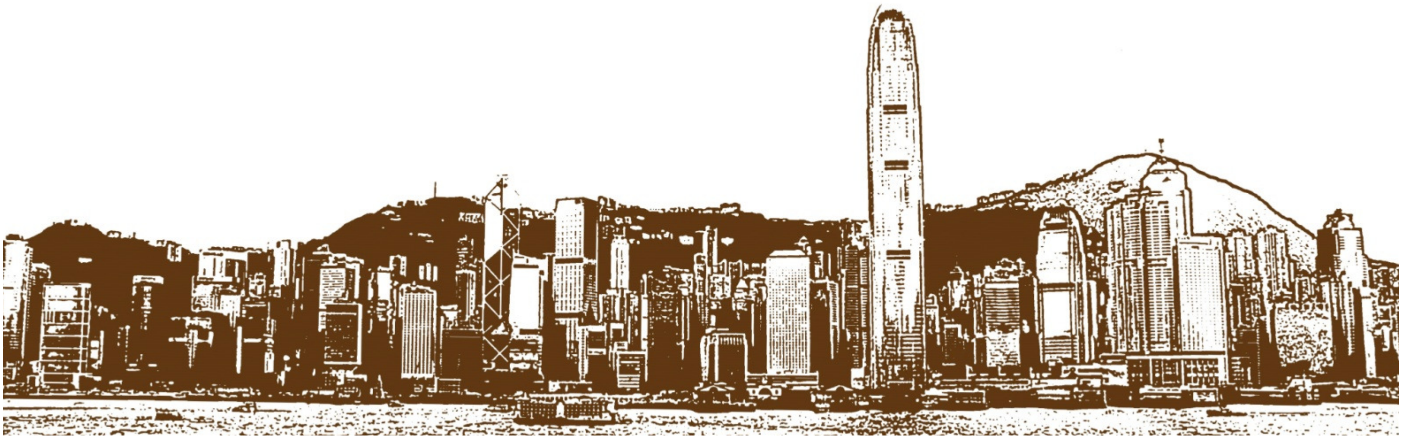
HKVCA Brown Paper

Venture Capital, Private Equity, and Hong Kong's Entrepreneurial Businesses



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Content

Acknowledgements

Disclaimer

Chapter 1	Introduction	1
Chapter 2	How did we fare? Successful entrepreneurial businesses in the past 10 years	3
Chapter 3	Looking for Seed Capital	6
Chapter 4	Moving to the next stages: Venture Capital and Growth Capital	9
Chapter 5	Buyout: Multi-facet solutions for Co-control, Succession, Corporate Carve-outs and MBO	13
Chapter 6	Strategic Trade-Sale: An Alternative to IPO	17
Chapter 7	Views from Family Offices: Venture Capital, Private Equity and the Cross-border Opportunities for Hong Kong's entrepreneurial talents	19
Chapter 8	Putting them all together…	21

Chapter 1 Introduction

As an industry group, we find 2012 an opportune time to bring venture capital and private equity into the discussion of entrepreneurial businesses in Hong Kong. There is increased consensus among the community and the new government leadership that small and medium businesses are in need of greater vitality for the good of Hong Kong. It has also been a decade after the watershed year of 2001 that saw our city's entrepreneurial fervor reaching its peak, the launch of GEM Board and government-backed on-site incubation programs, and then the burst of the tech bubble. In the 10 years that followed, we witnessed, admiringly, the venture capital- and private equity-backed entrepreneurial boom in Mainland China, heralded by the IPO of Tencent and Ctrip in 2004. Thus it would be instructive to (i) look back holistically how entrepreneurial businesses have actually fared in Hong Kong in the past decade, (ii) identify the nuances and viable models how entrepreneurial businesses at different stages may work with angel investment, venture capital and private equity, and, through this paper, (iii) make the lessons known to you, our audience, namely: entrepreneurs and aspiring entrepreneurs; industry veterans, who may consider joining the management of an entrepreneurial business or even setting up one; investors; government and policymakers; and the general public. It is so that we have a clearer perspective how value can be created with Hong Kong's entrepreneurial businesses as we proceed into the next 10 years.

Setting the stage: the state of venture capital and private equity

Hong Kong has been the hub of Asian private equity and venture capital ever since its advent in the pre-Asian financial crisis days in the 1980s and 1990s. The two biggest industry events for Asia private equity are held here every year. We have a number of independently-owned home-grown private equity firms that have become industry leaders in China, regionally, or even internationally, including prominent names such as SAIF Advisors, Baring Asia Private Equity, and Pacific Alliance Group; Mount Kellett Capital Partners is even named after a mountain in Hong Kong.

The Asia private equity and venture capital industry has grown tremendously in size in the past 10 years. According to Emerging Market Private Equity Association, annual private equity and venture capital fundraising in Asia has increased from HK$55 billion in 2001 to HK$224 billion in 2011[1], While Hong Kong's venture capital private equity industry is easily overshadowed by the city's business volume in the secondary and derivatives markets, it is important to draw the distinction in terms of their impact on the *real* economy. Venture capital/private equity makes direct investment *into* businesses, whereas in the case of secondary market activities, securities simply change hands in an open exchange. This paper contains real-case interviews on how angel investing, venture capital and private equity have contributed to Hong Kong businesses over the last 10 years.

Until recently with the investment in TVB and City Telecom, Hong Kong's venture capital and private equity industry has largely evaded the attention of the local press. This is very different from Mainland China, where private equity and venture capital is one of the most talked-about phenomena in the media. According to Fortune Magazine[2], private equity is considered to be one of the "15 most important things that shaped the lives of Chinese people in the past 15 years", along with residential properties, high-speed trains and mobile phones.

There is indeed no need to overhype venture capital and private equity. Yet it is helpful if through this paper policymakers and the local business community can better understand how venture capital and private equity works as an industry, in order to form the right expectations of engagement, as we all should do when conducting business.

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[1] Source: EMPEA

[2] Fortune China, 12/1/2011

How venture capital and private equity functions

Venture capital and private equity is a fund management business. As such, venture capital and private equity fund managers raise funds from investors who subscribe to the specific strategy of the fund products they market. Investors typically will go into the fund as "limited partners", meaning that they cannot interfere in the day-to-day operation of the fund, including the fund managers' investment decisions, except on a few pre-specified occasions. The fund typically has a finite life, and that means normally the investors cannot withdraw at will. In exchange, other than fund management fees, the fund managers do not get paid economics before investors receive their profits. These universal features have a number of important implications:

First, a venture capital or private equity fund manager can only invest according to what is prescribed as the fund's strategy, and should serve the best interests of its investors within the premise of the fund. Looked in another way, a venture capital/private equity firm may organize a fund product that is tailored to a specific strategy, should there be sufficient demand from investors.

Hence, if a Hong Kong-focused fund can be raised successfully, the venture capital/private equity investor mandated to manage the fund will have to invest in Hong Kong companies. Likewise, if there is not a dedicated Hong Kong fund in the market, a Hong Kong investment opportunity must be compelling enough to attract investors not tied to a Hong Kong investment mandate.

Secondly, while venture capital and private equity can be patient capital, the fund manager's principal fiduciary duty is to exit the investment within the finite fund term and realize gains for its investors. Its objective is fundamentally commercially motivated. In fact the greatest social responsibility for a commercial fund manager is to manage competently the money entrusted upon by its investors, which may include non-profit organizations, pensions, education endowments and government reserve funds. To think of supporting Hong Kong entrepreneurial businesses as an act of charity does not help in adding vitality to the economy sustainably. Rather this paper aims to make the point with real-case examples that, at different risk-levels, investors can find "investable" entrepreneurial enterprises and managers in Hong Kong that are committed to high-quality business judgment and execution, and that Hong Kong can be a place to build great entrepreneurial businesses.

Finally, as practitioners investing in the real economy, we are in a credible position to echo the voice of the Hong Kong enterprises covered in this paper: acknowledge the pace of change that has been taking place around us. Acknowledge how fast China's industries can *learn*, especially in the past few years, and that they will continue to do so in the years to come. Acknowledge that the Asia private equity industry has come a long way over the past 10 years, not only in scale, but also in sophistication and institutionalization. Most interestingly, at this juncture of a Facebook IPO and a China slowdown, acknowledge the need to calibrate the right dosage of opportunism as we orient our next steps forward.

We hope this paper will provide you with illuminating insights as you plan your new venture, your new career, your new investment theses, and the policies for this wonderful city.

May 2012.

Chapter 2 How did we fare? Successful entrepreneurial businesses in the past 10 years

Setting out parameters to measure how Hong Kong has been in creating successful entrepreneurial businesses in the past 10 years is easily a controversial exercise. What constitutes a Hong Kong company? What defines success?

This study looks at the number of Hong Kong businesses—defined as Hong Kong-headquartered or Hongkonger-founded businesses—that achieved a proper IPO on the Hong Kong Stock Exchanges (Main Board and GEM Board included) between 2001 and April 2012 and remain listed as of 2 May 2012. This rules out Hongkonger-founded businesses that had an IPO elsewhere (e.g. Rainbow Department Store in the Shenzhen Stock Exchange) or achieved listing through reverse takeover (e.g. Hong Kong Resources and Brightoil). Further, we define success as companies with a market capitalization of HK$750 million (just roughly US$100 million) as at 2 May 2012, which is a very low hurdle to be considered a small-cap company by international standards.

The following companies are also eliminated from the study:

- Spin-outs or affiliate of another listed or family group, except for companies that were acquired as private equity-style investments;
- Companies that have significantly deviated from their original business, or have been taken over through reverse merger;
- Companies whose stocks are suspended or being investigated for accounting scandal, or show very poor financial prospects (defined as those that are trading significantly below book value and generating negative return on assets);
- Real estate companies; and
- Companies that operate their headquarters outside of the Guangdong/Shenzhen region *and* have very little business presence in Hong Kong, even though they are founded by entrepreneurs who are Hong Kong citizens (e.g. shipbuilder Rongsheng in Shanghai, or auto dealership Zhongsheng in Beijing).

