

Market Update | Fourth Quarter 2010

New Name

As you know, on December 1, Piper Jaffray Private Capital was renamed North Sky Capital and became a fully independent firm. In connection therewith, we also rebranded our funds with the North Sky name. The transition was well-planned and transpired seamlessly overnight on November 30.

Since inception we were designed to answer only to our investors and to avoid any real or perceived conflicts from being affiliated with an investment bank. Our rather unique, client-focused arrangement with Piper Jaffray enabled us to function for eleven years essentially as an internally-governed, self-contained unit within Piper. As a result, this change truly was in name only. Our management team remains exactly the same, as do our investment processes, deal sourcing, fundraising, back office and reporting functions and outside legal, auditing and tax advisors. Our personal bonds and professional relationships also continue with our long-time friends at Piper Jaffray, albeit now on purely an informal basis.

On December 1, we upgraded our physical office space and IT systems to better meet the needs of our investors. We hope that you will visit us in the months ahead to see our new location. Please contact us to coordinate a meeting if you are going to be in Minneapolis.

The Chinese Opportunity

*Fools rush in / where angels fear to tread
And so I come to you my love / my heart above my head
Though I see / the danger there
If there's a chance for me / then I don't care (1)*

We have been analyzing and investing in China for several years now. Our visits this year were similar to years past – stunning growth and opportunity almost everywhere we looked. Based purely on statistics, choosing to invest in China may seem like a no-brainer:

- Population of 1.3 billion people, increasing by 12-13 million per year (2)
- Rapid urbanization as 20-30 million people move from rural areas to the cities each year and their demand for goods, services, housing and energy doubles or triples (3)
- 2010 GDP growth of 10%, approaching \$6 trillion annually (second only to the USA) (4)
- Retail sales of consumer goods increased 19% year over year (5)
- More web users than the entire population of the U.S. (8)
- 800 million cell phone users (7)
- China recently also surpassed the U.S. as the world's top energy consumer

We could go on and on. These statistics, combined with recent venture capital success stories like Baidu, Alibaba, 51Job, Shanda and Ctrip, offer an almost irresistible appeal. But the aphorism of “a rising tide lifts all boats” is grossly inappropriate here as many of the boats (especially those of foreigners) will be smashed upon rocks jutting out of the Yellow Sea. We are fascinated with China and its seemingly endless array of investment opportunities. But more forethought, more respect is owed to these opportunities—especially the private equity ones—than many investors seem willing to give today.

Complicating Factors

- Currency and liquidity risks. LPs assume that GPs will find a way to return U.S. dollars to them. For many investments in China, however, there is no assurance of this due to currency rules. Also, the Yuan is essentially pegged to the US dollar but for how much longer will it be at this level?

- Huge Capital Inflows. In 1H 2010, 61 private equity funds raised a total of \$5.8 billion, which is comparable to the amount of total investments made in China during 2009. (6) There also has been a proliferation of local RMB denominated funds, adding further competitive pressure and unwelcome pre-money valuation increases.
- Inexperienced managers. The most common roman numerals in China are I and II. *Caveat emptor* indeed.
- Political risk. The Chinese government can change course quickly, which can create or destroy investment opportunities. Regulations at the local level (and variations from province to province) can also create additional investment challenges.
- Can't pay your mortgage with unrealized gains. Many firms we have met with have "booked" impressive write ups as the stock market has skyrocketed but have yet to monetize those investments. That 8x return sounds good during the marketing pitch but the fine print suggests we review "Currency and liquidity risks" above.
- Turnover. Loyalty among personnel at Chinese PE firms remains almost non-existent. The high turnover rates in Chinese PE firms make New York MBAs look like they are standing in cement.
- "Non-Western" business practices. Chinese executives have been known to take personal liberties with company finances. Also, historically, it has been commonplace for management to keep multiple sets of books.
- Labor inflation. Labor is still cheap, just less so than it used to be.
- Traditional buyouts are almost non-existent due to tradition / culture, bank lending practices / lack of a proper legal framework for security interests, need for approvals from government at entry and exit from a company and the fact that Chinese executives typically know the trajectory their company is on and are unwilling to sell all of it now; preferring instead to sell a minority stake and retain most of the upside potential of the company.

We have learned a lot from our time in China about private equity, including:

- It is absolutely essential to meet all the managers in the Chinese universe in order to see the subtle but important differences among them and to discern which ones truly have the qualities needed to generate outstanding returns in a complicated market.
- Flyover investing by US VCs or LBO firms doesn't work. Your investment managers must either be entirely local or have a significant and permanent local presence. The best teams often have a small US contingent that transfers private equity know-how to the team but the majority of the overall team consists of Chinese nationals with local knowledge of customs, language, legal structures, business networks and government connections.
- There will be big winners. There will be horrific losers. Watch your top knot.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

- **January 12:** Sixth Annual Clean Technology & Renewables Conference hosted by Piper Jaffray, New York City
 - **January 19-20:** CleanTech Investors Summit, Palm Springs, CA
 - **March 3-4:** Women's Private Equity Summit, Half Moon Bay, CA
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1 Sung by Sinatra. Songwriters Mercer and Bloom.

2 CIA Factbook

3 Bloomberg

4 National Bureau of Statistics

5 PE Daily China

6 PE Daily China

7 New York Times

8 International Telecommunication Union

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