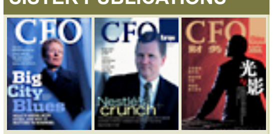

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TO INFINITY AND BEYOND

China is developing a local private-equity industry partly at the expense of foreign investment firms. But one Israeli fund has discovered an unlikely path to success.

By Cesar Bacani

The drive from Shanghai's Pudong International Airport to Suzhou Industrial Park 150 kilometers to the east normally takes under two hours. "We need to pick up a colleague in Shanghai, so this trip will take a bit longer," says an apologetic William Li, senior director at the China office of the Infinity I-China Fund. In fact, the Honda CRV needed nearly three hours to traverse Shanghai's inner ring road, get onto the Shanghai-Nanjing Expressway, and arrive at the industrial park. The late afternoon Friday traffic did not help.

But the time passed quickly because Li, 36, is passionate about private equity and venture capital in China. He had been answering questions almost non-stop during the three-hour flight from Hong Kong to Shanghai, unmindful of flight attendants wheeling food trays as he conversed with the interviewer across the aisle. The interview continued in the car, in the industrial park, and during a late dinner at a fashionable restaurant on a causeway projecting onto Jinji Lake. "This is my life," says Li. "When this fund is wound up, we will start another fund, and then another, and then another, and I hope to be part of all of them."

The "we" is Suzhou Ventures Group (SVG), the venture capital arm of state-owned Suzhou Industrial Park and a key partner in the Infinity I-China Fund, along with Israel's Infinity Equity. SVG had hired Li and three other newbies to become investment managers in 2002, even though none of the four young men had any experience in the industry—private equity in China at the time was the preserve of foreign players such as the Carlyle Group and 3i. But all four have grown into the job, helping SVG parlay its US$30 million in initial capital into assets currently valued at US$1.5 billion.

That success and the sheer volume of domestic capital looking for high returns are inspiring other domestic PE players. Late last year Fang Fenglei, chairman of Goldman Sachs Gao Hua Securities, founded Hopu Investment Management, which partnered with SVG to raise 10 billion renminbi (US$1.35 billion) for a China-Singapore Hi-Tech Industrial Investment Fund. Hopu also launched a second fund with Singapore's Temasek Holdings that is investing US$300 million in an iron ore mine in Mongolia. Another PE firm, Shenzhen Oriental Fortune Capital founded by entrepreneur Chen Wei, recently reached its target of 900 million renminbi for a fund that will invest in IT, healthcare, renewable energy, and retail. Total private-equity capital raised in the first quarter of 2008 was seven times that in the first quarter of 2007 (see chart).

An amended limited partnership law that came into effect last July may further drive domestic PE activity. Among other things, it exempts domestic partnerships from income tax and creates a new class of partners with limited liability. "This is part of China's drive to improve the functioning of the financial system and encourage the deployment into productive investments of the 45 to 50 percent of its GDP in household, corporate, and government savings," reckons Eswar Prasad, a former head of the International Monetary Fund's China division and now a professor at Cornell University.

It's also the dawn of a fascinating era for private equity in China. After years of false starts and, in the opinion of many, unnecessary and arbitrary blockades to cross-border capital flow, a private-equity business with "Chinese characteristics" is emerging. Many barriers still exist (see "A Qualified Welcome," next page), but a younger, more vibrant constituency is experimenting with new models to bypass them. SVG provides a preview to future Chinese cross-border plays. Make no mistake: Chinese private equity will loom large soon. The world will be hearing from them.

“I” for Israel

Some, like Prasad, offer optimism peppered with caution. As practiced in China and elsewhere, the industry’s business model typically involves not only fund-raising but also adding value to investee companies by improving operations, enhancing management know-how, and injecting technology and new products. “It’s very easy to look smart if the economy is doing very well,” says Prasad. “When things start to go sour, as they invariably do in most economies, then you really see who’s smart and who’s not,” “I fear there could be a pretty big shakeout.”

China’s financial system is still fragile, despite some marked improvements in the management and resources of the Big Four state banks, so a private equity debacle could wreak serious havoc. For foreign firms, there’s an additional worry that the government’s drive to boost domestic private equity and venture capital is coming at the expense of foreign rivals. Beijing has yet to issue a long delayed set of Foreign Investment Partnership Regulations. For now, foreign PE firms need to get official approval for each portfolio investment they make. Domestic firms face no such constraint.

In this tenuous territory, the Infinity I-China Fund—the “I” stands for Israel—stands out as an intriguing case study. The Israeli-led venture is structured as an onshore entity in China with a parallel offshore vehicle in Israel. The business model involves investments in overseas companies whose technologies and products are then injected into Chinese enterprises. These Chinese portfolio companies will do the manufacturing (costs in China are still lower than in Israel, despite the appreciation of the renminbi) as well as marketing and distribution across China and possibly the rest of the world.

