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Private Equity in China: Current trends and developments

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The Chinese government has in the recent years actively encouraged and promoted private equity as a distinct asset class. Government support, strong economic growth, massive private savings and an underdeveloped financial sector have put China at the forefront of private equity development in emerging markets. Even throughout the financial crisis total fundraising and investment remained relatively strong. The newest trend is a rise in RMB denominated funds taking advantage of the ever increasing domestic capital base. Also, in late 2009, the government undertook a measure to end the strict separation between domestic and foreign funds, allowing international GPs to raise or manage domestic funds. Although the new legislation suffers from the absence of a clear and central regulatory environment and uncertainties regarding taxation rules, it will clearly help to position private equity to remain an important asset class in the future.

INTRODUCTION

The Chinese government has in the recent years actively encouraged and promoted private equity as a distinct asset class. Government support, strong economic growth and an underdeveloped financial sector have put China at the forefront of private equity in emerging markets. Between 2003 and 2008, 56% ($108billion) of all fundraising for emerging markets was targeted at China. Total domestic fundraising and investment peaked at $14.5 and $9.0billion respectively in 2008 and remained strong throughout the financial crisis, as China weathered the global storm better than most developed countries.

The newest trend is a rise in RMB denominated funds that take advantage of the ever increasing domestic capital base, are not subject to foreign exchange controls and do not face the same stringent investment restrictions as foreign investors. For instance, in January this year CITIC announced the creation of the so far largest local currency fund which closed at 9billion Yuan or $1.32billion. Earlier this year, Beijing has also announced new legislation that is designed to promote the establishment of onshore foreign-invested funds. These developments suggest growing recognition of the potential contributions that offshore fund sponsors could make to the development of China’s domestic private equity industry. However, at the current stage there is no clear and transparent regulatory environment and several issues remain questionable. But, with the growing size and influence of private equity in China, it is only a matter of time before the needed changes will be implemented. A major hurdle and uncertainty is, however, the required interplay of several Chinese government institutions including the Ministry of Commerce (MofCOM), the National Development and Reform Commission (NDRC) and the State Administration of Foreign Exchange (SAFE). Given that the government has already demonstrated its ability to establish an effective regulatory framework for Foreign-Invested Venture Capital Investment Enterprises (FIVCIEs) that regulates the pooling of foreign and domestic capital limited VC-investments, a broader reform of the private equity landscape does not seem far away. Chinese regulatory authorities seem committed to establishing a framework for private equity and a number of municipal governments such as Shanghai have already gone a step further and introduced incentives to attract offshore-sponsors and general partners for RMB funds.

This paper will summarize the recent development of private equity in China, including a brief assessment of the macroeconomic environment and the financial markets such as the equity and the bond market. As we will see, these markets remain significantly underdeveloped compared to Western standards but also in light of the recent economic progress in China. Therefore, I will argue that private equity is well positioned to remain an important asset class in the future. I will pay special attention to rise of RMB funds in China and show how the recent legal changes have led to the establishment of foreign-invested onshore funds. Next, I will argue that a central regulatory framework would help to accelerate the involvement of international GPs and LPs in RMB denominated funds. Such an agreement should specifically regulate the repatriation of invested capital and taxation of domestic GPs. To conclude, the recent changes have been very promising and will cement China's position as most attractive private equity emerging market. Looking ahead and given continued government support, all signs indicate that private equity will remain a strong asset class and continue to play a significant role in shaping China's market economy and in fostering the privatization of SOEs.

OVERVIEW: PRIVATE EQUITY IN CHINA

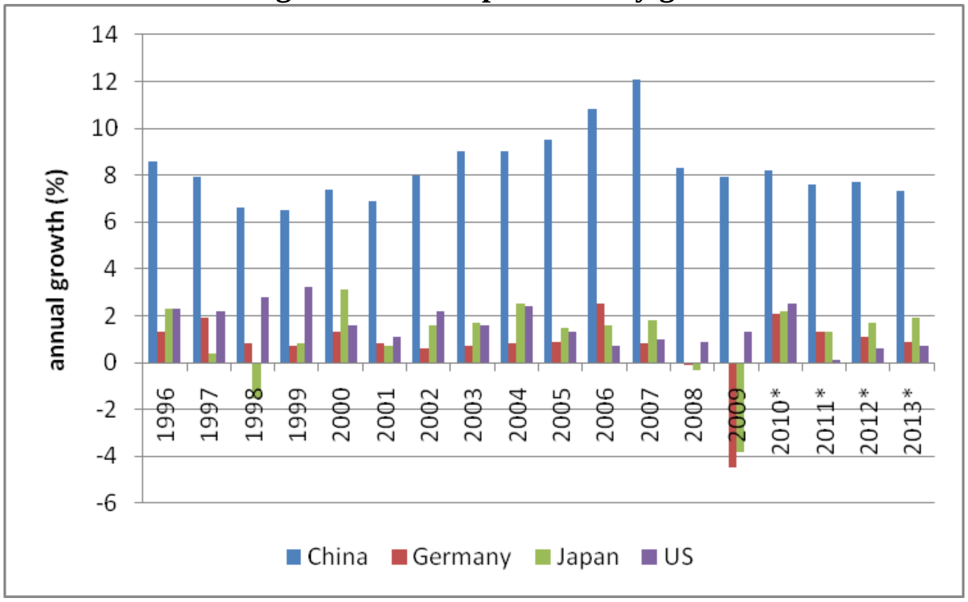
Private equity in China is an increasingly popular asset class. China's prolonged strong GDP growth attracts international investors that want to benefit from the country transition to a market economy and the inherit efficiency gains. But those are not the only reasons why private equity emerged as a viable financing alternative. The Chinese government endorses and welcomes private equity as asset class as it recognizes the beneficial role of PE for the economy's transition to a market based system. The official endorsement is reflected in a legislation and regulatory environment that became increasingly sophisticated over the past years, although it does not yet meet Western standards. Finally, private equity benefits from the large amount of capital that is available in China. For instance, according to the World Bank Development Indicators China's annual gross domestic saving rate even exceeded 50% of GDP from 2005 to 2008. Also, continued economic growth has led to the formation of many high net worth individuals that are seeking attractive investment opportunities.