The results are shown in the following page. 51 companies meet the criteria, representing just 3% of the stocks listed in Hong Kong. A number of household names that are seen as the beacons of Hong Kong's entrepreneurial success stories in the recent years, including Milan Station, Moiselle, Convoy Financial and Solomon Systech, unfortunately do not make the cut. Further, if the list excludes "grey hair" companies, meaning those founded during the 1980s (such as I.T. and Hong Kong Economic Times) or earlier (such as Belle, Embry, Lee & Man, and Dah Chong Hong), **only 37 companies would meet the criteria, meaning on average only 3 to 4 such companies a year have managed to achieve an IPO since 2001 and still remain healthily around. This is quite a dismal number.**

While the methodology of this study may have room for refinement, the message is clear: **there is in the past 10 years a dearth of entrepreneurs in Hong Kong who have the ambition to build new big businesses—after all, US$100 million is small market capitalization—and managed to pull it off.** Hong Kong is not short of small and medium enterprises, but if the IPO scene is any indication, for a long time we really lack entrepreneurial companies that break out to become larger players.

	Stock Code	Company Name	1st Trading Date	Market Cap as at 5/3/2012 (HK$m)	Industry	Year Established
1	1880	BELLE INTERNATIONAL HOLDINGS LIMITED	23-May-07	$ 126,510	Shoe retail	1978
2	1828	Dah Chong Hong Holdings Limited	17-Oct-07	$ 14,920	Trading	1964
3	891	Trinity Limited	3-Nov-09	$ 11,450	Fashion	*2006*
4	773	China Metal Recycling (Holdings) Limited	22-Jun-09	$ 10,120	Metal recycling	2000
5	1177	SINO BIOPHARMACEUTICAL LIMITED	8-Dec-03	$ 9,730	Pharmaceuticals	2000
6	538	Ajisen (China) Holdings Limited	30-Mar-07	$ 9,330	Restaurants	*1996*
7	806	Value Partners Group Limited	22-Nov-07	$ 8,510	Fund management	1993
8	2343	PACIFIC BASIN SHIPPING LIMITED	14-Jul-04	$ 7,940	Dry bulk chartering	*1998*
9	1382	Pacific Textiles Holdings Limited	18-May-07	$ 7,270	Textiles	1997
10	2342	COMBA TELECOM SYSTEMS HOLDINGS LIMITED	15-Jul-03	$ 6,610	Telecom systems	1997
11	1146	China Outfitters Holdings Limited	9-Dec-11	$ 5,210	Fashion retail	*2006*
12	3933	United Laboratories International Holdings Limited (The)	15-Jun-07	$ 5,080	Phamaceuticals	1990
13	3335	DBA TELECOMMUNICATION (ASIA) HOLDINGS LIMITED	11-May-06	$ 5,050	Prepaid cards	2004
14	809	GLOBAL BIO-CHEM TECHNOLOGY GROUP	16-Mar-01	$ 5,020	Corn-based refined products	1994
15	746	Lee & Man Chemical Company Limited	16-Jan-02	$ 4,940	Handbag and chemical manufacturer	1976
16	999	I.T LIMITED	4-Mar-05	$ 4,930	Fashion retail	1988
17	573	Tao Heung Holdings Limited	29-Jun-07	$ 4,070	Restaurants	1991
18	1999	Man Wah Holdings Limited	9-Apr-10	$ 4,010	Sofa OEM	1992
19	1008	BRILLIANT CIRCLE HOLDINGS IN	30-Mar-09	$ 3,930	Printing - Commercial	1990
20	543	Pacific Online Limited	18-Dec-07	$ 3,610	Internet media	1997
21	830	Far East Global Group Limited	30-Mar-10	$ 3,470	Building façade	1998
22	653	BONJOUR HOLDINGS LIMITED	16-Jul-03	$ 3,400	Cosmetic retail	1991
23	923	Fook Woo Group Holdings Limited	31-Mar-10	$ 3,340	Paper recycling	1968
24	1633	Magic Holdings International Limited	24-Sep-10	$ 2,970	Skincare products	2005
25	591	China High Precision Automation Group Limited	13-Nov-09	$ 2,840	Automation instrumentation	1991
26	1328	International Elite Ltd.	25-May-09	$ 2,690	Call center	2000
27	838	EVA PRECISION INDUSTRIAL HOLDINGS LIMITED	11-May-05	$ 2,340	Precision manufacturing	1993
28	856	VST HOLDINGS LIMITED	9-May-02	$ 2,310	IT distributor	1991
29	633	China All Access (Holdings) Limited	16-Sep-09	$ 1,990	Satellite communications solutions	2006
30	558	L.K. Technology Holdings Limited	16-Oct-06	$ 1,960	Injection molding	1979
31	1388	Embry Holdings Limited	18-Dec-06	$ 1,780	Lingerie	1976
32	1198	ROYALE FURNITURE HOLDINGS LIMITED	15-May-02	$ 1,710	Furniture retail	1997
33	860	MING FUNG JEWELLERY GROUP LIMITED	3-Sep-02	$ 1,620	Jewellery OEM	1989
34	950	LEE'S PHARMACEUTICAL HOLDINGS LIMITED	14-May-10	$ 1,600	Pharmaceuticals	1994
35	852	Strong Petrochemical Holdings Limited	12-Jan-09	$ 1,570	Crude oil trading	2000
36	3889	Global Sweeteners Holdings Limited	20-Sep-07	$ 1,150	Corn sweetener producer	1998
37	197	HENG TAI CONSUMABLES GROUP LIMITED	3-Dec-01	$ 1,130	FMCG & Cold Chain distributor	1994
38	3398	CHINA TING GROUP HOLDINGS LIMITED	15-Dec-05	$ 1,130	Garments	1992
39	3683	Great Harvest Maeta Group Holdings Limited	11-Oct-10	$ 1,100	Shipping	2002
40	423	Hong Kong Economic Times Holdings Limited	3-Aug-05	$ 1,050	Print media	1988
41	550	Cinderella Media Group Limited	23-Jul-07	$ 1,040	Print media	1992
42	1110	Kingworld Medicines Group Limited	25-Nov-10	$ 1,020	Drug distributor	1986
43	311	LUEN THAI HOLDINGS LIMITED	15-Jul-04	$ 1,020	Garment & textile	1983
44	1803	ASR Holdings Limited	16-Jan-12	$ 952	Air freight services	*2004*
45	1161	WATER OASIS GROUP LIMITED	11-Mar-02	$ 947	Beauty salons	1998
46	733	HOPEFLUENT GROUP HOLDINGS LIMITED	15-Jul-04	$ 937	Real estate agency	1995
47	536	TRADELINK ELECTRONIC COMMERCE LIMITED	28-Oct-05	$ 923	Software	1988
48	935	DRAGON CROWN GROUP HOLDINGS LIMITED	10-Jun-11	$ 921	Terminal service provider	1990
49	8020	Chanceton Financial Group Limited	12-Oct-11	$ 875	Financial Advisory	2009
50	919	Modern Beauty Salon Holdings Limited	9-Feb-06	$ 847	Beauty salons	1986
51	889	DATRONIX HOLDINGS LIMITED	22-Jun-01	$ 816	Electronic components	2000
52	483	BAUHAUS INTERNATIONAL (HOLDINGS) LIMITED	12-May-05	$ 726	Fashion retail	1991
53	1181	Tang Palace (China) Holdings Limited	19-Apr-11	$ 722	Restaurants	1997
54	2288	Sundart International Holdings Limited	21-Aug-09	$ 697	Interior decorative materials	1986
55	3318	China Flavors and Fragrances Company Limited	9-Dec-05	$ 682	Chemicals	1991
56	379	PME GROUP LIMITED	13-Nov-02	$ 666	Industrial abrasives	1957
57	8351	Larry Jewelry	7-Oct-09	$ 657	Jeweller	1999
58	509	Century Sunshine Group Holdings Limited	1-Aug-08	$ 657	Alloy and fertilizer trading	2000
59	1315	Vision Fame International Holding Limited	18-Jan-12	$ 651	Construction services	1992
60	1830	Perfect Shape (PRC) Holdings Limited	10-Feb-12	$ 630	Beauty Salons	2003
61	1263	PC Partner Group Limited	12-Jan-11	$ 626	Video graphics card ODM	1997
62	912	SUGA INTERNATIONAL HOLDINGS LIMITED	18-Sep-02	$ 621	EMS	1991
63	812	TANRICH FINANCIAL HOLDINGS LIMITED	30-Jan-02	$ 595	Brokerage	1990
64	1150	MILAN STATION HOLDINGS LIMITED	23-May-11	$ 593	Luxury goods trading	2001
65	929	IPE Group Limited	1-Nov-04	$ 593	Electronic components	1990
66	2307	KAM HING INTERNATIONAL HOLDINGS LIMITED	23-Sep-04	$ 591	Fabric & garments	1996
67	515	TC Orient Lighting	23-Jun-06	$ 580	PCB and LED packaging	1998
68	1282	World Wide Touch Technology (Holdings) Limited	15-Dec-10	$ 571	Capacitive touchpad manufacturer	1996
69	3828	Ming Fai International Holdings Limited	2-Nov-07	$ 556	Cosmetic & amenity products	1980
70	130	MOISELLE INTERNATIONAL HOLDINGS LIMITED	11-Feb-02	$ 547	Fashion retail	1997
71	2327	JIWA BIO-PHARM HOLDINGS LIMITED	14-Oct-03	$ 539	Pharmaceuticals	1987
72	833	ALLTRONICS HOLDINGS LIMITED	15-Jul-05	$ 534	Plastic and Electronic components	1993
73	822	Ka Shui International Holdings Limited	27-Jun-07	$ 533	Alloy casting and injecting molding	1980
74	1019	CONVOY FINANCIAL SERVICES HOLDINGS LIMITED	13-Jul-10	$ 532	Financial planning	1993
75	2878	SOLOMON SYSTECH (INTERNATIONAL) LIMITED	8-Apr-04	$ 521	IC design	1999
76	6838	WINOX HOLDINGS LIMITED	20-Jul-11	$ 520	Stainless steel products OEM	1999

Sources: Company Websites, Google Finance, Webb-Site.com

Of the 37 young Hong Kong entrepreneurial companies that achieved recent success, a number of them have received venture capital and private equity investments prior to IPO[3]:

Company	VC/PE Investor(s)
Trinity Limited	Fung Capital
Value Partners	Whitney & Co.
Comba Telecom	Baring Private Equity Asia
China Outfitters	IDG, Orchid Asia
DBA Telecommunication	Softbank China
China High Precision Automation	Orchid Asia
China All Access	Chengwei Ventures

(Source: HKVCA)

To holistically review the full spectrum of the entrepreneurial landscape in Hong Kong, in the ensuing sections, there will be real-case examples of Hong Kong companies at various growth stages that share their stories of collaboration with private equity, venture capital and angel investors.