The idea has found strong backers. Launched in late 2006, I-China raised US$150 million in just six months, prompting the company to raise the target to US$350 million. “We have now raised over US$300 million,” says Amir Gal-Or, managing partner at Israel’s Infinity Equity. The fund has attracted anchor investments from state-owned China Development Bank and IDB Group, Israel’s biggest conglomerate. Other investors include SVG and a subsidiary, China Singapore Ventures Co. (CSVC), and a host of Israeli pension funds and U.S. wealth management groups such as Friedman, Billings, Ramsey.

I-China has started deploying capital. The offshore entity has invested US$6 million in Mate Intelligent Video in Israel, which has developed software that analyzes real-time images from security cameras and flags potential security threats. The onshore fund has made a parallel US$16 million investment in Digital China Suzhou, an offshoot of Digital China, the country’s largest systems integrator and distributor of IT products.

The idea is to bring Mate’s technology to the Chinese market via Digital China Suzhou, which will customize the software for China and package it with Digital China products. The company will use Digital China’s extensive sales and distribution network to reach government and corporate customers, and its customer care centers for after sales service. Mate plans to list on Nasdaq in the second half of 2009. Digital China Suzhou is looking to go public in Shanghai in the fourth quarter. The projected return for Infinity: at least 100 percent on each investment.

Blueprint for Success

Inside Infinity’s offices in Hong Kong’s Central business district, the 45-year-old Gal-Or explains why he thinks the innovative partnership will succeed. A former F-16 pilot with the Israeli Air Force’s acrobatic team, he has an MBA from Tel Aviv University and is a graduate of Harvard University’s program in venture capital and private-equity investments. “Israelis, in general, are well-equipped to understand the Chinese,” says Gal-Or. “Both of us are into relationships, improvisation, and flexibility, and we are both pragmatic and aggressive.” Israelis want detailed contracts, he adds, “but we understand that documents are not going to make the difference, that the relationship is more important.”

Infinity began cultivating relationships in China long before I-China was launched. “My brother has been doing business there for more than 10 years and would show me around on family visits,” explains Gal-Or. Scouting around for private-equity possibilities, he found a rich lode in Suzhou Industrial Park. Initially planned and partly developed by a Singapore government-linked consortium in 1994 (the Chinese took majority control in

2001), the park is home to some 260,000 people who work in about 2,500 foreign-invested and domestic technology enterprises that enjoy tax, customs, financing, and other incentives.

Gal-Or met Lin Xianghong, the young chairman of SVG, who was receptive to his ideas. “It was the right timing and we were lucky,” Gal-Or says. “The government was very interested in high technology and in Infinity’s core strategy” of investing in Israeli and Chinese businesses and creating partnerships between them. When the Infinity-CSVC China Fund was launched in 2004, Wu Yi—at the time China’s vice premier overseeing the economy—and Israeli Prime Minister Ehud Olmert were witnesses. It was the first-ever license issued to a foreign-managed onshore RMB-denominated fund. “The certificate bears the number 00001,” says Gal-Or.

Infinity-CSVC invested in six portfolio companies, among them Shellcase, an Israeli supplier of wafer-level digital imaging and telecommunications electronic products, and Suzhou-based Chinese wafer-packaging manufacturer WLCSP, one of the first clean-room plants in China. The fund has made a partial exit from WLCSP, at a valuation two times its initial investment. WLCSP, which uses Shellcase’s miniaturization technologies, is targeting sales of US$100 million by the third quarter of this year and is planning an initial public offering in China.

The fund’s apparent success and the good working relationship between the Israeli and Chinese partners eased the way for I-China. (PE firms typically float a new fund every three years.) The fund scored a coup when China Development Bank, which is under the direct jurisdiction of the State Council, China’s highest executive organ, invested US$50 million. With SVG and IDB also onboard, the signal was sent that I-China was as close to being a sure bet as any foreign fund can be in China, considering the uncertainty surrounding non-Chinese funds in general.

The Chinese View

Getting the blessings of officialdom and actually satisfying expectations are two separate things, of course. Can I-China deliver? “Why not?” asks William Li as the Honda CRV speeds toward Suzhou. “We have already done it with the first fund”—he describes the Infinity-CSVC China Fund as a “test fund.” Li had led the Infinity-CSVC team that invested in WLCSP and four other portfolio companies. Not bad for someone who freely admits to knowing next to nothing about the private-equity business when he joined SVG in 2002.