However, it remains very difficult for private companies in China to tap these capital reserves and access debt or equity financing. Chinese financial markets remain relatively underdeveloped. Banks are reluctant to provide loans to private enterprises; bond and equity markets are relatively illiquid and do not represent viable financing options for entrepreneurs. Therefore, private equity represents a feasible alternative. In the earlier years, the asset class was mainly driven by savvy Western GPs that raised dollar denominated funds from international investors which were then invested in mainland China via off-shore vehicles. More recently however, the industry experienced a significant move towards RMB denominated funds which were sponsored by Chinese investors.

STRONG GROWTH AND AN UNDERDEVELOPED FINANCIAL MARKET MAKE A STRONG CASE FOR PRIVATE EQUITY

China's economy grew on average by 10% annually since 2000 and came out of the recent financial crisis much better than most Western economies. At the heart of China's growth story is an increase in productivity. For instance, Deng estimated that labor productivity growth of large- and medium sized firms in the industrial sector grew at an average annual rate of 20.4 percent between 1995 and 2003 (2007, 11). One of the main drivers of productivity growth was the privatization or the relative decline in importance of SOEs. Interestingly, the remaining SOEs that started to face increased competition from private companies recorded the highest *relative* productivity gains of all company types. Other factors that contributed to the increase in productivity were the positive effects of foreign direct investment and a large increase in capital stock that allowed for higher marginal growth rates of labor productivity. Of all these, Deng et al (2007) found that allocative efficiency, the allocation of outputs and inputs according to their highest market-value use, accounted for 41 percent of annual productivity growth on average. As indicated by figure 1 below, China's labor productivity substantially exceeded productivity growth in the largest modern economies for the past years. Likewise, the gross fixed capital formation has averaged an astonishing 50 percent of GDP for the last five years and the annual growth rate averaged 11.9 percent.

Figure 1 : Labor productivity growth[1]



Source: Economist Intelligence Unit Online Database

As a consequence, China's companies became increasingly competitive on the world market and their position was supported by a stable Chinese currency. Currently, the Yuan is once again pegged against the dollar. In July 2005, however, after a 2.3 percent revaluation the currency was allowed to appreciate by 21 percent over a period of three years, but has remained fixed since the middle of 2008. Here, it is important to note that the currency peg did not *cause* China's competitive position and the country's domestic growth. Instead, the built-up of foreign exchange reserves and an arguably undervalued exchange rate is the consequence of large productivity increases of Chinese firms *given* that China has a fixed exchange rate regime and not vice versa. Either way, the country's foreign reserves reached $2.4trillion by the end of March this year, representing around 30% of the world's foreign exchange reserves.

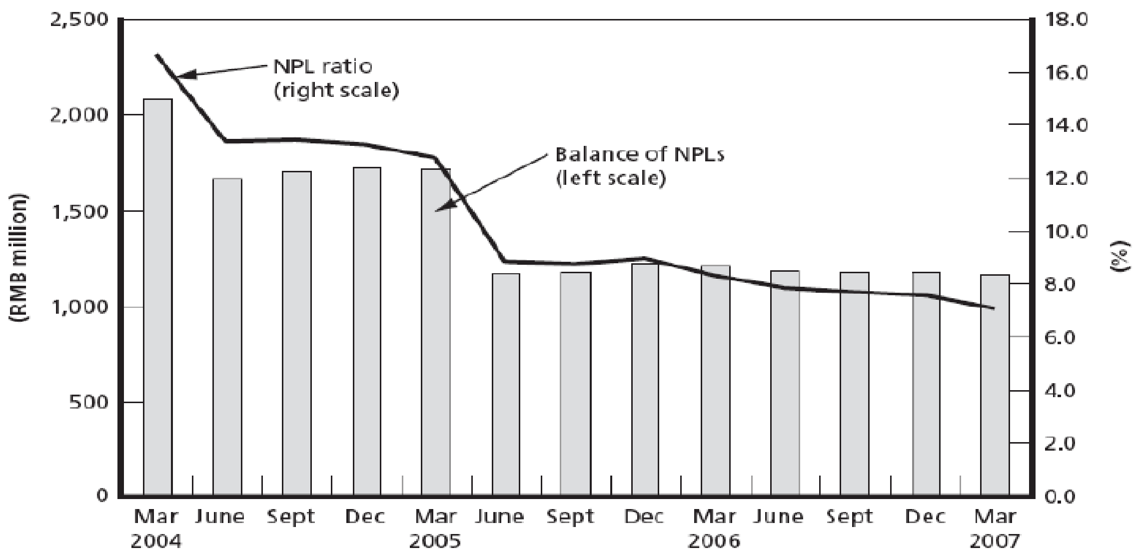
<u>An Underdeveloped Financial Market</u>

