

The **Chinese** private equity  
and venture capital market  
and *its implications* for  
***European fund managers***



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## Introduction

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The Chinese private equity (PE) and venture capital (VC) market has attracted significant interest from global investors in recent years. A survey conducted by the Emerging Markets Private Equity Association (EMPEA) this year reveals that China and India top global investors' wish list. China, in particular, is expected to see the greatest expansion in commitments from its investors in the next two years. The widespread enthusiasm is perhaps not surprising, given the strength of China's economy and the large pool of domestic enterprises with the potential to achieve extraordinary rates of growth that are rarely seen in mature economies. The gradual appreciation of Renminbi (RMB), the Chinese currency, adds yet another attraction for overseas investors.

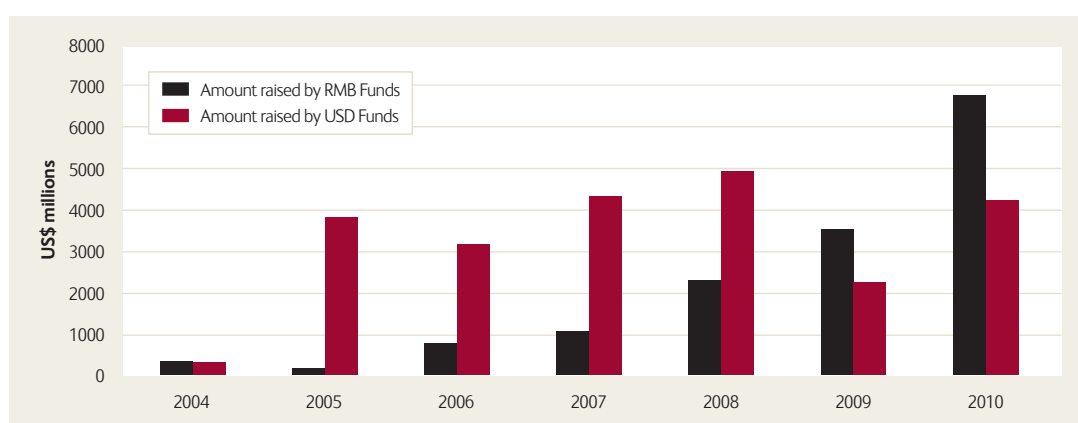
A number of global PE/VC managers, including a few European managers, have established their presence in China since the inception of the market. In fact, it is these managers rather than the domestic players who contributed to the majority of the investment activity during the early development of the Chinese market. In more recent times, we have seen many more managers here in Europe actively exploring ways of tapping into the growth in China. Raising RMB funds, for instance, has been one of the recent talking points. Amid this growing interest in China, we look at the trends and characteristics of the market and investigate some of the practical issues European managers may face when assessing investment and fundraising opportunities in China.

## Background and Recent Developments

China's PE/VC market was formed just over a decade ago. Despite its brief history, the market now has around 1000 PE/VC firms actively investing. According to Zero2IPO, a leading PE/VC research centre in China, in 2010 around \$39bn was raised and \$16bn was invested, making this market the largest in Asia and one of the most important in the world.

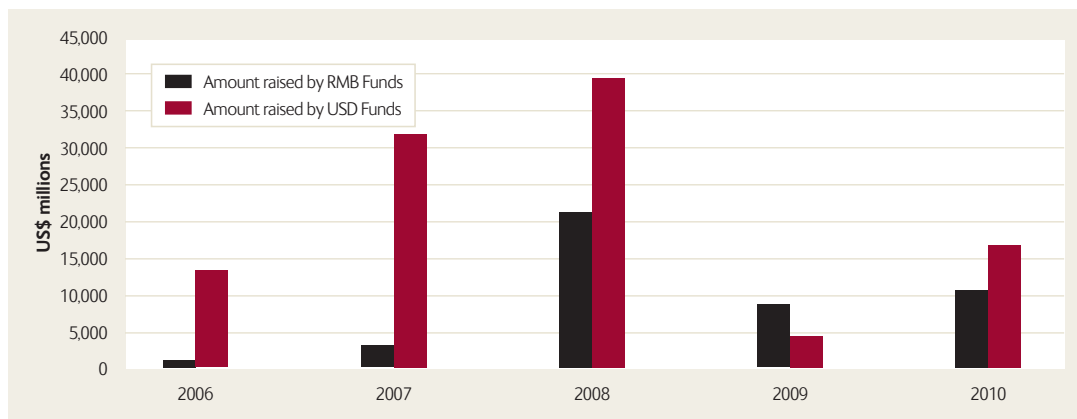
During the earlier years, nearly 80% of PE/VC deals in China were done by global managers, such as Sequoia, KPCB and 3i, through their offshore funds (funds registered in jurisdictions outside of China and usually denominated in USD). But the landscape has changed considerably in recent years, with a surge in the number of home-grown fund managers. There have been about 70 to 80 new local managers established each year in the past few years, according to Lefei Liu, 2010 Chairman of the Beijing Private Equity Association. The calibre and long-term ambition of these managers varies, and it is fair to say that not all of them are equipped with the essential experiences and skills to compete in the market over the long term. However, at the top end, many managers appear to have both a sound understanding of the nuances of the Chinese market and significant exposure to PE/VC investment through their prior roles at international financial organisations or their own entrepreneurial activities. Some of them also benefit from deep-rooted political and business connections. These local managers are now sharing the top positions with the international managers both in terms of the volume of investment activity and performance.