[3] Belle International and Ports Design, which were founded or acquired before the 1990s, have also received private equity funding since 2001. Solomon Systech, which has a market cap below HK$750m as of May 2, 2012, was a venture capital investment. China Outfitters, China Metal Recycling, Magic Holdings, Sparkle Roll, Hong Kong Resources, and Group Sense and Qin Jia Yuan Media Services, which currently have a market cap below HK$750m, have received private equity funding upon or after their IPO or reverse merger between 2001 and April 2012.

Chapter 3 Looking for Seed Capital

First we look at the local start-up scene. After the crash of the dotcom bubble, the Hong Kong government has been the most active source of seed capital, disseminated through three main channels, namely, the SERAP (or "Small Enterprise Research Assistance Program") administered by the Innovation and Technology Commission, and the incubation programs at the Hong Kong Science Park ("Science Park") and the Hong Kong Cyberport. Hong Kong also has a relatively small community of angel investors, who aggregate as a few angel networks such as the Hong Kong Business Angel Network (www.hkban.org).

To give you a sense of how local start-ups navigate their challenges, we would like to share the story of two actual start-ups, Vitargent and Frenzoo. The companies are interesting case studies for juxtaposition because:

- Vitargent is being incubated at the Science Park, while Frenzoo was incubated at Cyberport;
- The two companies operate in fundamentally different industries: Frenzoo can rapidly distribute its mobile game titles through AppStore, but Vitargent requires long sales cycle for its biochemical sensing technologies;
- While both companies were SERAP recipients, Vitargent raised seed funding from local angels, whereas Frenzoo raised seed investments from venture firms in Estonia and the US;
- While Vitargent received media attention ever since it was a school business plan winner in 2010, Frenzoo has largely stayed away from media limelight;
- While both businesses are home grown, their founders' backgrounds are distinct: Vitargent's Eric Chen is a fresh CityU graduate from Mainland China, while Frenzoo's Simon Newstead is a veteran New Zealander technologist from Juniper Networks; and, yet,
- Like most start-ups, both startups had had some hiccups at their early stage of development.

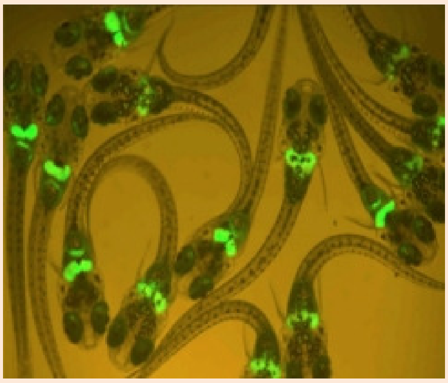
We hope you can take away several learning points from these two Case Studies:

- Understanding why time-to-delivery is a critical consideration in product and budget planning;
- How to take advantage of the government funding programs;
- The pros and cons about angel investors; and
- The potential innovative bank financing solutions available to start-ups.

Case Study: Vitargent – interview with Founder Eric Chen (陳子翔)

Vitargent (www.vitargent.com) is a biochemical sensing technologies company focusing on consumer products safety and environmental monitoring. The company resides in the Hong Kong Science & Technology Park (HKSTP) that has garnered tremendous press coverage for its estrogen-testing capabilities in foods using transgenic fish.

Initial dream-building



The story of Vitargent began in September 2009 when founder Eric Chen was collaborating for an in-school business plan competition at City University of Hong Kong ("CityU") with two schoolmates. They saw food safety-related technologies as an interesting thesis and they embarked on looking for a suitable university research project as the basis of their business plan. This led them to identify the work on transgenic fish technology by Prof. Cheng Shuk Han (鄭淑嫻) and PhD fellow Chen Xueping (陳雪平) at the university's biology and chemistry department. Leveraging the Vice Chancellor's help, Eric's team managed to convince Dr. Cheng to lend the technology for their business plan competition, and they went on to become the first Hong Kong team ever to win the regional HSBC Young Entrepreneurship Award, and a 2nd runner-up in the Lee Kuan Yew Global Business Plan Competition in Singapore.

Initial hand-holding

Believing in the vision of the business plan and emboldened by the success, Eric persisted and incorporated the company in April 2010, while his two other teammates pursued a professional career. Eric managed to win the support of CityU and Prof. Cheng for the licensing of the transgenic fish technology and convince Xueping to join as the company's CTO and bring along her lab members. The university's Knowledge Transfer Office was kind enough to assign an officer to assist Eric in the application of government funding, and granted the company a favorable perpetual global exclusive licensing deal. The university also introduced Eric to the CityU Eminence Society, its distinguished alumni association, through which the company found three of its initial angel investors. Eric also tapped the help from the mentors of the HSBC Entrepreneur Award. One mentor, Jeffrey Cheung (章子豪) from Crossgate, eventually became Vitargent's lead angel investor and interim CFO.

By early 2011, Vitargent's initial capitalization was finally in place, from multiple sources:

1. HK$3.0 million from angel investors for about 1/4 of the company. Eric did not initially contribute capital to the company (he was a fresh grad and had no money). Instead he was committed to not getting paid for 6 months.
2. Up to HK$4.76 million of R&D project-focused 1:1 matching fund from SERAP for over 2 years (later increased to HK$6 million), of which $2.5 million has been matched with the angel funding. This funding will have to be repaid with 5% of the company's sales and 10% of the company's subsequent funding. While the matching fund is a loan in nature, the company can mortgage the assets purchased with the matching fund to obtain further external financing. There is also a 30% cash award on the matched fund, released over two tranches.
3. HK$2.1 million incubation program grant from HKSTP, which is part cash, part in-kind.
4. HKSTP's Life Acceleration Program, of HK$4 million worth, through which the industry park will purchase the equipment Vitargent specifies, and the company can lease the equipment for free for 4 years.

Then... the real test

Then came April 2012, a year after all the initial funding was in place, Eric has the following to share:

- *Venture is a value-discovery process.* Vitargent is fortunate to form a strategic partnership with SGS, the world's leading testing house, on food-testing in Hong Kong, which gives the company very strong endorsement. However, Eric discovers that while transgenic fish gives the company the best press, the same customer set also demands other testing services that the company can scalably offer. Also, food testing turns out to be more than commercial, as it deals with cross-border trade and public sentiments, while cosmetics testing delivers much higher margins. Going forward, Eric will position Vitargent to be a roll-up platform for sensing technologies.
- *Budget your fundraising needs well, but on the look-out for creative solutions.* Dr. Raymond Leung (梁少康, Chairman & CEO of TDK China) and Dr. Gus Chow (周博裕, CEO of Harmony Asset), who are both CityU alumni, once told Eric, "When you raise capital, budget 2× what you think you need." It turns out that biotech business takes longer to generate cash inflow, since customers need time to test and validate new technologies. This compelled Eric and his team to make hard choices on cash flow and funding alternatives. "Young entrepreneurs should understand that the business world can be brutal and is not there for charity. But it is all fair game," Eric noted. In the meantime, Eric realizes there is a micro enterprise lending program (小微企貸款服務) from Wing Lung Bank that is tailored for start-ups at HKSTP, which offers clean loans for a low as P% p.a. for up to HK$300,000. Eric is also looking into the new SME Loan Guarantee Scheme, through which Vitargent may seek a 5-year secured loan that is 80% guaranteed by the government at 5.5% p.a., for up to HK$12 million.
- *The Government can do better.* In Eric's view, the government's support to start-ups is "very generous by regional standards". The bureaucracy is not cumbersome in the funding process. However, that the different government departments are working in silos is giving government-funded start-ups significant growth bottlenecks, as they are plainly reluctant to trial or adopt the services and solutions of start-up companies. "The Innovation and Technology Commission (the administrator of SERAP) has tried very hard to help," Eric acknowledged. "But the mid-level officials at the Environmental Protection Department and the Agriculture, Fisheries & Conservation Department are just too conservative and unresponsive." "Application of government agencies would be a strong validation for government-funded ventures. This model has worked well in China and Singapore. Hong Kong is a small market for validation; the bigger market potential is in China. But if potential customers in China see the solutions of a Hong Kong government backed-company are not even adopted by the Hong Kong government itself, how would they logically trust the solutions?"

Case Study: Frenzoo—interview with Founder & CEO Simon Newstead

Frenzoo is the developer of the lifestyle mobile game series MeGirl (www.megirl.com), which, via distribution on Apple and Android app-stores, has become very popular among its target demographics, i.e., young female smart-phone users in the US. The first game reached 400,000 downloads in 4 months. By the second game, it achieved 1 million downloads in one month.

Simon's entrepreneurial story was not all smooth. Formerly the head of Emerging Technologies in Asia Pacific for Juniper Networks, a leading US network equipment company, Simon was in an advantageous position to come into contact with the newest and most exciting networking technologies and applications, and he had strong conviction that 3D chat was one of them. Frenzoo was originally started as a Cyberport incubatee, mentored by Marvin Lai (賴宗志), developing a lightweight application whereby users can chat with each other in customized 3D avatars. That product idea won him €200,000 in seed funding from Ambient Sound Investments, the investment vehicle of a group of founding engineers behind Skype, which in turn easily got him matching SERAP funding.

Yet the product never caught on. Frenzoo essentially had to be "restarted", keeping only the team and the core IP assets of the efficient multi-user online 3D avatar-based interactive technologies. Frenzoo rebrands itself as MeGirl for its new mobile game business (Simon likens it to the relationship between Roxio and Angry Birds); Simon shuttles between Hong Kong and San Francisco, which is now the forefront of mobile games; and with the early great traction of the MeGirl games, the company closed a second seed round of US$1 million from various US venture firms.