Despite the economic progress, China's financial markets remain underdeveloped. The banking sector was partly cleaned up through the government's decision to remove the large portions of non-performing loans (NPLs) from the bank's balance sheets via so called Asset Management Companies. The ratio of NPLs to total assets was brought down from around 14% in March 2004 to 12% or RMB 1,700 million as shown in figure 2 below. The ratio remained relatively stable since June 2005, after it was lowered to level of 8%. However, by 2007, major commercial banks still faced NPLs of around 8% of their balance sheets, which prohibits them from engaging in

[1] Efficiency of labor measured in terms of output per worker (real GDP per person employed)

riskier lending activities. As a consequence and in the absence of clear accounting standards, loans to private businesses are perceived as much riskier than loans to SOEs, and therefore Chinese banks are reluctant to engage in private sector lending. Only around 1% of all loans are given to private companies! Allen, Qian and Qian argue that this is a direct legacy of the banks' experience with and ongoing exposure to NPLs. (2008, 513).

Figure 2: Amount of NPLs and NPL Ratio at 17 Major Commercial Banks



Source: (Okazaki 2007, 52)

The corporate bond market is also underdeveloped and does not provide a viable financing option for small or mid-sized companies. Lack of transparency, weak corporate governance, unclear accounting standards and low creditor protection prohibit the development of a more liquid bond market (Allen, Qian and Qian 2008, 540). By the end of 2006, the corporate bond market constituted only 4.3% of the total domestic currency bond market in China or 1.2% of GDP (Aglietta 2007). Since then, the Chinese government declared the goal to develop the bond market as quickly as possible. In 2006, the first corporate credit bond "in real-meaning" was issued without bank guarantee. However, the corporate bond market remained a shadow of the market for government bonds and central bank bills. By the end of 2008, corporate bonds constituted only 4.5% of the total, as shown in figure 3 below.

Figure 3 : Fixed Income Instruments Outstanding in Chinese Bond Market (as of Dec. 2008)

Bonds Outstanding	# of Issues	Par value (bn)	Percentage
Government Bonds	110	4875	32.27%
Central Bank Bills	135	4812	31.85%
Policy Bank Bonds	222	3672	24.30%
Financial Institutions Bonds	99	425	2.81%
Corporate Bonds	295	680	4.50%
Corporate Commercial Papers	259	420	2.78%
Asset Backed Securities	49	55	0.36%
Mid-Term Notes	39	167	1.11%
Panda Bonds	3	3	0.02%
Total	**1211**	**15110**	**100**

Source: (Standard & Poors's 2009, 7)

Also, China's equity market is still in its infancy. The main stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange were initially set–up to promote the privatization of Chinese state-owned companies and do not represent feasible alternative for entrepreneurs. To give private companies the possibility to access the equity market, the Shenzhen stock exchange launched the SME board in 2003. Likewise, in October 2009 China initiated the Growth Enterprise Market (GEM) or also known as ChiNext, which is also targeted at SMEs. The GEM board has lower capital requirement than the Shenzhen board, but still requires either RMB 10 million in profits over the last two years prior to listing or 5 million in profit if the company has revenues in excess of RMB 50 million and annual growths rates of at least 30%. ChiNext was launched with an IPO of 28 small, private companies, mostly in the pharmaceutical and high-tech industries.

ChiNext is set-up as an independent market and specifically tailored for the needs of innovative companies. The exchange is set-up to promote SMEs and "create sound interactions among independent innovators, venture capital and capital market" (Shenzen Stock Exchange 2010). There are four declared objectives of ChiNext, these are:

(i) perfecting the financing chain for SMEs engaged in independent innovation and facilitating industrial upgrade;

(ii) promoting demonstrative and multiplier effects of capital market in driving economic growth, and enhancing development in venture capital investment;

(iii) stimulating public enthusiasm for entrepreneurship, innovation, and employment;

