李偉民律師事務所
MAURICE WM LEE SOLICITORS

Issue 9 (06/2008)

Introduction to Private Equity

私募基金简介

As an increasing number of funds are moving to Asia, private equity investment is prospering in Asia. During the last three years, the level of private equity activities in China has been growing at a faster rate, making China one of the most active private equity markets in Asia. Industries with high growth prospects such as energy, healthcare, biotechnology and telecommunications are very attractive investment targets.

Private equity is an asset class consisting of equity investments in operating companies that are not publicly traded on a stock exchange. There is a wide array of types of private equity investments which can be, among others, divided into the following major categories:

1. Leveraged buyout (or buyout) (杠杆收购): refers to the purchase of a controlling interest in a company's equity. A leveraged buyout, commonly referred to as an LBO, is a business takeover that uses a significant amount of borrowed funds. The target companies are generally those with a low level of existing debts and long history of consistent and reliable operating cash flows, as it is important that the target companies will have the ability to facilitate loan payments after the completion of LBO.

2. Venture capital (创业基金): refers to the equity investment in the start-up of a new business, or in a small or medium-size enterprise at its early stage of development. Such new or young businesses generally do have good future growth potentials.

3. Growth capital (增长基金): refers to the equity investment in a mature company that is looking for capital to expand, restructure its operations, enter new market or finance a major acquisition of other business without necessarily causing a significant change of shareholding control of such company.

Most private equity investments are managed by professional investment managers ("**IM**") which raise funds from various investors such as pension funds, corporations and wealthy individuals. Private equity funds are usually set up as either a limited liability company or limited partnership. Under the former, the usual corporate mechanisms will apply. Investors maintain their rights as "participating shareholders", and the IM in the capacity of "management shareholder" normally takes up the management role. Under the limited partnership arrangements, ordinary investors in the funds act as "limited partners" whose liabilities are limited to the amount of money which they invest, and they are not involved in the daily operations. The IM serves as the "general partner" who may have unlimited liability for the debts and obligations of the private equity fund. However, they have the right to participate in the management of the partnership. Another common investor in private equity funds is "fund of funds"(基金中的基金), which refers to a private equity fund that invests in other private equity funds in order to provide the investors of the original fund with a wider range of investment opportunities. Such "fund of funds" may achieve higher returns and better diversification of risks.

<u>Risks and Returns:</u>

1. Relatively high risks: inventors' risk of loss of capital is potentially higher in some private equity funds in that, for example, venture capital investing in the companies during their early stage of developments is riskier than the investment in a mature company. Also, investments in privately held companies tend to be riskier than those in public companies as the regulations and disclosure requirements imposed on the privately held companies are much fewer than those on the public companies.

2. Potentially high returns: generally, the rates of return correlate positively with the rates of risk. The returns of private equity investments therefore should be higher than those of public equity investments. Also, it was said that a company's ability to achieve high returns is usually more likely at its early stage of developments before the company reaches its maturity stage.