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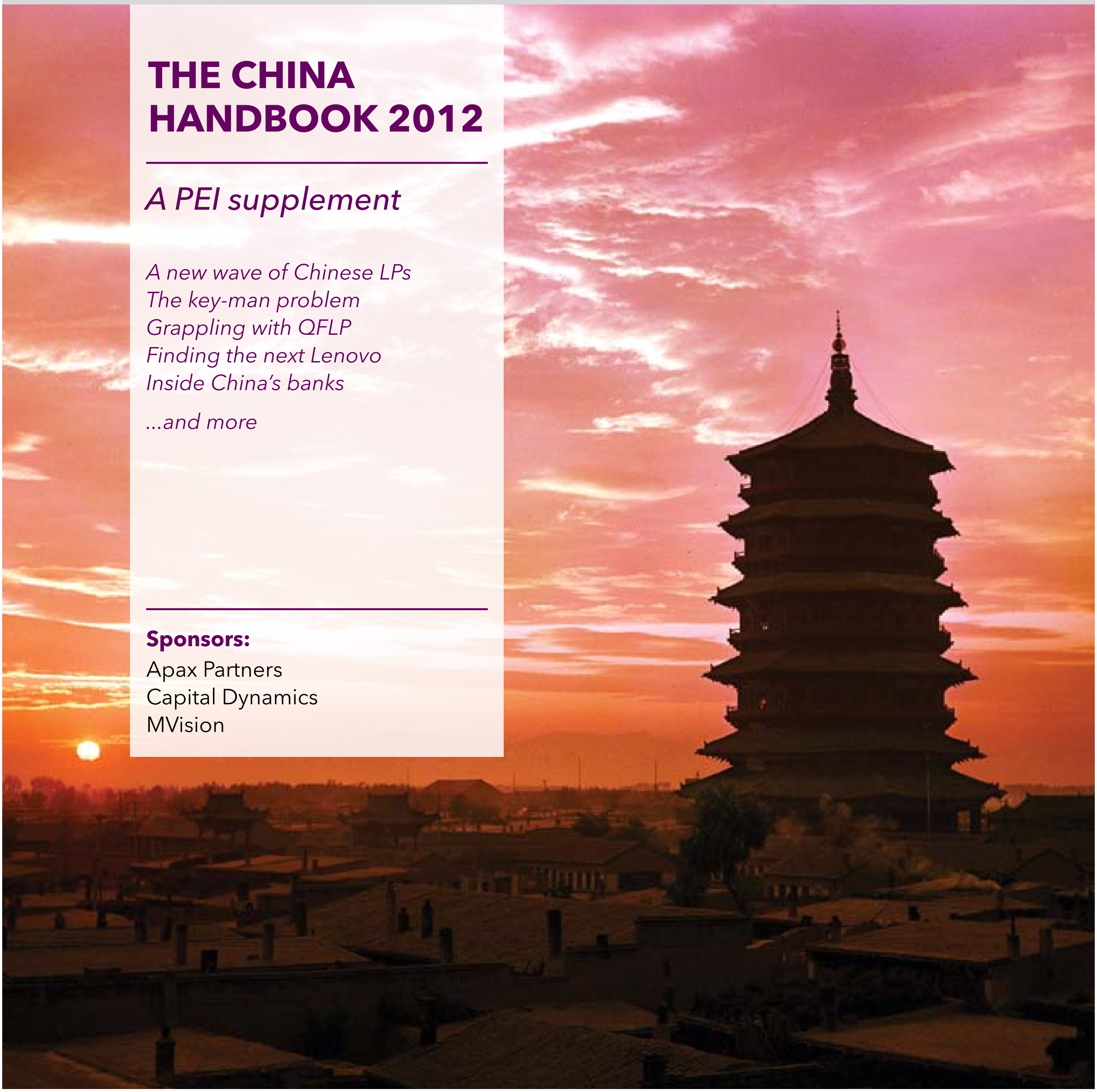

EXPERT COMMENTARY **CAPITAL DYNAMICS**

All change in China

China's extraordinary growth story is well-documented, but it remains difficult for private equity investors to tap into this notoriously fluid market. Thomas Kubr of Capital Dynamics outlines some of the key challenges – and explains how best to overcome them

Just how important is China to the future of the global private equity industry?