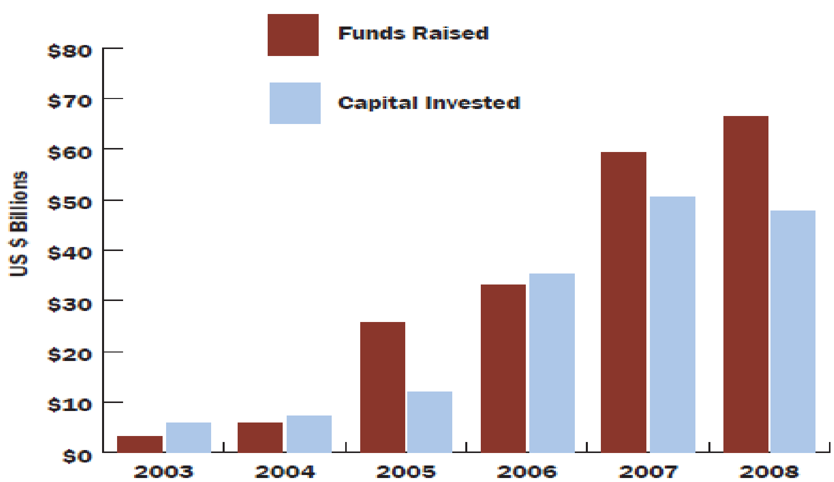
(iv) enriching capital market products and providing investors with a wider range of financial instruments for wealth management and risk hedges

By the end of April 2010, 74 companies were listed on ChiNext with a market capitalization of RMB 325billion and 395 companies were listed on the Shenzhen SME board with a total value of RMB 2trillion (Shenzen Stock Exchange 2010). The set-up of these exchanges for SMEs shows the government's recent effort to develop the domestic equity market. However, the small number of SMEs listed on both exchanges show that China has still a long way to go. The establishment of these boards will, however, attract more private equity investors as these boards represent an attractive potential exit channel, but they do not, close the financing gap for private companies at large.

THE PRIVATE EQUITY INDUSTRY IN CHINA: CURRENT TRENDS AND DEVELOPMENTS

Throughout the years leading up to the recent financial crisis, private equity in emerging markets displayed an extraordinary growth story. Fundraising increased from \$3.1billion in 2003 to \$66.5billion in 2008, which is more than a twenty fold increase over six years! Total investments rose from \$6.0billion to \$48.7billion, but already peaked at \$50.5billion in 2007 as shown in figure 4 below.

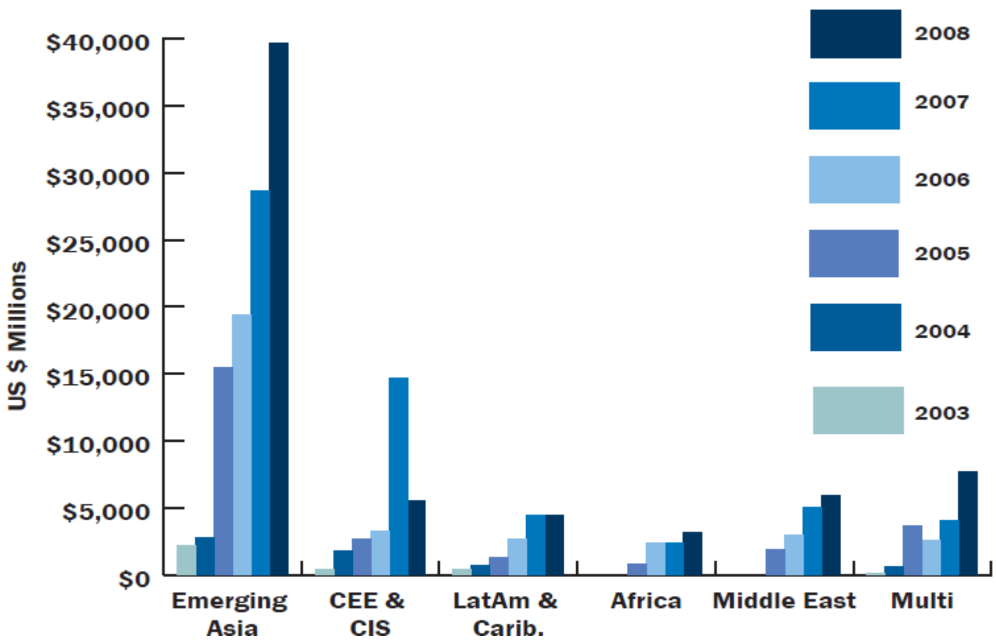
Figure 4 : Emerging Markets Fundraising and Investing, 2003 - 2008



Source: (EMPEA 2008, 5)

Most of this growth took place in the emerging Asia region and most notably China. Figure 5 below shows the distribution of total emerging markets private equity. Emerging Asia is clearly unrivaled as no other region showed such a strong increase over the six year time period. The PE market in Central and Eastern Europe peaked in 2007, driven by the closure of few very large buyout funds, but the fundraising level fell back to less than half in the subsequent year. In 2008, half the funds raised targeted Asia, and so was 56% of the cumulative amount over the six year period. $195.6billion was raised for all emerging markets and $108billion of that went to Emerging Asia.

