline. So they've wanted to wait and get more comfortable with the fundamentals of the companies that they're going to invest money into and the second reason is that some LPs told their GPs, Don't call capital. If you do call capital, I will default. Not us, but I know other LPs said that. Those are reasons why the

DS: …RMB INVESTORS RAISE THE QUESTION WHY WE'RE HERE…

investment pace was slow in the first half of 2009. In the second half, I'm seeing a lot of deals, the market has become re-energized.

Dayi Sun, JadeInvest (**DS**): My name is Dayi Sun and I'm from JadeInvest. Along with Judie we're a China only fund of funds. I agree with Judie's observations and with the thoughts of the previous session, in that another reason why many deals weren't done, has been in the mismatch of the expectations, whereas either GPs have raised their expectations of what they have to pay for a deal, or companies have lowered their expectations for what GPs should pay, but I believe that there are more of the former than the latter. Given that JadeInvest is a China-only investor, my major concern, is to figure out what the real model for private equity or venture capital is for China. There are parallels today, from the previous era of investing in China, when multi-nationals came here and tried to do everything first in the Western way, then in the Joint Venture way, then in the returnee way; now we're changing to the local way. The same applies to private equity. The question by Lixun Gong earlier, whose question is why do we need foreign private equity firms in China, I won't comment on why that is being asked, or whether the question has merit, but that question has made me think a lot about

what we, as a foreign investor, as a representative of foreign PE, what is it that we can do that will make a difference here. Because as we're seeing here today, there is a lot of talk about RMB investors, many of whom are raising the same question about why we're here, about whether we're just here to grab the low hanging fruit. My task is not to find out why, or whether we should be here, but to figure out, how we can stay here in the long run and what difference we can make.

SW…WE HAVE CHOSEN SHANDONG PROVINCE AS OUR PRIMARY AREA.

Steve Wu, Aureos Capital (**SW**): I'm Steve Wu and I'm from Aureos Capital. We're a PE fund management company that provides expansion and buyout capital to small and medium sized companies in the emerging markets. An important aspect of our firm is that we only focus on emerging markets. We have funds in Latin America, Southeast Asia, Africa, Central Asia and China. To date, we've founded 16 funds and we have a presence in over 29 countries globally. This may give an impression that Aureos is a very big global firm, but our funds under management are only about $1.2 billion. In part, because we're focused on SMEs and in part because the deals that we invest in are not that big, so the size of each fund is not big. We entered China as a firm late in 2006, almost three years ago. In addition to our SME focus, in China we have a geographical focus, where we have chosen Shandong province as our primary investment area, so that we can concentrate our resources, but also because we think that it's easier for post-investment portfolio company management as China is such a big country. So far, we've made a couple of investments in Shandong province and we've found that it's quite an interesting province with a lot of activities that have not been tapped by other PE or VC firms. Of course this also means that there are more problems investing there, but that's our job to make investments work and so far it's working. Our history is that Aureos was spun out of the Commonwealth Development Corporation (CDC) in2001 and managed a range of funds originally sponsored by CDC and to raise and manage a new generation of PE funds under the Aureos brand. Investors in Aureos funds include institutional investors, bilateral and multi-lateral development finance institutions, pension funds and fund of funds.

T&I: And your sibling, Actis, which was spun out of CDC later than Aureos has some overlap in your geographies?

SW: Correct. But we were and remain entirely separate from Actis.

Brett Tucker, Baird Capital (**BT**): I'm Brett Tucker from Baird Private Equity and more specifically from Baird Capital Partners Asia. We're based here in Pudong. As a private equity fund we invest in traditional, small and medium sized companies. By way of background, Baird is a 90 year old company that has been investing in private equity for twenty years; we've made over 220 investments over that 20 year period. We've

BT:… WE WERE INVESTING IN COMPANIES HURT BY CHINA… ….

raised and manage over $2.5 billion in capital. We've been in China for over five years. We first became involved in China, because we were investing in manufacturing companies who kept getting hurt by China, as Chinese manufacturers were taking our customers away in the US and Europe, so that by mid-2003 we said, let's not

DQ… IT'S POSSIBLE FOR FOREIGN GPs TO SET UP DOMESTIC FUNDS IN CHINA…

let that continue to happen and let's not be reactive to China, let's be pro-active. Let's go and find US and European companies that should be working in China, who are not, and set up an operations team here in China to support those companies. We're talking about businesses with $50 million plus in revenues. If you're the CEO of that kind of company somewhere in Germany or in Kansas, it's very difficult to deal with China by yourself. So we set up an operating team here in Shanghai, which is today about 20 people that just do sourcing, logistics, quality control & assurance, and project management. Then about two years ago we said, now that we've become comfortable with providing operational support in China, let's invest directly in China, which we began to do in China, investing in traditional industries, including healthcare, business services and manufacturing companies. We have a separate fund dedicated to China, for which we've held a first close and from which we're already investing.

Dali Qian, Debevoise & Plimpton (DQ). I'm Dali Qian, I'm the PRC Legal Consultant for Debevoise & Plimpton. My practice focuses on fund formation under Chinese regulations. We have a number of people who keep a close watch on the Chinese regulatory regime, with relation to private equity and venture funds, since about five years ago. We believe that we advised the first, real, limited partnership formation in China, done under the so-called FIVCE or Foreign Investments Venture Capital Enterprise regulations published by MOFCOM, in 2005 and 2006, even before the partnership law was revised to allow and accommodate the limited partnership structure. We also advised Hony Capital and CDH in setting up their offshore funds. Due to our practice here, we have a good sense about the regulatory changes. Since the revisions to the partnership law in 2007, it has been possible for foreign GPs to set up limited partnership funds in China, because the revised partnership law gives foreign investors opportunities to set up limited partnerships in China via foreign invested enterprises in China. Such foreign invested enterprises may include WOFEs, or joint ventures because they can be treated as a legal entity in China and thus become a general partner. Recently we've seen lots of local government authorities that have been issuing incentive policies, to encourage PE funds to register in their jurisdiction. In Shanghai, for example, in July of 2009, they passed a rule allowing foreign investors to set up equity investment management companies which could be a WOFE or JV and which could act as a GP or manager to RMB funds. It's interesting that not only Shanghai has introduced such rules, but the Beijing government is also introducing similar regulations and because we're "of counsel" to the Beijing PE Association, we have advanced access to information from the Beijing government on such rules. Beijing government has taken a very aggressive stance in their version of these rules, taking a clear

position in drafting their rules, such that, equity investment management companies can raise RMB funds in China and they can raise funds from either domestic or foreign investors, so that they've moved one step further than the rules established in Shanghai. The rules in Shanghai do not say directly that equity investment management companies can raise RMB funds.