"Its importance will be greater than most people can imagine," says Thomas Kubr, chief executive and managing director of Switzerland-based independent asset manager Capital Dynamics. "Private equity is in its infancy in the country, so its importance right now is relatively minor – it's still an emerging market. But within a decade, China will be at least on a par with the US and Europe as a private equity market."

Coming from a firm that has a truly global perspective, that's quite a claim.

A decade ago, the perception was that China was a difficult market for outsiders to penetrate. But that has changed as the country has opened up to foreign investment. "Whether you make a significant profit on your investment that stands the risk remains a different story," says Kubr.

GLOBAL VS LOCAL

Nonetheless, it's a market that still bears significant risks.

Take manager selection, for instance. Although precise data is hard to come by, Capital Dynamics believes there are well over a thousand groups in some way involved with private equity in China – of which it regards fewer than 100 as institutional quality.

Kubr: *more optimistic than most*

> *If a supreme expert in China private equity were to fall asleep for three years and then come back, he would not recognise anything around him*

"Some of those other groups may grow to become institutional quality," Kubr adds. "But in our view, there are only about a dozen home-grown GPs in China that are 'investment grade', meaning that we'd recommend clients allocate money with them."

The lack of a discernible track record is often a problem with local GPs. So too is a lack of team stability as well as a lack of understanding that managing a successful fund is extremely hard work that needs a permanent focus on delivering on-going success stories. What's more, says Kubr, some groups strongly under-estimate the long-term nature of the asset class. "We find some managers raising quick, short-term money – something that in my opinion you should never do in this asset class." Investor relations often seem to be low on the agenda too, he adds. "Quite a few managers out there just think 'Oh, we're in China – so anything goes, and we don't have to worry about it".

Of course, none of these tend to be such big issues when dealing with the global firms operating in China – many of whom have been laying down roots in the country for years. "You don't need to be a home-grown group to be successful in China," Kubr insists. "There are a number of players who have been out there for a very long time. You can get your connections and the right people to build up a presence as a foreign firm. There are probably a dozen or so that have managed to do that, and have access to good deals as a result."

Capital Dynamics has tracked their progress, and been a part of that success. "We've been investing in China for close to 10 years now in one form or another: global funds, regional and local funds, affiliate funds and so on. Clearly that was a way to get into the market initially, and we have done so."

So should investors go with the global firms, or think local? "There really is no right answer as to what type of group is better – there are simply different types of opportunity that you can access with different groups. As an institutional investor, it pays to diversify into different styles."

In a diverse corporate landscape where it's almost impossible to judge which sectors offer the best returns, investors should focus on manager quality, says Kubr. "China has such vast amounts of opportunities that you'll find gems in just about any industry, any region, at any stage. But it's really hard to find quality managers who are consistently able to achieve outperformance and manage the 'China' private equity risk appropriately."

A LONG-TERM VIEW

There are also the more macro-level risks to consider, of course.

"Clearly, China represents a different type of risk than any other large region or economy," Kubr explains. "My view is that China clearly has a long way to go on its road to economic development, and there will undoubtedly be bumps along the way. But I have no doubt that it will develop positively and that the risk of China reverting to the dark days of a few decades ago is not significant in our lifetimes.

"You have to be aware of the bumps. But if you have a long term view, which as private equity investors you need to have, then China is really no different to Europe, the US or Brazil, for example," he adds.

The currency situation is clearly one risk; as Kubr points out, if you invest in the Chinese market, one way or another you'll be linked to the RMB. "Whether that is good or bad is a macro conversation that needs to be had," he says.

Political instability remains a big worry for investors, he says – "It's a great sport in the West arguing about whether China's stable or not." Then there's the question of economic freedom. "There's no question there's a bit of discrepancy between the communist system and a free market system, and China's been able to navigate that quite successfully for the last couple of decades. Will they be able to continue to do that? I'm a bit more optimistic than most, but that's certainly a risk that some people are concerned about."

Regulatory confusion is also an issue, he says. "China is experimenting a lot with what does and doesn't work for the country. A bit of a challenge that you have coming from the outside is that there's not really much clarity over who has the power to regulate private equity – there are a number of institutions that have a claim to that, and those claims sometimes clash, both at central and local government level."

Still, he does believe progress is being made – albeit slowly. "Generally what we see is that China is opening up to more free flow of capital in both directions. It's also becoming clearer about what's permissible or not permissible in terms of raising funds, and what you can and cannot invest in, in China. The situation is still very fluid, however, and it will probably be many years before we see some stability."