Figure 5 : Emerging Markets Private Equity Fundraising, Totals by Region, 2003 – 2008

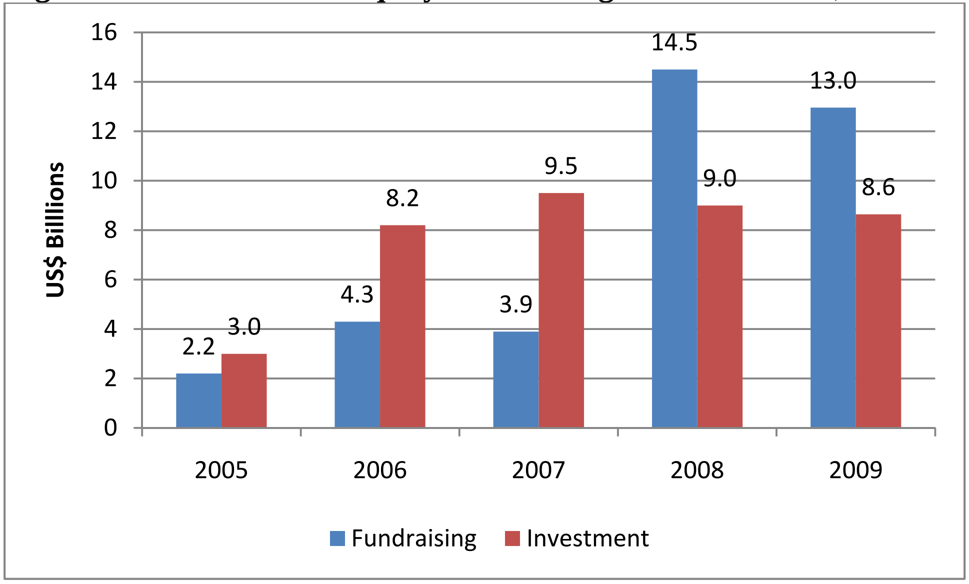


Source: (EMPEA 2008, 6)

Out of the $40billion raised for the emerging Asia region in 2008, $14.5billion went to China, that is an increase of 3.7x over the amount raised in 2007, or 36% of the total capital raised by emerging Asia funds and more than 20% of all capital raised by emerging markets funds in 2008. Investment remained at $9billion (2007: $9,5b.), making China the largest emerging private equity market in the world (EMPEA 2009a, 1).

China's private equity industry was clearly at the upswing when the global financial crisis hit which had a severe impact on both global fundraising and investment. The good news is, however, that China and many other emerging markets economies steered through the financial crisis relatively intact. China, as many argue, is in fact leading the global recovery. The Economist Intelligence Unit forecasts that real GDP will even grow by 9.9% in 2010 (Economist Intelligence Unit 2010). The good shape of the Chinese economy is reflected in the PE activities which remained strong relative to other Asian markets (European Union Chamber of Commerce in China and Bain & Company, Inc 2009, 19).

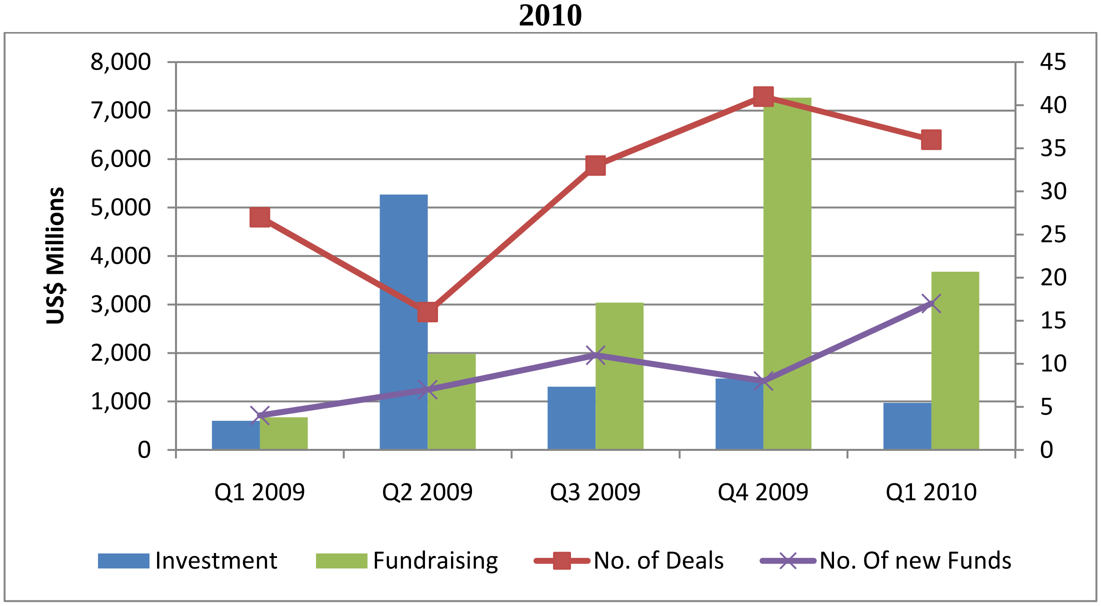
Figure 6 : China Private Equity Fundraising and Investment, 2005 – 2009



Source: (EMPEA 2009a, 1) AND (Zero2IPO 2010)

Figure 6 shows that private equity investment remained strong in China throughout the financial crisis. Total investments dropped only slightly from $9.0billion to $8.6 billion in 2009. Fundraising was more affected, because most of these funds depend on Western investors. Especially the Western institutional investors were hit hard throughout the financial crisis and reduced their capital commitment.

