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Public Policy Forum on Venture Capital:
The China Perspective

October 25, 2010

Key Market Challenges for China

- **Intensifying competition in all market sectors**
  - Markets are opening up, allowing for entrance of competitive foreign players
  - Domestic companies are also developing quickly, supported by strong capital supply and market demand

- **Increasing wages as standard of living rises in China**
  - Companies are facing increasing wage pressures as workforce demands greater compensation for their labor

- **RMB appreciation is a double-edged sword: *Be careful what you wish for!***
  - Trade surpluses and foreign political pressure will lead to continued RMB appreciation, thereby eating into China's traditional cost advantage
  - At the same time, RMB appreciation will also drive Chinese purchasing power abroad

Expansion Inland and Overseas

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As the China market matures, more companies will look to leverage the growing opportunities both inland and overseas

- With increasing urbanization and growing middle class, markets in the currently **untapped 2nd and 3rd tier cities** will grow in importance

- As Chinese companies continue to develop and mature, they will acquire attractively priced targets abroad and **seek expansion overseas**

A growing number of Chinese companies are stepping onto the global stage

Increasing Emphasis on Innovation and Brand

Chinese companies will place greater emphasis on innovation and brand-building as they look to sustain long-term growth

- Increasing pressure from competition, rising wages, and RMB appreciation is forcing companies to **move up the value chain** from simple manufacturing
- More **innovation** is necessary to compete effectively in both domestic and global markets
- More sophisticated consumers, the growing need for differentiation, and increased competition for talent has necessitated **greater emphasis on brand** value and recognition

Rise of the RMB Ecosystem

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- **Emergence of huge pools of domestic capital**
  - In April this year, the China National Council ruled that the National Social Security Fund will be allowed to invest up to 10% of its RMB800 billion fund in private equity
  - As of June 2010, China's national insurance funds will be allowed to invest up to RMB226 billion in private equity funds
- **Increasing number of RMB funds to match capital supply**
  - In 2009, nearly US$7 billion was raised by RMB funds in China, compared to approx. US$4 billion raised by foreign-denominated funds
  - Nearly all venture and private equity firms in China are looking to raise RMB capital from domestic LPs

- **Domestic exits now exceptionally attractive for venture-backed companies**
  - ChiNEXT (创业板), a NASDAQ-type exchange for high-growth, high-tech start-ups, was opened in October 2009
  - There are currently 120 companies listed on ChiNEXT, with total market cap. of RMB 474.4 billion, and average P/E ratio of 63.02 *(as of Sept. 22, 2010)*

Source: Zero2IPO, China Venture, Shenzhen Stock Exchange

Government Investing in Venture Capital

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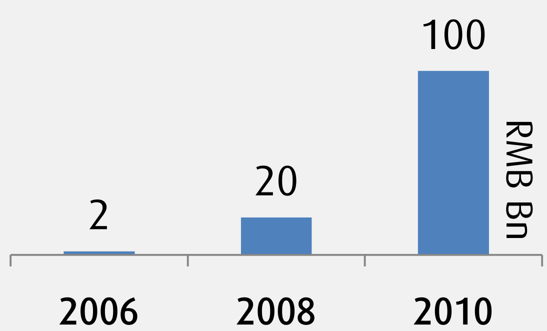
- The Chinese government has been investing in RMB funds since 2006, in an effort to attract more venture capital into the economy

- Government Introductory Funds are now starting to be more passive: contributing smaller percentages of Funds with less management involvement and fewer geographical restrictions

Growth in Government RMB Funds (2006-2010)



	Beijing	Shanghai	Tianjin	Chongqing	Shenzhen	Suzhou
Size (RMB Bn)	4.5	10	10	5	3	5
Funds Invested	20	20	20	15	10	20
Tax Incentives	For funds & partners	Funds only	For funds & partners	For funds & partners	Funds only	Funds only
Formation Incentives	Up to RMB 10Mn	Up to RMB 10Mn	N/A	Up to RMB 2Mn	Up to RMB 15Mn	N/A

Surplus of Capital Favors Active Investors

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- **Excessive capital from both domestic and overseas sources has led to intensifying competition at the growth stage**
  - Majority of firms have drifted towards growth and later-stage deals, hoping to cash in on "quick money"
  - This has vacated the early-stage space, leaving more opportunities for firms like Gobi

- **Entrepreneurs have become more sophisticated, demanding more value from investors**
  - As entrepreneurs in China are wooed by an increasing number of funds, they are becoming more savvy and sophisticated: <u>money is no longer enough</u>
  - In order to generate more value, VCs must return to active investing—building out the teams & infrastructure necessary to support its portfolio

The Gobi Model

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Early-stage is more labor intensive in China. In order to provide additional value for entrepreneurs and to differentiate from other VCs, Gobi provides a full team with broad geographic coverage

Hands-on Professional Support…	… with Broad Geographic Coverage

- 15 Investment Executives to manage current and new investments
  - Investment professionals with deep operational expertise
- and 10 additional Executives in the following vertical functions:
  - Finance Team
  - Legal Support
  - Executive Recruitment
  - Public Relations

Gobi Office Locations

(As of Sept. 2010)