T&I: Tianjin published the first such rules?

DQ: That was a different matter. In Tianjin, they first set up a special trial, for "Industrial Investment" funds and then in 2007, they allowed foreign investors to set up funds. The rules coming from Beijing and Shanghai governments now provides clearly for the establishment by WOFEs of funds and that such WOFEs can be GPs and can raise funds. Absent a rule on partnership established for foreign investors I think that's good news for GPs. But there are still two hurdles lying ahead: foreign exchange and foreign investments restrictions. As for foreign exchange, under SAFE circular 142, foreign invested enterprises may not convert foreign capital into RMB for domestic equity investment purposes. In 2008 SAFE issued this rule in an attempt to slow or to control the flow of "hot money" into China, but actually this regulation has flopped. Under that rule, the foreign LP or GPs were unable to convert foreign capital into RMB and to make RMB capital contribution to RMB funds. The second hurdle was the restrictions on foreign investments, in terms of the ratio, because when foreign money is converted into RMB, it was unclear how you treat these RMB; as domestic capital or as foreign investment. If they're treated as foreign investment, the RMB fund are subject to restrictions of foreign investment categories. Plus it was unclear how the government supervises the investment.

DQ... TIANJIN SET UP A TRIAL, FOREIGN INVESTORS SET UP FUNDS...

T&I: And a third hurdle, if you're investing outside of Beijing or Shanghai, in that the local regulators in different cities or provinces may or may not rule on such matters in the same way?

DQ: Yes, that's a problem, but as long as you set up the fund in one of the major urban centers that's not a problem; setting up in either Beijing or Shanghai jurisdictions is not a problem. When you set up in some other jurisdiction in the provinces, its subject to the experience level of the local authorities there. Back to my two hurdles, there are two potential resolutions to them, from a regulatory point of view and we hope that SAFE will issue some kind of circular that will specify that the GPs or LPs are not subject to the restrictions under Circular 142, and that their foreign capital can be converted into RMB for capital contribution. And as for the investment restrictions by sector for foreign investors, we have heard that some local governments are asking the NDRC to acknowledge that if the RMB funds contain foreign capital, but that foreign capital is less than 20% of its total committed capital, then that fund should not be treated as a foreign fund and therefore the downstream

DQ...SETTING UP IN BEIJING OR SHANGHAI IS NOT A PROBLEM, BUT IN THE PROVINCES...

investments of that fund should not be subject to the approval of MOFCOM. Rather they should be treated as domestic investments.

Ji Ran Laurie Kan, On Capital (**JRL**): I've heard from another law firm on this, that in order to qualify a foreign fund for being a RMB fund, if

JRL: AS AN RMB FUND GP…YOU MAY BRING IN US DOLLARS?

foreign capital is to be added to that fund, that there is a shortcut to having foreign participation if you situate yourself as a GP with a special role, that will invest in the same fund, then your US dollar capital is exempted. Put in other words, if you qualify as an RMB fund GP, then you may, in your own capacity, bring in US dollar capital. Is that your understanding Dali?

DQ: No, I don't think that is going to work, because as you describe it SAFE Circular 142 still applies. But for a GP, if your GP capital contribution is a limited amount, then there may be some methods to solve the Circular 142 restriction. For example if a GP only contributes $1 million dollars, it's a small amount in fund capital contribution, which could be borrowed. You may find a local partner to set up a joint

DQ: I DON'T THINK THAT WORKS… SAFE CIRCULAR 142 APPLIES…

venture as GP and the local partner can provide RMB capital, then as a GP, you can contribute RMB into the RMB fund. But Laurie, to your question, under the current SAFE restriction, I don't think that there is any exemption for the GP. (Room erupts in different voices)

Gordon Shaw, Baring Private Equity Asia (**GS**): That defeats the purpose of [having an RMB fund] if you're saying the ceiling on foreign ownership is only 20% then you can no longer

GS…IF THE CEILING ON FOREIGN OWNERSHIP IS 20%...YOU CAN NO LONGER HAVE AN RMB FUND.

have an RMB fund.

JRL: That 20% is for a kind of parallel fund and those funds would be treated as a foreign investment. It's something that for practical purposes, we want to test.

GS: Because having RMB would allow you to make investments more quickly.

JRL: Then you have to consider whether, if you have this ability, you also have the same benefits or whether you're locked up for one or three years.

GS: On this same topic, I heard one GP, saying that you could defer SAFE approval for an investment, convert your money, come onshore and make your investment, and then when it's drawn, you get the SAFE approval for the purpose of your investment. But at least you wouldn't lose out on an investment. At the same time it's difficult for an offshore LP to say, that they have to mix dollars with RMB when they don't know the amount in US dollars.

DQ: I think you're all referring to FIVCIE, because SAFE has a special circular for the treatment of FIVCIE, which SAFE says, may not be subject to the Circular 142 restriction, so that you may have US dollars coming into China and those dollars are converted into RMB when they reach the portfolio companies. But that has to be a foreign invested venture capital investment company, which is specific to venture capital investments. They do have some special conditions because they're VC. But for general PE funds, or for Limited Partnerships, SAFE restrictions still apply.