Figure 7 : Quarter-on-quarter Comparison of Aggregate Investment and Fundraising Amount of PE Funds, number of Deals and number of new Funds between Q1 2009 – Q1 2010

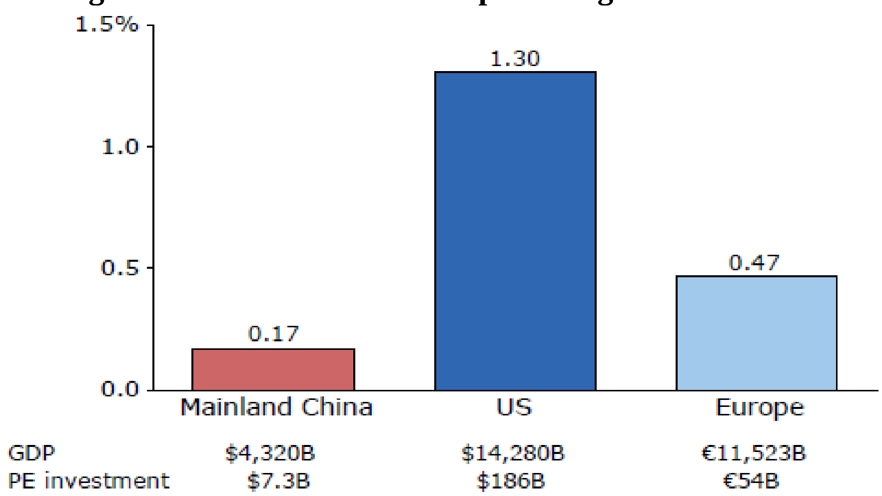


Source: constructed using data from (Zero2IPO 2010)

Figure 7 above lists the PE activities for the past 5 quarters. The number of new funds raised increased from 4 in Q1 2009 to 17 funds in the first quarter 2010. These funds raised a total of $3.68billion which is more than five times the amount raised in the first quarter 2009. Interestingly, 14 out of the 17 new funds raised in the first quarter of 2010 were local currency funds, thus denominated in RMB. Traditionally, foreign-currency funds are substantially larger than RMB funds. The three dollar-funds established in Q1 2010 raised $1.84billion, thus about as much as the 14 local funds combined. Nevertheless, this underlines a very recent phenomenon, namely the rise of RMB funds in China. Local currency emerging market funds are very specific to China. In most economies, PE funds do not need to set-up local funds to capture domestic capital. However, with the Yuan not being freely tradable and the strict control of capital (especially flowing out of the country), RMB funds become a very interesting alternative and are discussed in more detail in the subsequent section.

Despite the impressive growth story of PE in China, the private equity landscape remains relatively underdeveloped if compared to Western economies. Figure 8 shows that PE investment relative to GDP was substantially lower in China than in the US and Europe in 2008. The US has a PE ratio to GDP of 1.3% and Europe one of 0.5%, which is still about three times as much as in China. Although the industry has made significant progress throughout the recent years, a lot of growth potential remains in China. China's economic growth attracts investors and so far the state has made substantial effort to promote the industry with an increasingly friendly regulatory environment. Although the legal framework is in no way comparable to that of Western countries, it sets a high benchmark for other emerging markets. As a consequence, practitioners have ranked China as the most attractive emerging market for private equity every year since 2004, according to the *EMPEA/Coller Capital Emerging Markets Private Equity Survey* (EMPEA 2009a).

Figure 8 : PE investment[2] as a percentage of total GDP in 2008



Source: (European Union Chamber of Commerce in China and Bain & Company, Inc 2009, 19)

[2] Total investment different from figure 7 as this excludes venture capital investments

RMB funds

The rise of RMB funds in China is remarkable but should not come at a surprise. Given the country's domestic growth and high savings rate, there are huge amounts of capital within China that seek investment opportunities. One of the most obvious advantages of a RMB fund is its ability to raise capital from local investors, such as onshore corporations, government fund of funds, insurance companies, the social security funds and high net worth individuals. However, up to very recently, China's private equity industry has been dominated by foreign PE-firms which invested capital on behalf of international and mostly institutional investors. One of the key drivers of change is once again the government which has pushed to promote a domestic private equity industry. For instance, China's National Social Security Fund, with almost $150billion under its belt, has recently announced that it would invest a proportion of its capital in domestic, non-government backed private equity funds (Sovereign Wealth Funds Institute 2010). Also, the state has actively changed the regulatory environment to favor PE and it created viable domestic exit channels, such ChiNext (discussed above).