The lessons, as Simon would summarize, are noteworthy to aspiring entrepreneurs in the mobile applications space:

- Get validation from your target customers early. That would save you huge opportunity costs and more importantly save your company. The powerful distribution of AppStore allows you to test the market economically.
- Understand the implications of the powerful AppStore distribution channel. If you build your own website, you will have to spend much more and wait longer to get to 400,000 downloads. In the same token, competitive barrier is lower with AppStore. Product longevity is shorter. To build an enterprise, you cannot be a "one hit wonder". In the case of MeGirl, Simon positions the business as a "genre play". "We have been successful with fashion games. Leveraging that success and positioning ourselves as a lifestyle mobile game company would provide credibility and legitimacy to grow into titles covering music, dating and relationships, celebrity, and many more."
- Keep the best of both worlds. Simon still runs his development team out of Hong Kong, even though the MeGirl games are oriented for the US market. "Hong Kong has high mobile penetration and is an early adopter of mobile applications. It has talents in engineering and math. They have a good sense of international trends in the market apps space, unlike their Chinese or Korean counterparts who only look inward into the domestic markets, and they are cheaper than hires in San Francisco, which is a very important consideration for a start-up." For marketing, business development and strategic alliances, however, you have to be in San Francisco.
- Make the best use of government funding support. "If you cannot handle the amount of government paperwork, you are not going to be able to handle the due diligence from venture investors."

Chapter 4 Moving to the next stages: Venture Capital and Growth Capital

The line between venture capital and growth capital can be quite blurry. Both involve an institutional investment fund or corporation taking a minority stake in a company. The main distinctions with growth capital are perhaps that the investment size is larger and the target is likely profitable. Still there are exceptions. For example, the most high-profile growth capital investment in Hong Kong in recent memory was, unfortunately, budget airline **Oasis**, which never achieved profitability before it went bankrupt in 2008. **ASB Biodiesel,** which requires significant funding to complete build-out of its 100,000 tpa biodiesel plant in Tseung Kwan O (estimated to be US164 million debt and equity combined[4]), is also expected to remain unprofitable until it can commence production.

In addition to the VC/PE-backed companies that are currently publicly traded as reported in Chapter 2, other Hong Kong private businesses that have received venture capital or growth capital funding since 2001 include:

Company	Business/Products	Venture capital/Growth capital investor(s)
Venture Capital Investments		
9gag	Online comedy community	First Round, True Ventures, Greycroft, etc., in April 2012 (US$2.8m)
Altai	Wireless infrastructure vendor	Morningside (VC arm of Hang Lung's Chan family) in 2006 (US$10m). Spin-off from ASTRI.
Borqs	Open-source mobile operating system developer	Invested by Kleiner Perkins, GSR, Keytone, Norwest, Intel and Foxconn since 2007. Beijing-based, but founder is from Hong Kong.
Convenient Power	Wireless power charging solutions supplier	Invested by Qiming Ventures in 2009. Raised a follow-on round with new investors Matrix Partners and Mitsui in 2011.
Cherrypicks	Mobile marketing solutions	Invested by SAIF, STIC Ventures, etc. in 2005.
Editgrid	Online spreadsheet developer	Invested by WI Harper in 2007 (US$1.25m). Sold in 2009 (see Case Study in Chapter 6).
Travelzen	Online travel consolidator	Invested by Keytone Ventures in 2009 with a follow-on round in 1Q11; a Cyberport tenant—see Case Study below.
Growth Capital Investments		
A-Max	Portable media device OEM	General Atlantic (US$38m) in 2005.
Amperex	Leading lithium-ion/ polymer battery maker	Invested by Carlyle and 3i in 2003 (US$30m). Acquired by TDK in 2006. Raised a significant expansion round again from CDH and New Horizon Capital in 2011.
C&O Pharma	Drug developer	IPO in Singapore in 2005, invested by CMIA in 2007, acquired in 2011.
Celestial Tiger Entertainment	Branded TV channel and media content distributor	Invested by Saban Capital in 2011; joint venture with Celestial Pictures and Lionsgate Pictures.
Glamour Sales	Online luxury goods retailer	Raised US$60 million in 2 rounds of funding from AXA Private Equity, Mandra Capital, Mitsui and more recently US luxury retailer Neiman Marcus—see Case Study below.
Qeelin	High-end jewelry designer	Invested by Crystal Partners, a small London-based boutique firm.

(Source: HKVCA)

Note that aside from entrepreneurial businesses, established family groups occasionally also seek out private equity for mostly very large-size expansion capital financing for their business and subsidiaries. These include investment in their listed and unlisted entities and in some cases involve both old and new shares:

Company	Expansion Capital Investor(s)	Year of Investment
AMTD (independent financial advisor, subsidiary of Cheung Kong)	Blackpine	2011 (US$30m)
Emperor Watch & Jewellery (luxury retail)	L Capital Asia (private equity arm of LVMH); and hedge funds D.E. Shaw and Shikumen	2010 (HK$580m)
Galaxy Entertainment (gaming)	Permira	2007 (HK$6.5 billion)
Shui On Land (real estate)	Citigroup Venture Capital International, etc.	2004 (US$350m)
Sun Hung Kai & Co. (brokerage)	CVC Capital	2010 (US$275m)

(Source: HKVCA)

[4] Source: SCMP, Nov 9, 2011.

To illustrate in the different road-paths how venture capital and growth capital may take place in Hong Kong, here we feature online luxury outlet **Glamour Sales** and online travel consolidator **Travelzen** as Case Studies. Although both are Hong Kong-headquartered Internet-based businesses, they present interesting similarities and contrasts:

- Travelzen's Ted Sze is a serial entrepreneur, while Glamour Sales' Olivier Chouvet is a *parallel* entrepreneur—he and his wife are concurrently owns 12 businesses in Asia.
- Ted is a local while Olivier is from France, and yet both are spending most of their time in Shanghai while basing their headquarters in Hong Kong.
- Travelzen was a proof of concept when it raised its first venture round, while in the case of Glamour Sales, the company's business model was already proven in Japan when it was raising growth capital to expand into China.
- Their delivery models are very different—Travelzen delivers virtual tickets and vouchers while Glamour Sales sells physical merchandises.
- Travelzen subsequently merged with its China partner, while Glamour Sales subsequently brought in its US strategic partner to China.

These two Case Studies will highlight the following learning points:

- The importance of knowing that China's industry dynamics is evolving very quickly;
- How to address investors' "easy prejudices" against non-local entrepreneurs in China;
- That having a thorough understanding of what drives a business is a competitive edge in a frothy market; and
- Identifying where the strengths of Hong Kong may lie for future entrepreneurial opportunities

Case Study: Travelzen – interview with Founder and Co-Chairman Ted Sze (史習德)

Founded in 2007, Chinese online travel agency Travelzen (www.travelzen.com) is Ted Sze's second technology venture. About a decade earlier, his previous company, real-time online stock trading and information system developer QuotePower International, raised HK$8 million from the government Applied Research Fund.

While Ted did not have a background in the travel industry or Mainland China, the idea of Travelzen was his culmination of years of strategic thinking. First, Ted noticed that as a global financial center, Hong Kong has an experienced software engineering talent pool building mission-critical systems in world-class financial institution setting. Yet as his experience with QuotePower revealed, Asia is such a heterogeneous region that the only market large enough for a technology company to scale is China, and China exactly lacked the talents with product development expertise in mission-critical systems. Ted reckoned that if he were to build his next venture with top-notch software engineering veterans, the operation has to be China-focused.

Second, Ted surveyed various vertical segments in China and identified that international travel will be the next industry prime for a technology-enabled overhaul. Just like in financial services, he believes technology would enable development of sophisticated travel products not available before to customers. He wanted to build a company around a robust technology platform that can offer flexibility and intelligence superior to the incumbent Chinese domestic air ticketing systems. Fortunately to Ted, his vision found an important audience: the leadership of Shanghai Ever Bright Town International (SEBTI), one of the country's largest air tickets consolidators, also sensed that the Internet is the way of the future, but did not know how. This makes them ideologically a very good match to start Travelzen as joint venture partners.

Yet Ted also realized that, unlike in the Silicon Valley, he could not raise money from Chinese venture capitalists just to build a vertical software platform. They want the look and feel of an Internet business to which they can relate. Therefore to demonstrate its superiority in product flexibility, instant booking and confirmation and fraud detection-- all of which were under-addressed by existing Chinese players, Travelzen operates as a full-fledged OTA covering international and domestic air travels, hotels and events, as an "ongoing proof-of-concept" to SEBTI and prospective venture investors. The company subsequently received its first round of institutional venture capital funding in late-2009.

The next big act, as both Ted and SEBTI have envisioned, was to create a powerful asset by combining Travelzen, which now has the core technologies proven to work, and SEBTI, which has tremendous buying power but is essentially a manually operated labor-intensive business. The integration was complex. It required merging the two accounting systems, restructuring the merged organization to streamline overheads, and persuading SEBTI's travel agency partners to migrate to the automatic platform. What is more, as the combined entity going forward will have to focus on excellent business development execution within the travel industry ecosystem, Ted needed to "move upstairs" as Co-Chairman and support the new executive leader from SEBTI to further enhance the technology system. He made the right call. By the end of 2011, the integration was completed.

Lessons for Hong Kong entrepreneurs

Ted acknowledges that venture capitalists have a natural bias against Hong Kong entrepreneurs doing business in China. What many investors fail to acknowledge is that industries in China are evolving very quickly, not just in terms of scale but also in terms of complexity and sophistication, and sooner or later technology will become the critical element of competitive advantage. "Today even many leading Internet businesses have low proprietary technology content, and that is still fine to the investors," Ted noted. Ted sees that Hong Kong entrepreneurs may thrive developing those pieces of critical knowhow-intensive components for the country's fast-evolving industry value chains. According to Ted, three things are very important:

1. **Believe in your own vision.** "Many investors discredited the importance of China's international travels when I started Travelzen and thought domestic travels alone was the lucrative piece. Look at the volume today, and look at the difficulties global air reservation systems continue to have in bridging into China's domestic systems."
2. **Be incessant in the pursuit of excellence.** "It took us 5 generations of CTO to get to where we are today."
3. **Don't look at where the ball is. Look at where it will be.** "Do not underestimate the pace of upgrades industries can achieve in China. What Hong Kong takes for granted as industry advantages can quickly get eroded."