T&I: Judie, talk about your observations on GPs at present, team turnover within China?

JF: We see more movement within GPs during the past year than previously. As always there are a couple of reasons, some good, some bad, but last year it was mostly bad. We observe that many funds here are new, raising a first fund or a second fund and they think that they're going to be raising bigger funds, but the reality is much tougher. Fund raising doesn't go smoothly and some of the partners lose patience and decide to pursue other opportunities and the fund falls apart. We've seen that in China. The other issue we see is among the high caliber people who are working at the big names, the Pan-Asia funds, who eventually figure out that given the quality of the portfolio companies, the carry has almost been wiped out; they're going to be working for three to five years for no carry. That gives them the incentive to think about setting up their own fund or to work for a local fund. But in any case, it becomes an easy time for them to consider a move, because the lock up is weaker.

T&I: Other issues for LPs in China?

JF: There are a number of general issues we're facing. As I mentioned our Fund of Funds

JF: …PEOPLE FIGURE OUT THEY'RE WORKING FOR NO CARRY.

focuses on small to medium sized funds, which means, they've raised from $100 million to $500 million and which in turn means that often times we were dealing with first or second time funds. When I talk with this group of GPs and ask them about their portfolio companies, normally I come up with this feeling: it's too good to be true. While I think that it's good to hear that they have a good portfolio, that implies that either they have a unique strategy or they have a great team. But sometimes, when I see a GP that has a normal strategy and team just like other GPs, I have to wonder how they can have such a great portfolio. This causes us a lot of debate internally. We see that the team is only okay, but the portfolio is great. So that causes us to ask whether the quality of the portfolio companies is sustainable, i.e. whether they can deliver the same quality in their fund two. We keep asking that and often times we see that when the Chinese GPs are doing their first fund, they're simply using their personal network, their relationships for deal sourcing. That means that sometimes they come up with good deals, in companies with good fundamentals and with good valuations. The question is whether they can replicate the success of the first fund, with the second fund

JF… GPs ARE USING THEIR PERSONAL NETWORK IN DEAL SOURCING.

because there is a limitation of their personal network. And when I share my concern about this with the GPs, sometimes, they can give me a good answer, sometimes they cannot. It makes me think that perhaps, three to five years ago, when you had the money, you could make good deals and make a good profit. But today, I think that the GPs somehow have to have a "secret sauce," a differentiation point to other GPs, otherwise they're just like anyone else despite a successful first fund and we don't think they can replicate their success in a second fund. I always ask GPs what makes them different from other GPs and I'm open to any kind of answers. They may tell me that they have domain knowledge in certain industries; they can tell me that they have geographic coverage like Aureos just mentioned and they're focused on one or two provinces; or they can tell us that they have special relationships with Universities or a research institution, from which they can source VC deals. What we can't accept is a GP who says, we're generic, we do everything, in the same way as other GPs.

JF… CHINESE PE IS IN ITS INFANCY. IT'S TOO EARLY TO FOCUS ON ONE OR TWO INDUSTRIES…

David Wang, WI Harper (**DW**): If you look at those three factors, domain knowledge, geography or relationships, which one do you think works better?

JF: People normally have a mixture of all three, and as LPs we're receptive to that, provided that the GP can back that up. For example if a GP says, I focus on Shandong and when I ask them how many of their portfolio investments are in Shandong Province, as Aureos did, saying that they have three investments in the province, that's okay. Of course I'm going to ask how did you source those deals, what is your secret sauce. We also debate this with our colleagues in the US, try to get some advice about what happened in the US market. But we think that because the Chinese PE market is still in its infancy, maybe it's too early to focus in one or two industries, maybe that's too narrow and if the economy goes into a bad cycle that would give a fund a bad investment year. When a GP tells us that they have domain expertise in three or four industries [we like that]. In terms of geographic coverage, normally people will tell us that they have offices in Beijing and Shanghai, but in some rare instances they'll tell us that they have an office in ChongQing and that they've built up a good relationship with the government of ChongQing that generates deals. All of that is good.

SW: For example in our case, Aureos has an advantage in that our international network, with 29 offices across the world, can be attractive to the entrepreneurs, because the SMEs do not have a network that allows them to open operations abroad. If they use our channels and our networks abroad, we hope that this can provide additional advantage to these firms.

T&I: Final point on team dynamics, we're also seeing turnover in fund of funds?

JF: Normally when do our analysis of a potential investment, we're looking into the track record and experience of the team. If their strategy is sound, or if they come up with a derivation of that strategy, that matches the current market better, we want to see they can back up their investment strategy.

T&I: Given that you do invest in first and second time funds and what do you predict for survival rate?

JF: It depends a lot on timing. For funds of vintage ’07, or later, I think they’ll survive

JF: …FUNDS VINTAGE ’07 OR LATER WILL SURVIVE BECAUSE THEY’VE GOT DRY POWDER…

because they’ve got dry powder and they will not go back to the market until 2010 or 2011.

For others, it’s just bad luck that they’ve had to raise funds in 2008 and 2009. Or for those who invest their funds quickly, they’ll have a hard time. Regardless of that, we still believe in China, we still believe in smaller funds and smaller deal sizes, which we think will generate higher returns.