So far, a strict separation between domestic and foreign funds was enforced, meaning that international GPs could not raise or manage domestic funds. In late 2009, however, a pivotal turning-point has been reached when the government undertook a major step that would eventually allow foreign firms to raise local currency funds.

In November 2009, China's State Council's issued the "Measures for the Administration on the Establishment of Partnership Business by Foreign Enterprises or Individuals in China". These measures together with a decree that became effective on March 1, 2010 established rules and procedures for foreign-invested partnerships. The degree was issued by the State Administration for Industry and Commerce and labeled "Decree 47: Administrative Measures for the Registration of Foreign-invested Partnership Enterprises". Basically, since March 1, non-Chinese entities are allowed to participate in RMB funds by non-PRC entities. This participation can be either in the form as investor (limited partner) or as managing director (general partner). While these rules are clearly set out to promote and encourage the formation and operation of RMB funds within China, a number of issues remains unresolved, but is expected to be clarified within 2010 (Smith, et al. 2010).

The new legal measures that came into force allow for the creation of onshore foreign-invested RMB funds, but as mentioned above, several uncertainties remain. In theory, these funds provide a way to combine both international and Chinese capital and human resources, which would be a major step for the Chinese private equity industry. It would bring together best industry practices and the reputation of established foreign firms with the local knowledge that is so important for successful business in China. So far, this has only been possible for venture capital vehicles, so called Foreign Invested Venture Capital Investment Enterprises (FIVCIEs). These FIVCIEs, however, were restricted to investing in either high or new technology companies only.

The new legislation suffers from an unclear legal situation. While the new laws create a more favorable investment climate, the funds still have to comply with existing rules, such as the SAFE Circular 142 that restricts the conversion and repatriation of foreign currency. The current law prohibits foreign capital, once contributed to a fund, to undertake further investments within the PRC. This obviously affects international LPs that want to invest in a RMB fund, but also foreign GPs that want to manage an onshore vehicle. Standard practice in private equity is that the GP provides 1% of the total capital to demonstrate his commitment and align its incentives with those of the investors. Currently, there is no clear answer to this issue, but industry observers expect an amendment even within 2010 (Smith, et al. 2010). Moreover, some municipals such as Shanghai have already announced plan to set-up a system that would allow the conversion of foreign currency into RMB capital contributions (the Trial Plan), although these would most likely be subject to quota limits.

The final and probably most significant hurdle is taxation. Any profits or income for the general partners of an onshore fund, that is carried interest and management fee, would be taxable under the PRC’s income tax rate of 25%. In contrast, off-shore funds operating out of the Cayman Islands are tax-exempt (Ashurst/Guantao 2010, 3). Thus, at the moment it remains questionable if onshore foreign-invested RMB funds will flourish under the existing legal environment, however, the PRC has proven several times that it is quick to react and change its legislation in way that supports its policy goals. And without doubt, the promotion of the private equity industry is high on the government’s agenda these days.

Thus, there are now three basic fund-types in China: i) The new onshore foreign-invested fund as described above; ii) the traditional off-shore fund that is usually dollar denominated; and iii) the onshore domestic-invested RMB funds. I will briefly summarize the advantages and disadvantages of the latter two for a complete picture.

The off-shore fund is the traditional investment vehicle for PE funds. It is established outside the jurisdiction of the PRC and thus not governed by PRC law; often these funds are registered in the Cayman Islands. Since, these funds are usually denominated in USD investments in China require approval of the State Administration of Foreign Exchange (SAFE) in respect of the conversion of foreign capital into and out of RMB, which, however, is by now a fairly standard process. Offshore funds are not allowed to invest in all Chinese industries, only in those that are preapproved for foreign investments.

As noted earlier, onshore domestic-invested RMB became increasingly active in the Chinese private equity landscape over the recent years. These onshore-funds are registered under the PRC’s Partnership Enterprise Law, which is also a fairly standard process. As all of these funds are raised domestically, no government approval process is required as for off-shore vehicles. This results in a faster execution speed and a competitive advantage vis-à-vis foreign funds. However, since these funds cannot access international capital sources they have been until very recently rather small, mostly less than the equivalent of $100million. This is not only because these funds have to rely on Chinese capital only, but more so because China has not yet established a domestic private equity culture and there are few general partners with a proven track record. This is about change, as more Western-educated Chinese who spent their careers at international financial institutions return to China and join or establish private equity firms. A prime example is the CITIC Private Equity Funds Management Company, the domestic private equity arm of CITIC Group, a largely state-owned financial conglomerate which evolved out of the China International Trust and Investment Company that was established under Deng Xiaoping in 1979. CITIC has a track record of successfully raising multi-million dollar off-shore funds, but in January 27 2010 it announced it has raised a nine billion Yuan or $1.32billion on-shore fund, the largest Yuan-denominated private equity type of fund ever raised in China. One of the largest investors was China's National Council for Social Security Fund (Browne 2010). Figure 9 summarizes the key differences between offshore and onshore domestic-invested funds.