Case Study: Glamour Sales—interview with Co-founder & CEO Olivier Chouvet

魅力惠 GLAMOUR-SALES
亚洲权威奢侈品购物网站

Glamour Sales (www.glamour-sales.com, www.glamour-sales.com.cn) is a membership-only online retail outlet of luxury goods headquartered in Hong Kong, with primary operations in China and Japan. The company was founded by French entrepreneurs Olivier Chouvet and Alain Soulas, and joined by Hong Kong-based China CEO Thibault Villet, who has lived in Hong Kong for 16 years and formerly served as Greater China President of Coach and a Vice President of L'oreal China. As of March 2012, Glamour Sales has 1 million members in China and 600,000 members in Japan.

Olivier has lived in Japan and Shanghai for 12 years. He is highly entrepreneurial: together with his wife, they have built 12 businesses in the region such as trading, advertising, marketing and architectural services. Glamour Sales is the largest of them all. The company raised more than $60 million of funding from AXA Private Equity, Mandra Capital (a Hong Kong-based private equity firm), Mitsui and most importantly, US luxury retailer Neiman Marcus (which has two outlet business lines). Its business is now fully funded without further need of outside capital.

Olivier currently lives in Shanghai due to geographical convenience for his business: "Beijing, Hong Kong and Tokyo in 2 hours". More importantly, Olivier considers Shanghai-- along with New York City-- "the most exciting city on Earth in 2012". "Since the 2010 World Expo Shanghai's living environment has improved greatly." Olivier is even sending his 2 older kids to local Chinese school.

Rationale for a Hong Kong headquarters

Olivier sees Hong Kong as the most favorable place to manage a multi-country business in Asia because of its proximity to his Shanghai home base; its English proficiency, rule of law and highly efficient supporting infrastructure ("It is easy to open a multi-currency account at HSBC"); and the ability to build a high-quality back-office team. "The same would not be possible in Shanghai or Tokyo," Olivier noted. More importantly, Hong Kong has the know-how in brand management and merchandising with more than 20 years of experience -- this area of expertise cannot be imitated in a short time. Many of Glamour Sales' merchandising and brand management counterparts for the China operation are based in Hong Kong.

Building a business against (a lack of) common sense

Olivier initially drew skepticism from venture capitalists in China when the company was raising growth capital to expand into China: he is not Chinese, and most of them disagreed that private membership would work for online flash sales when other Chinese e-commerce competitors are competing for number of visitors.

Yet Oliver points out that Glamour Sales has the right core competence for online luxury flash sales: that is, to command expertise in creating an alternative distribution channel for excess inventories in an exclusive online environ.

- You must be able convey to partners your capability to manage and protect their brands as an experienced solution provider. Your partners do not wish to see their brands in an "online Wal-mart" that kills their full price business. A private membership model addresses the concern about prestige.
- Trustful relationships with Italian and French brands are very important. A European team like Olivier's, which has 12 years of experience in 5 Asian countries working for them via multiple touch-points, has a definitive advantage.
- Without a trustful relationship to get direct support from brands, the business would not be able to secure a long term stream of merchandise deal flow at discounted price and on consignment basis, which is key to the Glamour Sales business. It will not be sustainable if it keeps building up inventories at full price to prop up revenues. For Glamour Sales, its Chinese operation needs only US$30m-40m in sales to breakeven.

Olivier has similar experience in Japan, where incumbent Japanese retailers and e-commerce players still have not found a way to competitively penetrate the domestic online luxury goods outlet market. It continues to be the domain of 3 foreign players, namely Glamour Sales (been there for 3 years), Glit Groupe (best known player from the US, been there for 4 years) and German competitor Brands4Friends.

Advice for Hong Kong from a seasoned "parallel entrepreneur":

- Do not underestimate the network of European entrepreneurs in Asia. "My Chinese friends are amazed at the parallels between Chinese *guanxi* and the 'French connection'."
- Warning of the shift of excitement among global entrepreneurial young talents: Olivier thinks Hong Kong still has an entrepreneurial spirit. Yet young talents from Europe are now more attracted to the energy of Shanghai, just like they were toward New York 15 years ago; Hong Kong is too expensive for them.
- Ideas to rejuvenate entrepreneurship in Hong Kong?
    - Olivier sees opportunity in revamping warehouses to attract entrepreneurial talents.
    - He also believes forming a dedicated venture-growth fund investing in Hong Kong is highly feasible: "10 local banks each chipping in US$10m and you will have a US$100m fund already."
    - Drawing from his experience, the opportunity for Hong Kong bringing in intellectual properties from overseas in the form of JVs and then expanding the business regionally is also an exciting opportunity that should be utilized, Olivier noted.

Chapter 5 Buyout: Multi-facet solutions for Co-control, Succession, Corporate Carve-outs and MBO

In an economy that is maturing but surrounded by markets of high economic growth, opportunities may be ripe for the more established cash-flow generative businesses in Hong Kong to bring in "buyout-type" private equity to advance a broad range of strategic objectives. Control-oriented strategies over the past two decades have evolved from the classic leveraged buyout model to address different situations. These include:

- Providing liquidity to the owner to facilitate succession;
- Carving out a business from its corporate parent, to help the latter fulfill certain financial or strategic objectives;
- Co-control with entrepreneurs to further develop the business, especially when entrepreneurs see the constraints of their own capabilities in fulfilling certain objectives; and
- Supporting a management team to take over their employer's business to unlock the value.

There are also "secondary buyouts", whereby a PE investor acquires controlling stakes from other institutional investors.

The recent involvement of private equity in TVB and City Telecom has attracted significant media attention, thanks to the high profiles of the target companies. There are in fact a wide variety of Hong Kong businesses that have undergone buyout in the past 10 years, as grouped in the table below:

Target	Business	Year of Transaction	Private Equity Investor(s)
Succession			
Hui Lau Shan	Dessert chain	2007	Navis
Trinity	High-end menswear retailer	2006	Fung Capital
TVB	TV broadcasting and production	2011	Providence, etc. (HK$8 billion for 26%)
Corporate Carve-out			
Hong Kong Broadband	Fixed-line and broadband assets of City Telecom	2012	CVC Capital (HK$5 billion)
Co-control			
ecVision (US-based; former Applied Research Fund investee)	Product lifecycle management software vendor	2009	Fung Capital (bought out non-management shares)
GDC Technology	Digital cinema server provider	2011	Carlyle, Yunfeng (Jack Ma's fund)
Japan Home Centre	Houseware retailer	2010	EQT
Modern Metal & Precision	Aluminum die casting	2010	EQT
Trimco	Apparel labeling services	2005	Navis **(exited in 2012 at 10x)**
MBO			
Asia Broadcast Satellite	Satellite operator	2009	Permira (HK$1.5 billion)
John Hardy	Designer jewelry	2007	3i
Nord Anglia (HQ relocated to Hong Kong)	Operator of international schools	2008	Baring Private Equity Asia (US$360m)
Shinwa International (HQ relocated to Hong Kong)	Car audio system ODM	2004	CITIC Capital and Shinsei Bank PE **(exited in 2011—see Chapter 6)**
Secondary Buyout			
Birdland	Fast food (HK franchisee of KFC)	2004	Navis
The Executive Centre	Serviced offices	2009	Headland (formerly HSBC PE Asia)
Trimco	*Apparel labeling services*	*2012*	*Partners Group*

(Source: HKVCA)

To illustrate the different facets of how buyout can play in entrepreneurial businesses in Hong Kong, here we showcase three Case Studies: **Hui Lau Shan**, where the founders are seeking an exit; **Japan Home Centre**, in which the founders bring to a co-controlling partner to further develop the business; and designer jeweler **John Hardy**, where the senior management brought in private equity to complete an MBO.

We hope you will learn from these Case Studies the following:

- Implications of a harsher IPO environment for smaller companies;
- Private equity as a partner to build business together with the entrepreneurs, beyond just a financial investor;
- How entrepreneurial businesses may attract professional managers;
- What makes Hong Kong an ideal place to operate an international venture; and
- The underlying challenges in Hong Kong's current business environment, and how private equity may improve the execution response accordingly.

Case Study: Japan Home Centre— interview with Fredrik Åtting, Partner at private equity investor EQT

The company was founded by Peter Lau (劉柏輝) and Lisa Ngai (魏麗霞) in 1991. The co-founders implemented a successful home-ware retail model in Hong Kong, but they saw limitations in the Hong Kong market. They wanted external help to replicate the company's successful model in the region, and further expand the company. Therefore, the management initiated the idea of bringing in private equity investor to add value to the business.

Facilitated by financial advisor PricewaterhouseCoopers, the co-founders brought in EQT (a Swedish private equity firm with a reputation of strong operational focus and developing business as an investor). They preferred EQT because of its experience in growing single-country retail businesses regionally in Europe, and its track record of investing in jointly controlled retail businesses in China. Since the company generated very good cash flow and external equity expansion capital was not needed, the co-founders achieved partial liquidity by selling 40% of the company's stake to EQT in March, 2010.

After the investment, EQT assisted in recruiting a Chief Operating Officer to the business, who helped the co-founders with daily operation. It also brought in industry veteran Yuka Yeung (楊耀強) as an independent member of the company's board to instill strategic guidance and enhance corporate governance. EQT has helped in the formation of joint ventures in China and in expanding into the Southeast Asia market.