DS: On the question of first and second time funds in China and whether they will survive, my perception of the problems, relates to the question of whether we see a different model for private equity China evolving. China does have many unique features. In the United States, when we see the older funds, you can see that the funds have been stable. But you can’t expect that model to apply to China. As a result, we have two different approaches to investing in GPs in China. First is to try and quantify as much as we can. We look at our funds at a company level and try to analyze them, by slicing and dicing, looking at them a lot of different ways. The same thing with fund managers. For example, we separate first time and emerging fund managers from established managers. We try to create a risk and return profile based on our own subjective perceptions, which we then attempt to plot on a graph to see which funds tend to be on the frontier. That is the quantitative way. Then we look at managers in a qualitative way, which is to talk to talk with them. So far we have invested in eleven fund partnerships, and they have correspondingly invested in about one hundred portfolio companies. We look at each of those companies to see, based on our analysis, which sub-segment tends to perform better, according to their current forecast and current returns for the future. Based on that we try to figure out which sub-segments of the market may have better returns. And if a fund is an emerging manager, is there a correlation with the portfolio performance. While it’s still too early to say anything definitive we do have some findings, one of which we can share here. We all know that there is no Venture Economics or Cambridge Associates which compile return information for China. We’re interested in the returns from China PE funds. We have

about 1900 partnerships in our own database, and fortunately for us, we’re able to talk with these funds about all kinds of sensitive issues, such as returns and we collect return data for

DS… ONLY ONE YEAR’S DATA FOR CHINA DID NOT EXCEED RETURNS FROM US FUNDS…

about 200 funds. Actually, only 200 of them have meaningful return data. And with that we compute our own quartile performance data for China. For some vintage years, the data sample is really too small to have meaningful data, but for the years were there are ten or more partnerships, we try and compare that with US numbers. And while I'm speaking only from memory, there was only one year, where the median quartile data for China, did not exceed

DS: IN CHINA WE ASK WHETHER PAST SUCCESS WAS DRIVEN BY A SYSTEMATIC APPROACH, LUCK, OR …

the returns from top quartile funds in the US or other regions. Of course if you look at different sample sizes, even for the US, for some segments or for some years, the sample is also too small to be significant. But in terms of the direction of what we observe, PE has generated good returns in China. And if you consider the things Judie has just mentioned, for the firm's that have returned meaningful data, out of our database of1900 funds, a lot of those were raised within the last five years. So in truth, there is not meaningful return data, so I'm comparing more meaningful, historic data here. I think that David (WI Harper) is the only firm in the room with return data from the '80s, or '90s. Basically, if you look at the return data, I totally agree with what Judie has just said. If you're in the US, there is a fixed, evolved model. But in China we can ask two more questions about firms in our industry? The first question is, whether past success was driven by a systematic approach, that is, are they able to replicate that success, or was it through luck, or someone pushing down on you from the top, by your heritage, by whatever, by a boom in the market. We don't know, but we try to understand the environment when a firm entered a deal. We want to see if something is going to change. Then the second question is, if they have the potential for delivering big returns in the future; whether they will align their interests with their LPs well. That is an important question for a lot of the first time and local managers. A lot of times, the GPs don't understand why we need to ask this, especially when we talking with really experienced local managers who are trying to raise their first US dollar funds. We see a wide spectrum of GPs who are doing widely different things. You have a Hony and a CDH, who bring a US fund discipline to their RMB investments. Then there are others who say, Ah, I'm managing one fund for one group of LPs, but at the same time, I'm managing another 20 funds, for another group of LPs, with the same team. How do you resolve the latter? These contentious issues? Sometimes a manager will counter that they're not really managing a fund, thinking instead that what they're doing is project finance. We believe that is the model for China in the future. I personally don't know, but it's still very early, so I'm open to all these different kinds of models. I don't believe that in China, a single model will dominate the whole investment landscape. In the end some firms will disappear; in the end some US models and some local models will win. win.

Cary Zhou, New Margin Ventures (CZ): We are one of the early venture funds for China, established in 1999 and at the time we were

CZ: INVESTORS ARE LOOKING FOR DEALS THAT CAN BE TURNED AROUND IMMEDIATELY…

pretty much sponsored by the government. We had a couple of government backed funds. When I listen to all of this discussion about models it occurs to me that one consideration for many of the funds here, is that most of the funds here have only been around for from three to five years. The model even if you think it's good may only mean that someone has been lucky, so that even if you had a good exit happening over the last few years, but you haven't been able to list as an A share, then you don't get good returns, so the perspective on what has happened in China is twisted a little bit. We have just closed a pure RMB fund, for about 700 million RMB, from an all domestic group of LPs. We have a US dollar fund. We have had a joint venture fund in the past, which is now polluted, considered a foreign fund, because it's over 20% from dollars. (Laughter) In our view there is going to be a lot of competition in the future from RMB funds, because there is a lot of money around in China, however, these investors are more conservative and they're looking for deals that can be turned around immediately, not for what can be done over five years. A lot of these investors like to play in the secondary market, but many of them are being educated in why we need to wait around for five years for the payment of their management fees and carry, which is new for these RMB managers. Whereas we've been managing these two funds, a joint venture fund and a US dollar fund and now we're adding an RMB fund. Our challenge is to make all of our LPs happy. We have US LPs like Vincent and Pantheon and others. We have a list of local RMB fund LPs, domestic LPs. And we don't see any conflicts, because many of the first investments that we made, are at the first stage, we decide whether they're going to be listed outside of China or whether they're going to be listed domestically. In the past, when the entrepreneur asked for funding, they didn't care whether it was in US dollars or in RMB. Nowadays they're sophisticated, they say we want RMB, or something else, because there is so much competition by GPs. Whatever advantage they can get, they want it and so more entrepreneurs are asking for RMB.

CZ: WE WANT LPS TO SHARE IN THE PROFIT OF THE RMB FUND…

T&I: To clarify, you've raised $700 million RMB.

CZ: That's right. Almost $100 million US dollars. But because we raised another US dollar fund of $300 million, we've tried to keep the RMB fund smaller, only for those people who require RMB. Otherwise, we're still trying to sell our US dollar fund.

T&I: Describe how you separate RMB and Dollars in a single investment.

CZ: We addressed this up front with our US LPs; what we said was that we want them to share in the profit of the RMB fund, through its set-up. It's more of a token gesture that we're willing to share the profit that we generate from our RMB fund, to give a return to the LPs who have helped us from the beginning; that was our agreement from the onset with the LPs.