Figure 9 : Comparison between Off-shore and On-shore funds

Traditional Offshore USD China Fund	Onshore domestic-invested RMB Fund
USD denominated	RMB denominated
Organized under foreign law (e.g., Cayman, Delaware)	Organized under Chinese law
Non-Chinese investors (e.g., US pension funds, endowments)	Developing Chinese investor base
Investments in China subject to China's FDI and FX restrictions	Investments in China subject to almost no sector limitations
	Investments outside China subject to approval by MOFCOM and NDRC
Typically exit from international IPOs (e.g., NASDAQ, HK Stock Exchange)	Typically exit through domestic IPOs or trade sale

(White, The Rise of China's Domestic Funds Industry 2009)

<u>RMB Funds in China – an outlook</u>

Traditionally, the private equity industry invested in China via off-shore funds. While China benefitted from the inflow of international capital and the value-added from professional general partners, it also meant that fundraising was dependent on outside markets. The recent financial crisis has shown that these funds can dry up quickly. Given the amount of capital in the country, the shift towards onshore funds does not come as a surprise and will without doubt continue. While foreign GPs might have more impressive track records, domestic players that are rooted in the Chinese culture and especially if they have strong government ties, will enjoy a distinct advantage in their ability to leverage local circumstances and are destined to play a more important role in the industry

As of now, it seems that the largest challenges arose from the regulatory framework. However, given the government's demonstrated commitment to create workable legislation and to promote the industry, a very bright picture can be painted for local currency funds in China. The most pressing issues are the following. First, a central and clear regulatory environment needs to be created that allows for the pooling of domestic and international capital. For this to happen, several government entities will have to work together, such as the NDRC, the MofCOM, SAFE and SAT (EMPEA 2009b, 4). In the absence of a central law, several local and provincial governments have started to compete for foreign investors (e.g. the Trial Plan initiative in Shanghai). But also the governments of Beijing, Tianjin and Shenzhen have established incentives in the form of reduced taxes, less oversight and easier deal-approval to attract international players. As a result, it is reported that several Western PE firms are exploring joint venture with local firms. On the one hand, the competition is welcome as it puts pressure on the central government to react; on the other it further complicates the already convoluted legal environment (EMPEA 2009a, 2).

Secondly, and related to the first issue, is the question of taxation. A situation in which the GPs of onshore funds have to compete with offshore funds that are not subject to income tax will result in a market distortion and diversion of capital away from onshore funds. This seems to run contradictory to the government's desire to promote the industry and therefore a respective legal change can be expected soon, but currently it remains open how the regulatory treatment of foreign investors or general partners of local funds will compare to that of wholly-domestic players (Emerging Markets Private Equity Association (EMPEA) 2009, 2).

Lastly, China should continue to ease the rules for investing into private equity to allow local and foreign funds to better tap the country's large capital base. The country's national security fund has recently announced investment in private equity, but several other institutions have yet to follow suit. Those could include for instance financial institutions and insurance companies. Also, given the rise of high net worth individuals in China, successful financial intermediation will become more important in the future and should benefit the industry as a whole.

Overall, the prospects for private equity in China are very promising. The country is already the leading investment and fundraising market among all emerging markets and with continued government support China's position will not be easily challenged in the time to come.

CONCLUSION

The recent years have witnessed an impressive increase in private equity activities in China. Both, fundraising and investment peaked in 2008 at $14.5 and $9billion respectively and remained remarkably strong throughout the financial crisis. This has been partially due to the rise of local currency funds in China that replaced the falling global supply of capital. In the first quarter of 2010, already half of total funds raised were denominated in RMB. Traditionally, these funds have been much smaller than off-shore funds, however, there is a clear trend towards larger RMB funds; CITIC's recent closure of a $1.32billion onshore-RMB fund is just an indication of that trend.

One of the main reasons that speak for a RMB fund is its ability to access the growing pool of capital in China and to invest without having to obtain governmental approvals required of offshore funds. Looking ahead, this trend will without doubt continue, given that the government recognizes and promotes private equity as a distinct asset class. In the past months, the government has started to implement rules that allow for foreign-invested onshore funds, and although the regulatory environment is currently far from being clear and transparent, both international and domestic LPs and GPs are already lining up to take advantage of the new laws. However, a central regulatory framework will eventually be needed and with private equity funds becoming increasingly bigger and more influential in China, they will help to accelerate the creation of such legislation, even if it means to play off municipal governments against each other.

Although it currently remains open how the regulatory treatment of foreign investors and foreign general partners of local funds will compare to that of wholly-domestic players, the Chinese government's track record of being able to establish a working set of rules is promising. For the Venture Capital industry, Beijing has already demonstrated its ability to create an effective legislation that allows for the pooling of domestic and offshore capital and it would not be the first time that the Chinese try out reforms in a subsector before implementing them on a larger scale. Therefore, it seems that exciting changes lie ahead and foreign-invested RMB funds will have a large role to play in the Chinese private equity industry.

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