Drawing from the co-control case in Japan Home Centre, Fredrik highlights the positive takeaways for the more established entrepreneurial businesses in Hong Kong:

1. There are private equity firms with industry expertise and expansion resources that can really help companies to take their next steps. They are more than pure financial investors.
2. Entrepreneurs can see private equity as a means to facilitate succession and achieve partial liquidity. Bringing in a professional management team can ease the daily managerial burden of founders. In some cases, distribution of proceeds from the sale of a business is a cleaner way to deal with inheritance issue than passing on to heirs who just want control over the family business, without genuine interest in running it.
3. Small-cap IPOs, which had been the predominant investment exit route in Greater China traditionally, have become more difficult to achieve especially in the Hong Kong Stock Exchange. Entrepreneurs would have to expand their companies further in order to have a proper IPO with good trading volume. In reality, it often means alternative liquidity routes may be more attainable than an IPO for the business concerned.
4. In fact, Hong Kong has a market conducive for co-control or full-control opportunities: a transparent regulatory regime for M&A and labor laws; rule of law; entrepreneurs with international orientation; and high level of confidence in company accounts.

Fredrik is optimistic that he will see an increasing number of co-control opportunities emerging in Hong Kong.

Case Study: Hui Lau Shan— interview with Bruno Seghin, Partner at private equity investor Navis Capital

Hui Lau Shan, a family-owned dessert chain founded in the 1960s, was 100% acquired in 2007 by Navis Capital, a Kuala Lumpur-headquartered regional small-cap buyout firm founded by three former Boston Consulting Group consultants in 1998. Bruno Seghin, the Partner leading the investment, recalls spending 18 months persuading the family to sell, and believes the family timed the sale very well. "They saw the dramatic rise in rents coming. The Hui Lau Shan franchise had capitalized well on its breakthrough in introducing mango-based dessert to the market. For a company that did not have a system, they knew it had been run to their managerial limit—the bookkeeping was overseen, although meticulously, by a school-teacher family member, who received fax report from each store every day." The private equity firm priced the offer basically based on industry experience, observing the traffic of each store to deduce the company's operating earnings.

The private equity firm inherited a company with three challenges: not only did it have no system; it had no management (the senior managers were all family members who had now exited), which meant it required a larger G&A investment than other buyouts. Moreover, soon after the acquisition, rents increased dramatically with the influx of Mainland Individual Visit Scheme tourists. In places like Mongkok, Tsimshatsui and Causeway Bay, rents even doubled in a single year.

Bruno's team responded with a series of strategic moves:

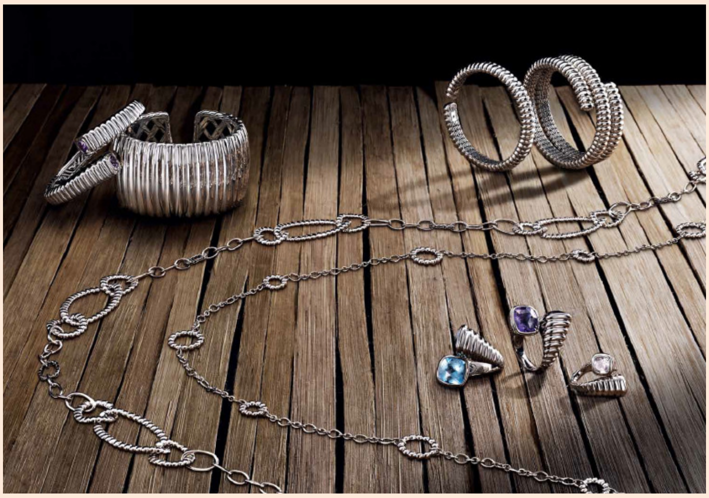
- It brought in a CEO from Malaysia whom the firm has known for 15 years, who was a seasoned accountant from Ernest & Young and came from a food-loving upbringing in a Teochew confectionary and cake-making family.
- It insisted on keeping the stores on the ground floor, but optimized the menu for different market segments, taking advantage of the price-inelasticity of patrons in high-traffic areas (contrary to industry beliefs), and regularly refreshing the menu in residential areas to entice repeat patronage.
- It expanded into shopping malls with new retail formats, in addition to just high street presence.
- It diversified the store operating models to dine-in, take-away and showcase to maximize sales per square foot.
- It spent 3 years orienting the marketing to young people. "Marketing hires from competitors like Cafe De Coral for instance did not work," Bruno remarked. "The era of mobile and social networking has transformed the marketing know-how required."
- Most importantly, it scientifically re-engineered the workflow.

As a result, while most quick service restaurants would not survive if rents reach 20-25% of sales, Hui Lau Shan manages to operate at a much higher rent-to-revenue ratio. Bruno sees the city's minimum wage law as a positive factor in motivating the company to be laser-focused on workflow efficiency, all the while maintaining excellence in fresh fruit logistics that competing dessert chains may not care about.

After spending 3 years stabilizing the Hong Kong business, Navis began to focus on the true beauty the Hui Lau Shan platform would offer, i.e., China. The previous owners had a rogue local JV partner, who opened its own-branded copycat stores behind the company's back. When Navis stepped in, it eventually had to open stores next to the copycat stores to force them to shut down. Today, Hui Lau Shan has ousted the old JV partner and opened stores Shanghai, Beijing, Shenzhen and Guangzhou, where it also operates a central kitchen. Together it operates 95 stores in Hong Kong, China and Malaysia combined as of May 2012, with the expectation of running 140 stores by the end of the year.

Bruno's experience in Hong Kong has been rewarding: two of his best investments have been Hong Kong companies (the other, apparel labeling service provider Trimco, was sold in May 2012 for 10× return). He likes Hong Kong entrepreneurs and managers because they are "practical, have no chips on their shoulders, and generally honest." While Navis does not expect deal flow to be plentiful because the city's high cost base deters intermediaries and service providers from serving small-cap clientele, the firm finds it worthwhile to mobilize dedicated resources to systematically search for opportunities in Hong Kong.

Case Study: John Hardy – interview with CEO Damien Dernoncourt



The MBO story

Founded in 1975, John Hardy is a US luxury jewelry brand, best known for its handmade design from Bali. Damien Dernoncourt, who had started several entrepreneurial businesses in Hong Kong since the mid-1990s, joined the company right after his INSEAD MBA in 2003 to lead the finance operation. He was promoted to CEO a year later and, in four years, restructured the business, moved the headquarters to Hong Kong to centralize functions that were either too expensive in the US or under-equipped in Indonesia, and grew the business threefold to US$150 million in retail dollar equivalent revenue. With the successful transformation, founder Mr. John Hardy, who was in his sixties, saw it the right time to retire and asked if Damien was interested to take over. Jumping at the opportunity, Damien brought in UK private equity firm 3i and acquired the business in 2007. This was the last leveraged buyout in Asia before the global financial crisis.

What followed was a rough ride. The luxury goods market was hard hit in the US amidst the global financial crisis, which was bad for John Hardy as its jewelry has an average selling price of US$900. With the business 65% leveraged for the buyout, Damien had to again streamline the overheads and aggressively pay down the debt to de-risk the business in face of fallen revenues.

The hard work paid off. By May 2012, the company repaid 65% of the debt, high-end spending in the US has recovered, and the business is back on track with healthy operating margins, albeit at a lower sales level. Damien is now ready for fresh capital to grow the business, which had been starved during the stabilization period.

Lessons learned

The advice Damien to entrepreneurial managers contemplating an MBO in Hong Kong is inspiring:

- Passion is important. Damien ran the business as if it were his own even when it was not.
- Learn how to engage your private equity partner. Global firms like 3i have tremendous network in the luxury and retail sectors. Make the best use of them. Yet you need to have the capability to calm the investor and step up to steady your boat in turbulent times. Damien took the initiative to aggressively pay down the debt to prevent investor's over-reaction when 3i had a much bigger fire drill in Europe during the financial crisis. Thirdly, pave way for a smooth exit for the private equity partner. Damien is mentally prepared that at some point after 4 to 5 years, the private equity investor will need a profitable disposition.
- Finally, believe in Hong Kong, at least for the time being. Damien will tell any aspiring entrepreneurs that, "within 15 minutes, you will figure out that Hong Kong is easily the best place start a business in Asia." He was quick to realize that Hong Kong is best placed to be the execution center of an international business, when one can find experienced functional talents with international experience—human resources, finance, legal, supply chain and procurement, easily. The executive MBA programs in Hong Kong also fuel continuous supply of functional supply of mid-level managers, an important progress from 15 years ago. Damien considers Hong Kong the "unsung hero" for John Hardy, which in the eyes of the consumer remains a US brand of premier designer jewelries handmade in Bali. Yet he also voices his worries about Hong Kong's long-term competitiveness. "English proficiency of fresh graduates has deteriorated, markedly. So has the living environment, especially in terms of air pollution and traffic."

Chapter 6 Strategic Trade-Sale: an alternative to IPO

Entrepreneurs may find a new home for their ventures through trade-sale. Hong Kong's entrepreneurial companies in the past 10 years have not attracted much interest from strategic buyers. The list is summarized in the following table. A few M&A's of these Hong Kong entrepreneurial companies were quite meaningful in size (i.e., north of US$100 million/HK$750 million). Note also that in two of these cases the company became an acquisition target after the company was publicly listed. To their investors, the public float may not provide sufficient liquidity for an easy exit. A trade sale gives them a clean way out.

Company	Business	Acquirer	Year	Value
Advanced Interconnect Technologies (invested by Newbridge in 1999)	Semiconductor packaging	Unisem (Malaysia)	2007	US$70m
Acasia Technologies (ASTRI spin-off)	Optoelectronic packaging	TDK (Japan)	2004	HK$109m
AGENDA (pre-merger entities invested by General Atlantic and Walden in 2000)	Digital marketing agency	Wunderman (USA), part of WPP	2008	undisclosed
C&O Pharma (listed in Singapore in 2005)	Drug-maker	Shionogi (Japan)	2011	HK$1.4 billion
COTCO Luminant Device	High brightness LED	Cree (USA)	2007	HK$1.6 billion plus earn-out
DMX Technologies (listed in Singapore in 2001)	Digital media infrastructure solutions	KDDI (Japan)	2009	HK$2.8 billion (S$183m for 53% stake)
e-Crusade	Digital marketing agency	Razorfish (USA), part of Publicis	2006	US$2.95m plus earn-out
Editgrid (invested by WI Harper in 2007)	Online spreadsheet developer	*An undisclosed large-cap US IT company*	2009	Undisclosed-- see Case Study
Power-All Networks	Cloud computing	Foxconn (Taiwan)	2011	undisclosed
Prime Credit (invested by ChinaVest in 1999)	Sub-prime lender	Standard Chartered (UK)	2004	HK$980m
Shinwa International (acquired by CITIC Capital in 2004)	Car audio system ODM	JVC Kenwood (Japan)	2011	undisclosed

(Source: HKVCA)

The Case Study featured here, Editgrid, is quite instructive because:

- The business is globally facing;
- It has undergone angel investments, SERAP funding, venture capital and eventually a strategic takeover;
- Founder David Lee, a local fresh graduate from HKU, did not have prior work experience before starting the company; and
- The buyer, which many young technologists look up to for their "Dream Jobs", is a large-cap US IT behemoth whose acquisitions are known to be very transformational, and it rarely makes acquisitions in Asia; and
- David has since relocated to Silicon Valley after the acquisition, which begs the question about Hong Kong's ability to retain talents.