JF: This sounds new to me, but help me to understand. The US dollar LPs who invest in the dollar fund, will be able to share in the profits from the RMB fund?

CZ: Right. Actually, it's more than fair, but honestly, when we established the new US dollar fund, we hadn't committed 70% of the previous fund, so we weren't entitled to raise another dollar fund. But we try to be a "one stop fund," so that when entrepreneurs come in we have both kinds of funds to support them; RMB and dollars. We have been debating this, whether to set up separate RMB and dollar funds for a while now. Even before the regulation was introduced limiting dollar participations to 20%. But ultimately, we felt compelled. We turned away so many good deals, just because we didn't have RMB. But the question is why we have to let the US LP share the benefits from the RMB fund. We did this, because we had to go back to our LPs and get their permission to set up our RMB fund. We had to give them something. And the profit that we're sharing is from the carry. Not from the fund itself. We will actually share profit.

BT: THE QUESTION BECOMES HOW DO YOU MANAGE THE CONFLICT?

Brett Tucker, Baird Capital Partners Asia (**BT**): That is the most coherent explanation that I have heard, not the carry part, but if the entrepreneurs demand RMB or there is no deal, that makes sense to me. We could go out and raise RMB money, despite being a foreign fund, but let me ask the two LPs at the table, what would you advise your own institutional investors about this? The issue to me, it seems, is that the same team is managing two different funds. There is an inherent conflict, so the question becomes how do you manage the conflict. If you can get your investors comfortable with the fact that it's the entrepreneur coming to us and saying, RMB funds or no deal, then there is a clear differentiation. But, if I were the LP and being offered a little of the carry to compensate for a potential conflict, that might be difficult to get comfortable with.

CZ: …I'M FLEXIBLE, VERSUS THE GUY WHO HAS ONLY DOLLARS OR RMB.

CZ: Well, from the point of view of the deal flow, we have two separate sheets for RMB and dollar investments. That is clean cut. When you come to actually running the business it's actually very clean cut. We go to a potential portfolio company and say that we want to invest and there are usually three or four guys who can invest and eventually the entrepreneur has the final say. That's it. The advantage to me as a GP is that I can tell that company president that I can help him with either RMB or US dollars. I'm flexible, versus the other guy who has only dollars or RMB.

JRL: Is it a guidance fund that you raised?

CZ: The Chinese LPs are actually from our joint venture fund. We've haven't completely invested that fund yet. We had about $12 million dollars left. It was a 50/50 joint venture, so we tried to phase it out, and treat it as a US dollar foreign fund. In the RMB fund, we have some government support too, because they put up some money. These cities, Wuxi and others are willing to put up money if we're willing to move there, they put up RMB 200 million or whatever. However, there is a lot of regulation if you go there,

CZ… CITIES ARE WILLING TO PUT UP RMB 200 MILLION… BUT THEY WANT YOU TO INVEST THERE.

because when these governments put up that money, they want to see you invest in Wuxi, or in the other cities and we don't like that. From our beginnings we were a government fund, so we're familiar with dealing with governments, we began with backing by the Central government. So now, when these local governments which want to hand us a lot of new regulation, we don't want to take their

money, because we can money from elsewhere.

DS: Without thinking too much about the implications of how you go about structuring these RMB on shore funds, I personally like the practice and I've heard better rationale, better explanations. Because if you say to the US LPs you miss a deal and then you do the deal

DS: IF YOU DO THE DEAL WITH YOUR RMB FUND… IT'S WORSE

with your RMB fund, it's even worse, because then I see you're spending your time and your effort on a deal that is not related to me at all. So, at least to me, the better explanation is that if we don't this RMB deal, then our US fund will be in trouble in the future; then the investment makes sense. Of course that is only one thought. But your practice of sharing the benefits from your RMB investments, I have to say, that is the best thing I have heard from the current generation of dual US dollar/RMB funds. Because the practice of most funds at present is that they say that they have a very strict quota, for investing in proportion or pro-rata, from the funds, for these kinds of deals. These are almost automatic distributions of funds into these US dollar/RMB deals. That's one extreme end. The other extreme is the GP saying, "you already trust my investing in US dollar deals, you should also trust me as to

DS… DOLLAR MANAGERS HAVE A MOTIVATION TO PROVE THEIR RMB PARTNERSHIPS …

whether I should be spending time on deals made from RMB only as well." In other words, they don't want any restrictions they just want you to trust them. And we see some problems in both, already.

T&I: By problems, you mean?

DS: For example, you will have a lot of deals, in which it's not so clear whether they belong to the US Dollar fund, or the RMB fund, and then you'll use your subjective preference in putting deals into which fund. My understanding is that a lot of the proven US dollar managers, have more motivation, more incentive, to prove their deal capability in RMB partnerships, which makes me a little bit nervous. But this is the China Way.

T&I: Dali, is this like WOFEs twelve years ago?

DQ: I think that what is happening today, before the RMB becomes freely convertible, is we're putting various means and designs in place, as current

DQ… THE CURRENT FRAMEWORK DOES ALLOW VARIATIONS…

practices under the current regulatory framework. And the current framework does allow us to make some variations in our approach, depending upon the investor's demands, before future developments in the regulatory environment. I think we may have some choices, such as those provided in the Shanghai Circular or in the Beijing Circular, to use WOFEs, or JVs to raise an RMB fund and actually those are our starting points for forming RMB funds, but as time passes we're going to have more options.

T&I: Those Circulars are published, but when do we see the implementation documentation?

DQ: Take for example the Shanghai and Tianjin rules. Since the promulgation of the Shanghai rules, there have been quite a few foreign funds setting up equity investment/management WOFE or JVs here in Shanghai. Before these rules, they just had representative offices here. Blackstone is talking about this; they've recently registered their WOFE. First Eastern has set up its WOFE. And CLSA has set up a joint venture with a very large state owned company in Shanghai and will raise 5 billion RMB fund.