Li credits Lin, the SVG chairman, for taking a chance on him. Lin had decided against recruiting expatriates because of the high cost and concerns about loyalty. “Instead, he hired four people, myself included, with different backgrounds but [who knew] nothing about venture capital,” recalls Li, who at that time had just returned to China after earning his MBA from Kennesaw State University in America’s south. For a year, the recruits shadowed two senior vice presidents at Taiwan’s Pacific Venture Partners, which was managing US$20 million of SVG’s money. “Wherever and whenever they went, we went too,” says Li. By the time Infinity came calling, “we were already speaking the same language.”

Li was seconded to the Infinity-CSVC China Fund in 2004, where his seasoning continued. “Amir is very creative in negotiating and packaging deals, and I learned from that,” he says of Gal-Or. The Israelis also learned from their Chinese counterparts. The Israeli investors tended to be forthright in dealing with local entrepreneurs, seeking to spell things out clearly on day one to avoid later misunderstandings. Li says it is often best in China to take things slowly and approach the negotiating points indirectly. There were moments of friction in the relationship, he adds, but the younger Chinese team and the more experienced Israelis learned to trust each other’s judgment.

Hunting Ground

The car has reached the industrial park and Li plays tour guide. “That’s the 27-hole international golf course designed by Gary Player,” he says. “That’s Jinji Lake over there. We’ll have dinner at a restaurant built on a platform over the water.” There are free water-and-light shows on weekends, patterned after the Bellagio Fountains in Las Vegas, “but bigger and better,” says Li. The shade and flowering trees lining the wide boulevards are bathed in a soft blue glow from recessed low-voltage bulbs at their base; their trunk and branches are outlined by a profusion of fairy lights. There are no garish billboards or flashing neon signs. It's all tasteful, low-key and clean—like a suburban Singapore.

In fact, Suzhou Industrial Park was designed to be a mini-Singapore, down to a social security system patterned after the Lion City's Central Provident Fund, China's first and only provident fund scheme. But while the park had the backing of the central government in Beijing, the Suzhou local government was initially lukewarm. It had started its own industrial zone nearby, known as Suzhou New District, in 1992, two years earlier than the Singaporeans. Foreign investors chose to locate in Suzhou New District rather than in the master-planned and much more expensive Suzhou Industrial Park. After losing a reported US$90 million over five years, Singapore decided to trim its stake from 65 percent to 35 percent.

"The Singaporeans actually built only eight square kilometers," says Li. "The Chinese developed the rest." When the Suzhou local government took control, the park's acreage was doubled from the originally planned 80 square kilometers. "They're now expanding it to 288 square kilometers," he adds—that's two-fifths the size of Singapore. Li has bought a home in the industrial park, one of 200,000 detached, low-rise and high-rise housing units built there, where he lives with his wife, a teacher at one of the park's high schools, and their three-year-old son.

Now a profitable enterprise, the park can be a rich hunting ground for I-China. Office and research facilities designed for specific industries such as electronics, IT, bio-pharmaceuticals, digital animation, integrated circuit design, and nanotechnology are being built. Seven universities are starting to supply skilled manpower, among them the Suzhou Academy of University of Science and Technology of China, Suzhou Postgraduate School of Nanjing University, and the Sino-British Xi'an Jiaotong-Liverpool University. The goal is to attract 30,000 students from China and abroad in the next two years.

The car turns into the driveway of a low-slung, glass-and-aluminum structure that houses some of SVG's portfolio companies. Digital China Suzhou is on the second floor. It's 8 p.m. and everyone has gone home, except for Thales Zhi, 32, the company's vice general manager in charge of product management. He brings out Chinese-language materials on Mate Intelligent Video's security solutions, which could be used in airports, railways, subways, office buildings, and even coal mines. "We're still educating the market, but we expect 30 million renminbi in sales this year," says Zhi, who pegs the size of China's security market at 5 billion renminbi, second only to the United States.

He is counting on rising Chinese demand for security solutions with the holding of international events like the Olympics this year and the Shanghai World Expo and Guangzhou Asian Games, both in 2010. Digital China is preparing to market another Israeli technology, a control and management platform for emergency situations by Orsus Situation Management, an Infinity portfolio company, and is looking at a slew of other software suites in security and other areas. The Israelis "have original R&D capability, and they know how to make a perfect product," says Zhi. And because the home market is so tiny, they have little choice but to bring those products to other countries like China.

The New China

Boiled down to realpolitik essentials, this may explain why Infinity has been so warmly welcomed in China despite the central government's evident bias for the home-grown PE industry. Unlike the United States or Europe, Israel is too small to be a geopolitical competitor. At the same time, it has the technology and know-how that China can use to climb up the value chain. Add Infinity's canny focus on flexibility and relationships, its willingness to teach and learn, and the similarities in Chinese and Jewish cultures, and you have a partnership that has the potential to endure.