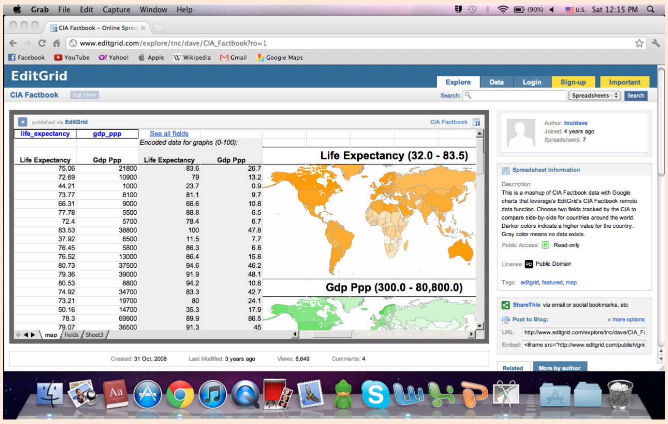
The key learning points to watch for in this Case Study are as follows:

- The critical importance of having a dedicated focus on product excellence;
- The trade-off—and payoff—of dedicating resources to product development and resisting the distraction of IT consulting business;
- Understanding the geographically agnostic nature of Internet businesses and its implications; and
- The possibility that an entrepreneur may further his or her venture dream even after being acquired, sometimes in an even more productive environment.

Case Study: Editgrid—interview with founder David Lee (李景輝)

David Lee is the founder of a developer of Internet-based collaborative spreadsheets. His story with Editgrid is a wonderful lesson for young aspiring entrepreneurs.

Without any formal job experience, David started Team & Concepts (the holding company of Editgrid) with a HKD$70,000 personally guaranteed loan from an angel investor he met through the iProA (Internet Professional Association) network. David's mind was set on developing a product, but had to fund the initial development by revenue generated from taking consulting projects. "It required a lot of discipline," David said. "Once engaged in consulting projects, consulting companies often have difficulties freeing up resources to focus on product development."



David was fortunate to raise the first round of angel equity from investor Joey Fan (范玖賢), whom he met in his early university days from the "E-Challenge Competition", a business plan competition organized by Young Entrepreneurs Development Council where Joey served as a Director. Joey provided an angel funding of HKD$500,000.

As Editgrid's product is Internet-based, the company soon attracted some buzz in what was called the Web 2.0 community. Angel investors from Silicon Valley began to approach David, thanks to beta customer referrals. David decided to take in a second round of angel investment, amounting to US$100,000 from an individual investor from Silicon Valley. With that, David obtained matching funding from SERAP. "The approval was quite easy," David noted, "probably because of the endorsement of the angel funding from Silicon Valley." David also received an additional angel credit line from Joey.

After the launch of public beta, Editgrid's product began to gain press coverage from well known Internet media such as *Techcrunch*, and this was the point where large IT behemoths started to make preliminary strategic approach. "Some were just low-balling, while some did not proceed further after more due diligence work." David remarked. But experiences with strategic buyers emboldened David to consider taking in serious capital from venture capital firms, some of whom have been monitoring the market very closely globally and offered to invest in Editgrid upon fulfillment of certain milestones.

David eventually took in an investment from San Francisco-Beijing firm W. I. Harper, signing the term sheet in early 2007 "without actually fully understanding the terms, in hindsight", David noted, as this venture investor moved very swiftly without asking for a business plan.

In 18 months after the venture capital investment, David decided to sell the company to an IT giant at a decent return to his investors, after evaluating several offers of strategic take-outs and venture follow-on investments. "Our product development focus was not laser-sharp enough when the management team was busy managing the company's growth," David recalled. "We also felt that under a bigger platform, the product can find a better life and hopefully live up to our dream of tackling an important world problem."

After the acquisition, David has moved to Silicon Valley and was given a lot of latitude to run his product development team. This gives David a lot of encouragement, and he has no plan to consider other temptations in the near term.

What are the three biggest lessons David has learnt from Editgrid? "Product, product and product," he answered. "When your product is good, talents will be attracted. Investors will find you, whether you are in Hong Kong or Silicon Valley. Just stay focused on product excellence."

Chapter 7 Views from Family Offices: Venture Capital, Private Equity and the cross-border opportunities for Hong Kong's entrepreneurial talents

As experienced VC/PE practitioners operating in Asia would confess, the smartest private equity investors in Asia are the large family groups in the region. An assessment of the opportunities in entrepreneurial business formation in Hong Kong would not be complete without their input.

Hong Kong had its golden era of business formation between the late-1960s and the early-1980s, during which a generation of very successful entrepreneurs rose to prominence. Many of these family groups now have their wealth managed in sophisticated family office set-up, where wealth preservation and international diversification are the primary objectives.

With the institutionalization of family offices, are these families still "in the game" looking for the next great entrepreneurial venture formation? Is investing in entrepreneurial businesses other than their own an attractive strategy to these family offices? More importantly, what insight can they share about how the "Hong Kong DNA" can really work to the advantage of the city's emerging entrepreneurs? This chapter will try to answer these questions.

Beside investing in VC/PE funds internationally, a number of Hong Kong family offices actually operate very active venture capital/private equity-style direct investment programs. Morningside, of Hang Lung's Chan family, has a long track record investing in life sciences, print media and IT, the latter has been so successful that its China team has raised two venture funds with outside investors. In Hong Kong, it has invested in Altai, an ASTRI wireless equipment spin-off, and Phoenix New Media, the new media subsidiary of Hong Kong-based Phoenix Satellite Television that went public on NYSE in May 2011. New World's Cheng family, through its investment arm VMS Capital, has also been very active in China private equity, most recently with the Hong Kong IPO of iron ore operator Newton Resources in 2011. The most attention-grabbing family office investment program has been that of Horizons Ventures, the captive venture capital firm of Li Ka-shing. It is an early investor in star technology outfits such as Skype, Spotify, Siri and Facebook[5].

To assess the views of family offices in entrepreneurial business investing, this paper has the privilege to talk to Jose Cheng (鄭可玄), Managing Director of **Fung Capital**, the private equity partnership of Victor and William Fung of Li & Fung; and Rodrigo Yang (楊維聰), Managing Director of **Sagamore Investments**, the private equity investment affiliate of Novel Group's Chou family. Fung Capital has a long track record acquiring fashion brands internationally, most recently Sonia Rykiel and, through its Trinity investment, Cerruti and Kent & Curwen. The Novel Group is also well known for its acquisition (and exit) of Tommy Hilfiger, and more recently for its investment in Michael Kors, which it successfully took public in December 2011 after 8 years. These two interviews reveal the perspectives of Fung Capital and Sagamore in backing Hong Kong entrepreneurs. Secondarily, given the two groups' heritage in outbound M&A, we also asked Jose and Rodrigo to share their approach in orchestrating cross-border value-creation opportunities, in light of Hong Kong's potential role in China's "go global" strategy.

[5] Forbes Asia Special Issue, March 2012

Interviews with Fung Capital and Sagamore Investments

Fung Capital's mandate is to complement Li & Fung's globally-oriented sourcing business by investing in Asia-centric consumer businesses. As such, it focuses on three investment types, all of which could lead to a Hong Kong investment:

1. Buyouts, which often require patience—menswear retailer Trinity, originally a business of another Hong Kong family, is one example;
2. Minority investment in small consumer or technology companies that have strategic value to Li & Fung—this can be China- or Silicon Valley-based ventures run by a Hong Kong founder; and
3. Old Hong Kong brands, which are likely available only in "special situations", where deal complexity and headline risks often dampen the investment payoff.

For Novel's family office, on the other hand, Hong Kong had not been a focus. When launching the investment program after the IT bubble in the early 2000s, the group was advised to develop sector specialty. The group chose to build expertise in life sciences, which is naturally a US-focused effort, and to capitalize on growth, in which case China is the natural destination.

That being said, between China and the US, Rodrigo is seeing an emerging opportunity set in which Hong Kong or Hong Kong-trained managers can play. His group is already exploring with the Science Park to bring a few US biotech companies to Hong Kong to help improve their clinical trial process. Being located in Hong Kong enables these biotech companies to work with CROs (contract research organizations) in China more efficiently to outsource well-defined R&D work at low cost, and yet without compromising the IP risk (Rodrigo is still hesitant to invest in IP-intensive businesses in Mainland China). Life sciences talents are available locally, as Hong Kong's universities have a good post-graduate pool of different nationalities. In another instance, to cater to the financing gap that is currently being addressed by grassroots lending in China, Sagamore is incubating a microcredit institution that is piloting in Inner Mongolia in collaboration with Accion, a US microfinance expert. This microcredit venture is incorporated in Hong Kong to protect Accion's proprietary know-how, and it is going to use trained banking managers from Hong Kong to scale up the program that is analytics-driven rather than relationship-driven. Rodrigo sees an experienced talent pool in Hong Kong's financial institutions sector who can take up managerial leadership roles in China and work wonders.

For all the progress China has made in commanding business interest from around the world, Hong Kong managers are still in an advantageous position to bridge the cultural nuances between East and West. "The Hong Kong *Comprador* model is still alive and well," Rodrigo concedes. "It just reinvents itself with time."