T&I: But we've heard that Beijing has rejected the Blackstone registration.

DQ: I don't know. Beijing is also pursuing a similar kind of policy so that there is a kind of conflict. I think that the notice from Beijing may only be a temporary rejection of Blackstone's structure. In the long run, I believe that it will be a prevailing structure.

DS: I read that Carlyle and KKR are setting up similar things in Beijing.

DQ: On the contrary I heard that they are talking to the Shanghai government (laughter from the room).

DW: I read the Beijing version of the story.

DQ: No doubt they're talking to both governments to see who is going to give more.

T&I: Brett, observations on Chinese companies reaching out to acquire foreign companies?

BT: We're seeing more of it happening and a part of our strategy is helping Chinese companies reach out to find partnerships with US companies. We now have a fund in Asia that invests in good domestic Chinese companies that are growing. If we see that they have an opportunity to expand overseas we will do that. And we have found that this is doable, even for smaller Chinese companies. But for these 100 million RMB to 200 RMB businesses, pretty small businesses, the question is how they go about expanding overseas, without the team or infrastructure to do that. The answer is that if they have good product, good management, good domestic base of business, they can do it. But, our experience has been that it is helpful to have a GP invest in your company, who can help you

BT: HOW DO THESE BUSINESSES… 100 MILLION TO 200 MILLION RMB… GO ABOUT EXPANDING OVERSEAS?

extend your operations outside of your country. The first deal that we did out of our Asia fund is a good example, it's a US company, that's expanding their business in Asia and we have two board seats. One is a China-based member and the other is a US based board member; so we can help them in both places. I think it's difficult to actually execute on this strategy unless you have global resources. There are a lot of US GPs that want to invest in good Chinese companies but there are a lot of US GPs who know nothing about China. Conversely, there are a lot of Chinese GPs who know nothing about overseas markets. So unless you have the ability to execute on both side of the ocean, it's a pretty tough strategy. To your comments, Steve about having resources all

around the world, we think of that as our advantage too. We're similar to some of the big funds, in having resources all around the world. And in working with small companies in China, you've got to have resources that can help them outside of China and who are willing to spend time with these relatively small companies. We're looking at a medical device company; high growth, very good Chinese company. 80% of their sales are in China and they want to take those devices to the US, but they don't know how. They don't know how to do clinical trials in the US. They don't know how to shepherd their applications through the FDA

SW: WE SET UP A GROUP … WHO FIND SYNERGIES BETWEEN OUR COMPANIES…

process, then set up sales and distribution in the US. If you're going to do that, for a Chinese SME, you've got to have people in the US and Europe who can help.

SW: That's our experience. It takes a lot of time to help these companies reach into overseas markets. Yet sometimes, local investment managers are too busy on daily activities to spend a lot of time on this. Many efforts need to be done with these companies in this regard. So Aureos set up a group of people, as central services, who are in charge of portfolio synergy management, who will look at the overall Aureos portfolio and try to find synergies between companies in one country with others

BT: SIX PEOPLE IN BEIJING TRYING TO DO DEALS IN THE US, ARE AS BAD AS FIVE PEOPLE IN KANSAS TRYING TO DO BUSINESS IN CHINA.

in other countries and try to work with local investment managers to derive benefit from those synergies; and who will help the portfolio companies go abroad.

BT: It depends on the company. If you're a firm of five or six people sitting in Beijing, trying to help people to do deals in the US, it's as bad as having five people in Kansas trying to help people do business in China. You can't do it.

DS: This is a good way for foreign PE firms to add value for Chinese companies or to create value in China, because capital is becoming a commodity. If it is really a hassle to obtain approvals, or to get listed, whatever, foreign PE firms have to find different ways to stay here.

T&I: Cary, start the discussion on technology investing in China.

CZ: Technology based investing in China, is different from what you call seed or VC investing in the US. Here there is no environment to support new high technology companies. First of all, the seed money probably comes from the government. But there is no industry support. If a company has a new product which they try to sell to a state owned company, they hit a lot of barriers. Or they don't get paid, or payments drag on forever. It is so difficult for a small high tech company here, to bring innovative ideas into being, to succeed in China. What we see that does work for tech companies here, is in costs, improvements, in mass production. That's the kind of companies that we pick up. And you have to consider the time required for investments as well. Let's consider that you

CZ…TECHNOLOGY INVESTING IN CHINA IS DIFFERENT FROM US VC…

have a five year fund. If you're investing in high-tech that company is still small after five years? What we look at is more like a success story, a product or a story or a solution that is already in the market and the local company tries to

adopt it, improve it, localize it; the key is being able to mass produce these things to reduce costs, which kills everyone in the market. Those are the success stories. And that is why our fund moved from being a venture fund to being a growth capital fund. We look for companies who are able to go to production so that they can gain a sizeable market share. We can't invest in people doing research in the Chinese Academy of Sciences, though we've dealt with them quite often in the past, trying

DW…WE SEE EARLY DEALS THAT ARE ATTRACTIVE. WE'VE BACKED KAI FU LI

to turn ideas into solutions, then into products.

David Wang, WI Harper (DW): WI Harper is interested in technology. We focus on Clean tech and I am focused on healthcare, a sector where 60% of revenues for small companies is derived from export. We do see some opportunities in Tech; but in a number of areas. Actually, we do see some early deals that are quite attractive. For example, we've backed Kai Fu Li's Innovation Works that is bringing us some very attractive early stage deals out of next generation technology.

T&I: Typically though, WI Harper invests in companies with products, sales, revenue.

DW: Yes. Absolutely.