Then again, the Singaporeans probably felt their partnership with the Chinese would also endure when they embarked on the Suzhou Industrial Park project. The bottom line is that China never stands still. What worked in the recent past can easily become unworkable today. At dinner at the Jinji Lake restaurant, Li is asked about partnership disputes between foreign and Chinese shareholders such as dairy makers Danone of France and China's Wahaha. The China of 10 years ago is far different from the China of today, he observes, and both foreign and domestic companies must adjust to the change. With foreign-currency reserves of US$1.7 trillion, the largest in the world, China can now afford to be selective about foreign investment, including overseas private equity capital.

The conversation veered to the Olympic Games, which will be held in Beijing in August. In Paris, activists had tried to grab the Olympic torch from a disabled Chinese athlete as she carried it through the city. “The West does not want China to rise, so it is disrupting the Olympics to keep us down,” says Zhi. At times diffident but more often confident, even bordering on cocky, the two young Chinese are emblematic of an emerging power that is asserting itself. Offshore private equity firms and other foreign investors ignore this new reality at their peril. CFO

Cesar Bacani is a contributing editor for *CFO Asia*.

Awash in Money

Private equity funds and capital raised in China

	Funds raised (US$mn)	No. of new funds
Q1 ’07	356	6
Q2 ’07	2,359	13
Q3 ’07	1,322	13
Q4 ’07	1,448	26
Q1 ’08	2,264	23

Source: Zero21PO Research Center

A Qualified Welcome

John Gu, a principal at international advisory firm KPMG, traces the current chill among foreign private-equity players in China back to August 2006. That was when six Chinese ministries jointly issued Order No. 10, entitled Rules on Acquisition and Merger of Domestic Enterprises by Foreign Investors. The new rules require Chinese companies to first get regulatory approval before creating an offshore vehicle (known as a “red chip” when listed in Hong Kong and other overseas markets).

This type of cross-border restructuring was the favored investment route of foreign PE firms. It had two main benefits. By investing at the offshore level, they were able to convert their holdings into pre-IPO shares free of Chinese taxes. They also gained protection from the English common law practiced in offshore legal jurisdictions, rather than less robust Chinese jurisprudence. The problem: Beijing has not approved any red chip application since 2006. “This investment route has been effectively shut down,” says Gu. “We are not aware of any case that has been approved.”

The only route now open to foreign PE players is to invest onshore. But as foreign investors, they need regulatory approval for every portfolio investment they make, a process that can take two to three months or far longer—Carlyle’s takeover of Xugong Construction Machinery, for example, has been in regulatory limbo for nearly two years. Domestic PE houses don’t need such regulatory approval, so they can move faster than their foreign rivals. “That’s a big advantage if the target company needs capital fast,” observes Gu.

China’s domestic private-equity industry got another boost last year with the implementation of the amended Partnership Enterprise Law. The original law allowed only unlimited liability partnerships; the new version provides for a class of partners with limited liability. Both corporations and individuals can now invest in a partnership, not just individuals as previously, and double taxation is avoided because partnerships are now income tax-exempt—partners pay taxes on wages and profit payments.

Unfortunately, the new law doesn’t apply to foreign-invested partnerships. Instead, those will be governed by yet-to-be-enacted Foreign Investment Partnership Regulations. A draft indicates that the government does not intend to put foreign-invested and domestic partnerships on the same footing. Unlike domestic investors, foreigners will not be allowed to make capital contributions by performing services for the partnership, and they must remit contributions within 90 days of the partnership's establishment. The draft is silent on whether a foreign-invested partnership needs to seek regulatory approval for each portfolio investment.

None of this bodes well for foreign private equity. "China is not particularly keen right now to provide additional channels for money to come in because strong capital inflows, combined with the large current-account surpluses, are putting pressure on the exchange rate," explains Eswar Prasad of Cornell University. "What they're very keen to get is foreign expertise, not capital."

Some foreign firms are starting to adjust. "We're looking at parallel funds, where both parties have significant advantages that they bring to the overall partnership collectively," says Gregory Mark Hill, managing director at Trenwith Securities in the United States. The domestic fund brings connections and the ability to move fast onshore, while the offshore fund conducts overseas deals and contributes foreign expertise. Tang Ning, founder and CEO of local consulting and incubation firm China Growth Capital, sees a niche for foreign PE houses. "If the target company wants to list overseas, offshore PE firms have the advantage because they have experience and connections," he says. – C.B. & Daniel Wang