Gobi's Government Partners

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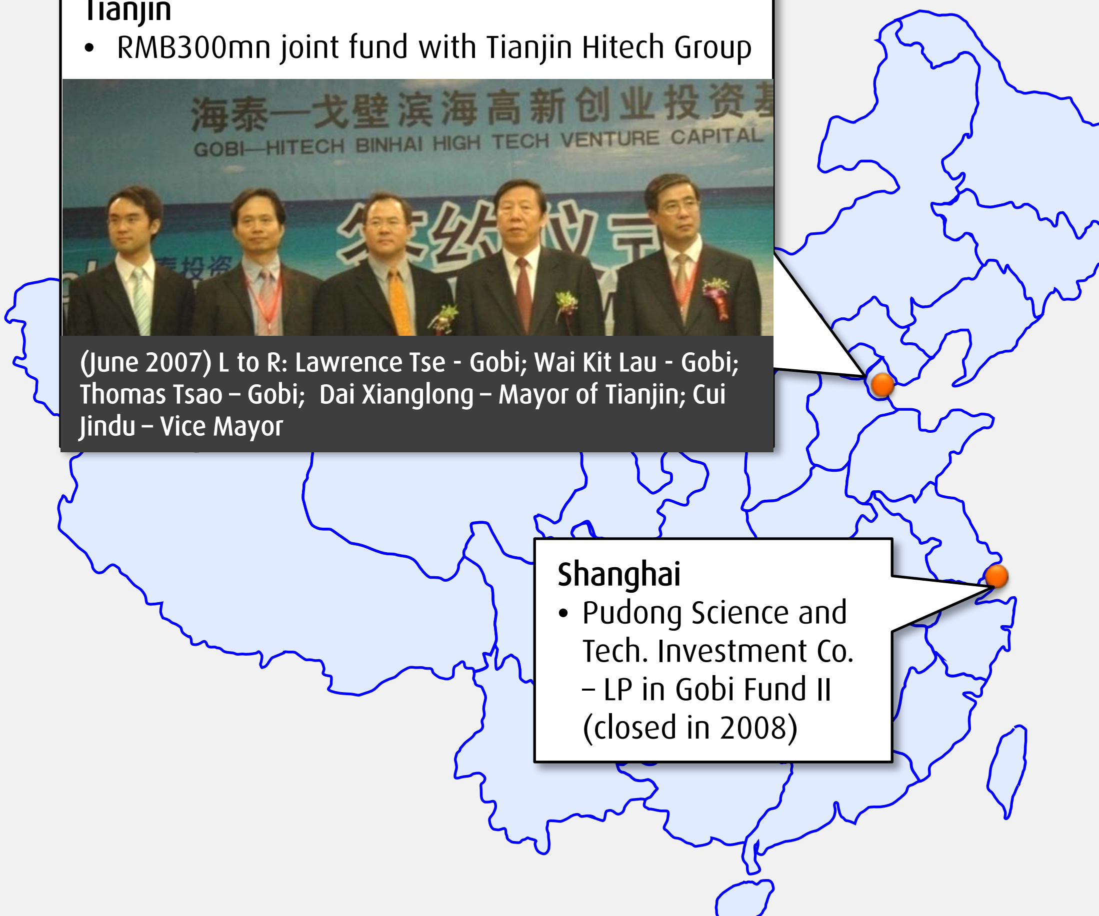
Strong government relationships lead to additional deal sourcing channels as well as access to valuable government resources

Tianjin
- RMB300mn joint fund with Tianjin Hitech Group



(June 2007) L to R: Lawrence Tse - Gobi; Wai Kit Lau - Gobi; Thomas Tsao – Gobi; Dai Xianglong – Mayor of Tianjin; Cui Jindu – Vice Mayor

Shanghai
- Pudong Science and Tech. Investment Co. – LP in Gobi Fund II (closed in 2008)

Singapore
- SG$100mn fund with the Media Development Authority (MDA)

(June 2010) L to R: Wai Kit Lau - Gobi; Dr. Tan Chin Nam – Chairman, MDA; Dr. Christopher Chia – CEO, MDA

Lessons Learned

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- Government should not be in the business of picking individual winners; instead, they should create the conditions that can nurture a self-sustaining venture ecosystem

- One-time grants or subsidies for startups are well-intentioned, but may not be the best use of time or resources due to lack of accountability

- Infrastructure projects such as innovation parks are helpful to showcase and create suitable environments for innovation, but too many competing projects dilutes the necessary critical mass and also confuses investors

Key Recommendations for Government

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- **Attract and leverage private capital, and invest more money into early stage funds:**
  - Pick the best fund managers – not the most promising startups or technologies
  - Offer higher management fees or higher carry to early-stage funds
  - Incentivize VCs, but also emphasize greater accountability

- **Build and structure capital markets to support and encourage liquidity**
  - Tax incentives for both early-stage funds and innovative companies
  - Implement regulations that allow for options and preferred shares
  - Build a NASDAQ-style public listing venue to provide domestic liquidity

The goal is to kick-start an ecosystem, and VCs are a key component of that; once the VCs are in place, the rest of the ecosystem will fall in line (incl. private placement firms, advisory boutiques, headhunters, late stage funds, etc.)