Lawrence Tse, Gobi Partners (LT): Let me quickly introduce us. Gobi Partners is a TMT and IT fund. We're primarily an early stage fund and we also do growth or series B, but ideally we like to get in early. We're not investing in what I would call research and development, but by way of example, we just had an exit a couple of weeks ago in a company called DMG, a digital media and advertising company that we invested in back in 2004, in its series A. We spent five years on the company; that's a long time. My partner was the interim CEO for over a year. We went through a lot, but in the end we came through. Is it a technical company? Yes. Was it early stage? Yes. But is it the kind of

LT…WE SPENT FIVE YEARS …IN THE END WE CAME THROUGH.

hard-core tech that David is talking about in medical devices? Probably not, but there was a lot of innovation involved in DMG.

SW: Let me ask you about that. Do you guys think that this new board, the ChiNext is useful?

Will the new board going to be helpful to you in listing your companies more quickly?

CZ: Let me answer that one and say that even for the Shenzhen GEM board there is still a requirement for profits in the listing. It's not like the US where what I call a deficit company can exit. In the US, there are a lot of deficit companies that exit.

CZ…EVEN SHENZHEN REQUIRES PROFITS … IT'S NOT LIKE THE US.

SW: But now with the ChiNext the amount of profits required is lower.

CZ: Even lower, but you still need to have an operating business.

SW: You don't think it's going to be helpful?

CZ: It's better. It could help. But my understanding is that if you focus on the US model, looking for commercial model exits for early stage technology, it's too early for that.

GS…WE'RE NOT SHY ABOUT TECH BUT IT'S VERY DIFFICULT…

GS: We're not tech focused at all. (laughter). But we've just finished a large transaction in a software company, that's in the computer aided engineering space. It's number one in China. It works in simulation, finite element analysis for mechanical engineering. It started life as part of a US-listed company, then a couple of years ago they did a management buyout and began life as a distributor, while at the same time doing R&D for a complimentary product to their former owners and this year they're going to be 50% in distribution and 50% in sales of their own products; a great story, a great team, and the kind of deal that is very hard to come by especially given that we have a minimum requirement of deal size of $30 million. It was mainly a secondary share purchase from their earlier investors. So we're not shy about making tech investments, but it's very difficult to find and make them.

Lixun Gong Lunar Capital: We're not a tech focused fund, but given the barriers that we see in entering these kinds of deals, for a five year fund, we're not looking for tech. But we are investing over the next couple of weeks, in a maker of special fibers, that is like what David has just described, a firm moving from development into mass production, opening its second production line very soon, so from our understanding, it's not a tech investment, it's more of a growth type investment, that uses technology as a very high barrier to entry.

Ji Ran Laurie, On Capital (JRL): I'm supposedly technology, given my background with Apple and Microsoft, but On Capital which is a China fund is not a tech fund and we're not even a growth fund. The opportunities in China are good enough so that we can say we're a China fund. With an annual GDP growth rate over the past year, at 8% to 9%, it's less than in previous years, but it's still better than any other mainstream market. And here there is not only absolute growth, but also growth in the size of the market, which means that there is so much economic opportunity, that either you know what is happening here, in terms of the opportunities or you don't. It's not capital that's important here, but knowledge of what is happening. Having said all of that On Capital was a tech fund when we launched our first fund in '04 and that focus rewarded us pretty well, given the global

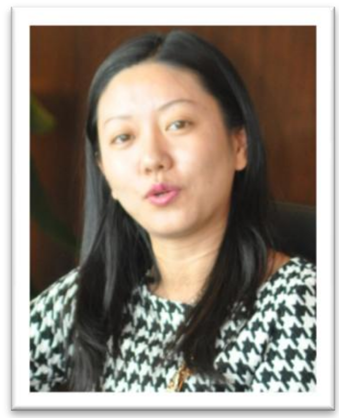
JRL…TECHNOLOGY REMAINS IMPORTANT, BUT IT'S DOMESTIC. …

economy between '02 to '04, when there were enough Nasdaq listed Chinese companies which all rebounded so suddenly, so drastically, that they moved from a status of nearly de-listing to giving us a thirty times returns in a single year. That was a short period of time, but after we saw that validation of the value of China-based startups , across so many sectors, for tech companies, it validated that China was on the world scene after the recovery from the tech boom collapse. Technology remains an important sector in China, but it's only domestic and its counter to our investment philosophy that there are sufficient investment opportunities in China where there is an almost guaranteed 10% growth rate and if you do just a bit better you can earn 15% to 20% growth in your investments. You need to stay away from troubled sectors, like exports, but if you can avoid trouble, you have ten to twenty sectors to invest in.

JF: For Capital YuanTao, we have to look back into our heritage, American Securities, a middle-market LBO fund in the US. Our New York and Shanghai team are familiar with traditional industries. We can analyze the

JF: WE'RE WILLING TO TALK TO VC FUNDS, BUT…

numbers and understand the fundamentals. Of the four funds that we have committed to date in China, most of the investments can be categorized as growth capital investments. Having said that, we know there is a VC market and that the funds are still generating good returns. We're talking to the VC funds trying to pick up investments in the market with those funds who know more about this industry. But it's a steep learning curve, we've just started. We're willing to talk to VC funds. We're willing to make investments if everything looks fine.



DS: We have made commitments to early stage VCs, including those investing in pre-revenue stage companies. The first thing about early stage investments is that we have to recognize that these are sub-segment investments and

DS…WE'RE STILL TRYING TO FIGURE OUT EARLY STAGE VC FOR CHINA.

they have to be made with good risk-adjusted returns. Of course if you have LPs that are always pushing you for quick returns on their capital, then these aren't good investments, because they do take a long time to realize. I have been involved in early stage investing, personally, as a tech VC before and I think that we're still trying to figure out the early stage VC model for China. It's really different from Silicon Valley and we think that there are barriers to VC in China, even at this stage.

T&I: Brett, introduce SME investing in China.

BT: The definition of SME investing is a broad one, but we define our SME investment companies as having from $2 million to $3 million profits. We don't look at the revenues as much as we do the fact that these companies are generating that much profit. We think, on the topic of Judie's point earlier about whether a fund can continually

BT…I THINK THAT THE ISSUE FOR GPS, IS TO RESIST RAISING LARGE FUNDS…

repeat success with the same strategy, given the large number of these kinds of companies, we think it's very possible.