"Macro-wise, China will not surprise people with outsize returns versus other developing regions over the long term," Kubr adds. "But at a micro level, the excitement about China lies in finding gems in the vast sea of opportunities that are out there. And because it's an emerging market we expect that China will have more gems than more developed economies."

For now, perhaps the one constant in this market will be the pace of change. "If a supreme expert in China private equity were to fall asleep for three years and then come back, he would not recognise anything around him," says Kubr. "You have to continually keep abreast of what's happening, what does and doesn't work. The only prediction I can make with any certainty is that there will be a lot of change coming." ■

COMPANY PROFILE **CAPITAL DYNAMICS**

Capital Dynamics* is an independent asset management firm focusing on private assets including private equity, clean energy and infrastructure, and real estate. Capital Dynamics offers investors a range of products and services including funds of funds, direct investments, separate account solutions, and structured private equity products.

Our senior investment professionals hold an average of over 20 years of investing experience and due diligence expertise, gained through diverse backgrounds as fund investors, direct investors, and co-investors. With 160 professionals and 10 offices worldwide, Capital Dynamics is able to deliver top-quality service to its client base of sophisticated institutional investors such as pension funds, endowments, family offices, high net worth individuals, and advisors.

Headquartered in Switzerland, Capital Dynamics has offices in London, New York, Zurich/Zug, Tokyo, Hong Kong, Silicon Valley, Sao Paulo, Munich, Birmingham (UK) and Brisbane.

CAPITAL DYNAMICS ASIA

Capital Dynamics' Asian investment experience dates back to 2003 when our team began investing in Asia. In 2007 we opened our first Asian office in Hong Kong and our Tokyo office was established in 2010. Today, the team based in Asia totals six dedicated investment professionals who are fully integrated into the broader investment management team, and can leverage our entire global network of contacts and relationships.

FOCUS ON INNOVATION AND QUALITY

Capital Dynamics is an industry leader in quantitative risk management; an essential component of successful private equity investing. The importance of risk management has intensified due to tighter financial regulations and heightened investor awareness. Our Portfolio and Risk Management team conducts customized, in-depth client portfolio analyses and our Portfolio Servicing team provides comprehensive and dedicated back office services for a diverse set of global investors.

We are proud of our distinguished reputation within the private equity community. In 2011 and 2010, we were voted "Fund of Funds of the Year in Europe" by *Private Equity International*.

Capital Dynamics is a signatory of the United Nations Principles for Responsible Investment (PRI). Our emphasis on quality has been recognized with the International Standard ISO 9001:2000 certification of compliance.

INVESTMENT TYPES[2]

Primary fund investments – We have invested in private equity funds since the late 1980s, spanning all geographies and strategies. We have established solid relationships with over 400 General Partners, and monitor 788 active funds.

Secondary fund investments – Active in the secondary market since the early 1990s, we raised one of the first dedicated secondary funds. The combination of our large number of existing fund investments and proprietary databases often provides an information advantage when evaluating secondary transactions.

Direct investments – Our extensive relationships with the globe's top-tier fund managers provide a consistent volume of high-quality investment opportunities. Our co-investment strategy is focused on mid-market buyouts, but also includes select development capital and special situations.

Clean Energy and Infrastructure – Our specialized team of senior industry investors employs a direct investment strategy focused on a diverse mix of clean and low-carbon energy assets that can offer attractive risk-adjusted returns and compelling diversification benefits from this emerging class of real assets.

Real Estate – Members of our Real Estate team have been investing in real estate funds since 1990 and maintain relationships with fund managers around the globe.

STRUCTURES

Funds of funds – We offer private equity, primary and secondary funds of funds, allowing investors to implement a global allocation strategy through access to premier private equity managers, in addition to portfolio diversification.

Separate accounts – We assist clients to create individual programs to meet unique risk profiles and liquidity constraint parameters. We offer legal structuring services to meet the regulatory, tax and compliance requirements for each separate account client.

Structured products – We customize solutions one client at a time. Every structured solution is designed to deliver compelling benefits such as early liquidity, enhanced return on investment, reduced risk, lower open commitments and/or decreased risk-weighted capital reserves.

Please contact us at info@capdyn.com, or visit our website www.capdyn.com for further information.

* "Capital Dynamics" comprises Capital Dynamics Holding AG and its affiliates

[2] History includes 2005 acquisition of Westport Private Equity Ltd., and the Real Estate team's prior experience