Jose agrees. Rather than choosing to work with Chinese airline groups, Berkshire Hathaway's business jet company NetJets forms its China luxury private aviation joint venture with Fung Investments[6], an investment arm of the family office, because of Dr. Fung's international credibility. Many seasoned Mainland Chinese consumer and retail entrepreneurs contemplating outbound M&A's also see the strategic value of partnering with Fung Capital, because of Li & Fung's world-class expertise in international sourcing and luxury brands.

[6] Source: Reuters, 27 March 2012. Subject to regulatory approval.

Chapter 8 Putting them all together…

The interviewees featured in this paper present very cogent real-life perspectives that reinforce what we as venture capital and private equity practitioners would like to convey: there is ample room for venture capital and private equity to create value in Hong Kong's entrepreneurial businesses. To sum up, we would like to leave you with a few words for thought.

To fellow investors, and to their prospective investors:

- Idiosyncratic although the deal flow in Hong Kong may be, this paper does showcase a few interesting Hong Kong investments. Firms such as CVC Asia Pacific and Navis have dedicated systematic sourcing effort in Hong Kong. Would such effort be worthwhile to your firm as well?
- Is there demand for a Hong Kong-focused venture capital or private equity fund product? If one had put all the investments showcased in this paper into a fund, she could have built a decent-sized portfolio. With sufficient investment and vintage diversification, it is quite possible that a multi-stage Hong Kong-focused investment mandate may generate the level of return typically required by a private equity investor.
- Here fund product design can make a difference. In our view, the best Hong Kong-focused private direct investment platform to date, interestingly, is **Social Ventures Hong Kong** (www.sv-hk.org): it has well-defined *return* objectives, clear evaluation metrics, a thoughtful operating model, and rigorous investment selection and portfolio management methodology—although catering to a very different set of sponsors. While using a social innovation example may seem a bit off-tangent, we think emerging PE/VC fund managers would find it an inspiring exercise to look at the common denominators and benchmark themselves against the aforementioned high-level attributes of SVHK.
- A Hong Kong venture/growth fund, if designed well, can serve not only as a tool for economic development that promotes the local real economy; it can also be a viable alternative investment product that delivers a differentiated return. We would even venture to say that, rather than a fiscal expenditure item, a Hong Kong venture/growth fund positioned as an investment product can be appealing to a broad array of government investors, including the Hong Kong Exchange Reserve Fund, China's sovereign wealth funds and other state-run institutional funds.
- Putting things in perspective, the Applied Research Fund program in the late-1990s was admittedly not a success from a financial return standpoint, so much so that it became a taboo in the government. Yet in the 1990s, the broader Asia private equity industry was also in its infancy; single-market venture funds of comparable vintages, from China to Korea to India, showed similarly high volatility and mixed performance. The markets and investment managers have grown tremendously in the past 15 years. Other governments have also learned the lesson and designed better public-private partnership models that result in successful experiences both economically and socially, from the in-province or in-state private equity investment programs in places like Quebec and New York, to a number of government-sponsored industry guidance funds in China.
- We are not suggesting that the HKSAR government *ought to* set up a Hong Kong venture-growth fund like a number of local governments in China. It is rather a market question that we would like to articulate: *If* there is such product as a Hong Kong venture-growth fund, would the HKSAR government be attracted to consider participating as a key sponsor? How about participating in the governance of the fund's General Partner?

To entrepreneurs:

- The recurring message from the interviewees in this paper highlights the observation that Hong Kong is once again at an interesting juncture, whereby Chinese enterprises are showing an urge of "going out" while struggling to seek ways to upgrade themselves as the economy slows down. This may pave the way for Hong Kong entrepreneurs' resurgence as a "21st century comprador".
- In what sense? Operating as a critical component in the food chain to help China compete better on the global stage could be one. Hong Kong has a natural disadvantage; there is no way you may compete in the "red ocean" on scale with competitors in Mainland China. This has serious implication when thinking about entering the "12th Five Year-Plan" target markets.
- Incessant pursuit of <u>product excellence</u> and <u>technology</u> as your core competence may be your saving mantra. You may be surprised that when a market is buoyed by bullish sentiment, many businesses in China have little regard for product excellence and technology (even at leading technology companies).
- Do not get complacent with tiny things. In Hong Kong, one can easily get confused with magnitude. When your head-on competitors aim high and you indulge in petty fame, you will get marginalized. It is important to think big. As an enterprise, the best social responsibility you can fulfill will be to keep thriving and sustainably generating employment and nurturing talents for the society. Yet in the past 10 years Hong Kong has generated too few new entrepreneurial enterprises that have grown to create respectable value.
- The government funding programs are actually very generous. Learn how to take advantage of them.
- There *are* venture capital/private equity investors who can help you build the business together.

To seasoned managers:

- For seasoned managers contemplating their next move, well-funded venture capital- or private equity-backed companies could be a viable alternative. Hong Kong has a deep pool of managerial talents in merchandising, branding and financial services fields, and the harsh rental environment has also trained up a crop of managers in the retail sector who excel in driving efficiency. You may be able to make a greater impact as a leader in an entrepreneurial business. Seasoned executives would find entrepreneurial companies more appealing with private equity and venture capital backing, since these investors often put in place world-class governance standards and incentive systems.
- Having witnessed how your own industry is evolving and knowing where the opportunities lie, with your industry credentials, you are actually in an advantageous exciting position to start a company on your own or, through management buy-in, take over a company to realize your entrepreneurial vision with the sponsorship of venture capital or private equity.
- A number of seasoned executives from Hong Kong or who led businesses out of Hong Kong have entered the investment industry, bringing with them operating expertise that is in high demand by private equity/venture capital firms. Some even started their own venture capital/private equity firms recently. Great examples like Boyu's Louis Cheung (張子欣, former President of Ping An Insurance) and Novo Tellus' Gareth Chang (張鎮中, former Chairman & CEO of Star TV) may as well be your source of career inspirations.

To policymakers:

Rather than delving in concrete policy recommendations here, from the standpoint of a long-term institutional investor, we would like to highlight a few "philosophical" pointers which we hope would help orient the right frame of mind for policymakers as they map out new policies for Hong Kong's businesses:

- While Hong Kong is doing great serving buyers and sellers the secondary market, do not ignore the participants in the primary market who invest in the real economy.
- Entrepreneurial businesses are more than just technology businesses. Beside technology, the examples of private equity/venture capital-aided value creation listed in this paper include retail, branded goods, food & beverage, financial services, even traditional industrial and apparel manufacturing.
- Look deeply into our core advantages. Across different government entities, the best source of intelligence for value creation and venture ideas for entrepreneurial businesses in Hong Kong, we would argue, may lie in Trade Development Council, which has tremendous insight into the ebbs and flows of business channeling through Hong Kong, and yet few investors and entrepreneurs are making smart use of it.
- Beware of the inherent constraints of policy lag when you are really to make an industry bet. That China does not need another wind turbine maker for the 12th Five-Year Plan seems obvious. Nor does any government want another Solyndra on their book. But the bigger lesson does not stop there. Investing in the future needs to take cues that may not be apparent now; what is quite apparent in business, though, is what *not* to invest: playing catch-up with the leader of the past. It may be more constructive to think hard about what Hong Kong may contribute to China's 13th Five-Year Plan.
- Sorting through the criticism on government's help in startups, the interviewees in this paper—Vitargent, Frenzoo and Editgrid—actually are quite happy with SERAP and the other government-sponsored incubation support they have received. Perhaps the more proper questions to ask would be: How would you make better decisions so more support goes to the *good* companies? And what should constitute a *good* company in your yardstick? (This paper has hinted repeatedly.) Any budget allocation carries an opportunity cost. The grant that keeps an ill-conceived venture employing 10 to chug along for 2 years and then shut the door may have extended the lives of 10 ill people for many years more.

Finally, to the greater Hong Kong community, and to the media:

- Celebrate Hong Kong entrepreneurs more, not just the few homegrown companies set up by locals, but also entrepreneurs from Mainland China (like Eric) and elsewhere (like Simon, Olivier and Damien) who choose to base their business in Hong Kong, as well as Hongkongers who work very hard building their business and products in China (like Ted) and abroad (like David). It is the capacity for international entrepreneurialism that makes Hong Kong great.
- On the other hand, be critical about entrepreneurs who seek social glorification too early. Be discerning about What Is Great. A sub-microcap public listing is honestly no big deal.
- Hong Kong actually is in dire need of <u>new</u> companies that aspire to become big, as this paper shows. Acknowledge this problem: an economy consisting of just oligarchs and mom & pop stores rarely can drive rejuvenation.
- Pursue excellence. The slowdown in China makes room for entrepreneurs who care about <u>execution rigor</u>, <u>judgment quality</u> and <u>product robustness</u> to find an audience in front of investors and customers. This is a golden window of opportunity for innovative excellence-focused emerging players when existing companies realize they cannot blindly compete on scale. Fundamentally, being very good at what you do is in itself a social responsibility. Just imagine the day Hong Kong loses its insistence on pursuing excellence, and what the city will become.

About the author

Denis Tse (謝迪洋) is currently the Head of Asia –Private Investments with Lockheed Martin Investment Management Company, one of the largest corporate pension programs in the world. Denis has been in the venture capital and private equity industry since 1999. He also co-founded what became Acasia Technologies, the first successful spin-out from the Hong Kong Applied Science & Technology Research Institute (ASTRI). Denis graduated with Honors from Northwestern University and has an MBA from INSEAD. He is a Kauffman Fellow and currently serves as the Ambassador to Asia for the Institutional Limited Partners Association (ILPA). Denis is a native of Hong Kong.

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HKVCA's mission is to stimulate a vibrant venture capital and private equity industry in Asia while promoting the role of member firms in value creation, innovation and economic development. HKVCA provides a forum for networking and experience sharing for its members; promotes industry professional ethics, international best practices and standards; and represents the views of its members before governmental and other relevant bodies. The Association organizes an active program of educational programs and conferences, delegations, joint activities with the government and trade bodies, and connects with other local, regional and international business groups.

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