T&I: How many SMEs in China?

JF: Forty million.

BT: That number includes the noodle shop on the street right? (laughter) But you're right. I've seen that number too and every number from 20 million and in between. Whatever the number it is, it's an enormous number. If you look at the amount of private equity that is going out to that number of companies and consider that ratio, versus a mature market like the US or Europe, there is plenty of room for these kinds of investments. I think that the issue for GPs is to resist the temptation of raising large funds. You can fill a portfolio with seven companies, on the small end and you've resisted the temptation to raise $500 million or one billion dollars, whatever, I think you can repeat your success over time, because there is so much opportunity in the space.

T&I: Baring has doubled its fund size every time for the last 12 years?

GS: …THERE IS REGULATORY RISK IN CHINA… BUT AS A REGIONAL FUND YOU CAN SHIFT YOUR FOCUS.

GS: Actually not. Fund III to Fund IV, okay, we tripled our size from $500 million to $1.5 billion. But we focus on mid-cap companies; from $100 million to $500 million US, in annual revenues. And we're still primarily growth oriented in China. We do have the ability to do buyouts, but the team that is based here in Shanghai, is not focused on that because these deals are just so hard to come by. When we do come across such deals and in the past, these have always been offshore.

T&I: The reason I pointed Baring out, was by way of saying that it is possible to double your fund size repeatedly and continue to succeed.

GS: That is a topic of concern for us as a regional fund. My concern, as the general manager responsible for the China piece, in raising a huge fund, would be the fact that the window for investing in China, comes and goes. Sometimes you run into limitations. For example Circular 75, the M&A regulation in 2007, when for six months, we just didn't know what to do. You couldn't structure deals anymore, into a red-chip or offshore holding company. You have to ask if you have a closed window just after you've raised a fund, what do you do then? There is a lot of political

BT: THE REALITY IS SALES TO A STRATEGIC INVESTOR OR SECONDARY TRANSACTIONS.

and regulatory risk in China. But if you're a regional fund, then you can shift your focus. So returning to us raising $1.5 billion, I see that more as a $750 million China fund.

T&I: Brett how do you exit from SMEs?

BT: At our size, if there is an IPO great, but the reality is that when you're investing in companies of that size there are going to be sales to strategic investors or opportunities in secondary private equity transactions. These companies are so small, that it's hard for them to go public. It's early days in China for secondary and strategic sales, so we'll see.

T&I: Judie, speak a moment on regional versus country specific funds versus a provincial fund?

JF: We focus on investing in funds that have more than half of their investments in Greater China. That is what we promised to our LPs. As we look at the Universe of such GPs working in the China market, the quality of the teams among the regional funds are better than newly set up or purely local Chinese funds. This is to regional fund's benefit. On the other hand, the decision making chain, in a lot of the global funds or the Pan-Asia funds is much longer than that of the China funds which benefits local funds. Those two considerations tend to render both types of firms equal. If you were to ask me what the dynamic is going to be in five years; will the market be dominated by the regional funds or the domestic funds, it's hard to say.

DS: We are a China only fund of funds, so we only invest in China managers. But to me, regional funds and single country funds are apples and oranges. They focus on different clientele, they have different benefit, they each have their own weaknesses. In China, which is a big, fragmented market and in which you have high growth, in many segments and markets, different players can operate in different areas. We focus on single country managers, because we believe that people interested in other geographies can find other vehicles in which to invest.

T&I: Everyone review your goals for 2010.

SW: We invested from our current China fund, have invested so far in four deals, and we're at about 50% of the investible capital. So we think at the

SW…OUR ISSUE IS TO SPEND TIME WITH OUR COMPANIES…

end of d 2010 we'll probably begin raising a new fund. Finding deals for us is okay, with our focus on Shandong province, we have pretty good deal flow. We'll spend more time to work with our investee companies, helping them with corporate governance, helping them grow their customers and revenues.

CZ: We are on fund four and five, just closed our current US dollar fund in '07. We were slow last year, but now we're going into investments again, we'll probably do about seven or eight deals in 2009. And we've just raised our RMB fund, so I'll bet that by the fall of 2010 we'll be fund raising again, because we'll use the 100 million RMB fund, it can be deployed very quickly, but we won't raise a big fund, despite being able to. We'll probably raise a half-billion dollar fund because we're not trying to make money on management fees; we'd rather deploy our money quickly then raise another fund.

CZ: … WE'LL BE FUND RAISING AGAIN.

BT: For us, prioritization is where you spend your time when there are so many opportunities, figuring out where to spend your time is one of our biggest challenges. There is just so much opportunity and you're pulled in a lot of different directions. We'll hopefully do two new deals over the next year.

DQ: The two major hurdles in our market remain: foreign exchange issues and foreign capital treatment. I don't see any indicators that these two hurdles will be improved by new regulation. Maybe foreign exchange could be improved, simply by SAFE issuing a circular. But the issue of foreign capital calculations and restrictions remains a very large problem and to settle it there must be significant change in the investment regulatory framework, and we don't know when this will be settled. My advice for GPs: keep watch on the regulatory framework which may have breakthrough in the near future and remember how to replicate your past successes and to align interests with your LPs.

DQ: THE ISSUE OF FOREIGN CAPITAL CALCULATIONS AND RESTRICTIONS REMAINS A VERY LARGE PROBLEM.

JF: We ask GPs to consider their strategy carefully and to develop their differentiation points. Don't tell us about what you think other people are doing. We want to know what you're doing, that is your special secret sauce. The second thing I advise is to take care of your back office. We often see that a GP is strong in making investments, but their back office, in terms of their financial reported is under developed. We see this normally in the local, new funds.

End of Shanghai Session Two. T&I

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