In line with the rise of local managers, the number and amount of new funds raised in the domestic currency (RMB) have also increased substantially. In 2010, RMB funds accounted for 60% of the total capital raised for VC investments and close to 40% of the capital raised for PE deals (Zero2IPO, 2011), the majority of which were raised by domestic managers. However, despite the growing interest, the number of overseas firms involved in raising RMB funds remains relatively small. Many firms are reportedly holding off on their fundraising plans in China as there is still a degree of ambiguity and uncertainty concerning the relevant policies and regulations.



**Figure 1:**  
China's VC Market –  
Fundraising

Source: Zero2IPO



**Figure 2:**  
China's PE Market –  
Fundraising

Source: Zero2IPO

Another significant development is the improvement in exit opportunities following the launch of ChiNext, China's NASDAQ-style stock exchange for start-ups, in 2009. The market was created to provide high-growth, innovative small and medium sized enterprises (SMEs) with access to capital and to promote sound interactions among independent innovators, venture capital and capital markets. Its listing requirements are more relaxed than other domestic exchanges, and the process is said to be more efficient. Over 100 SMEs were listed on ChiNext within the first year of its launch at valuations significantly higher than those prevailing on other Chinese exchanges: the average first-time sale on ChiNext valued stocks at about 66 times earnings (Bloomberg News, 2010). Although the sustainability of these valuation levels has been the subject of much debate (and indeed valuations have started to come down this year), investors' enthusiasm for ChiNext initial public offerings (IPOs) has not abated. About 60% of SMEs listed on ChiNext were backed by RMB funds, making the investors of these funds one of the main beneficiaries of the exchange. Not many foreign managers who invest in China via offshore vehicles, however, have been able to benefit from this exit route, due mainly to the restrictions imposed by the Chinese regulatory authority on the IPO of foreign-invested enterprises (FIEs). That said, there have been reportedly signs that such restrictions may be lifted in the near future (Reardon, 2009).

In terms of limited partners (LPs), investors in PE/VC funds, there is a paucity of institutional LPs in the Chinese market. The lion's share of capital flowing into RMB funds comes from companies (private, listed or state-owned) and wealthy individuals. The Chinese government has taken some steps recently to offer a number of institutions the flexibility to invest in PE/VC funds. For instance, in September 2010, the China Insurance Regulatory Commission (CIRC) granted Chinese insurance companies permission to invest up to 4% of their assets in onshore PE funds. This news stirred up considerable excitement within the fund manager community at the time as the move could potentially unlock RMB222bn (\$33bn) for PE funds. At the same time, the increased amount of capital available for investment in the Chinese market has also given rise to the concern that perhaps there is now too much money chasing too few deals. With up to 1000 PE/VC firms actively seeking investment opportunities in this market, competition will inevitably intensify going forward. On the other hand, the total amount of PE/VC investments in China represents only 0.2% of China's GDP at present, much lower than in more mature markets: 0.8% for the US and above 1% for the UK (Shen, 2010; BVCA, 2010). With this in mind, there should also be more scope for the market to absorb the capital and continue to expand.

## Key Characteristics of Private Equity Investment in China

A striking difference between the Chinese market and more mature PE/VC arenas is that private equity is almost synonymous with growth capital in China, i.e. providing capital to companies that are already established and trading profitably to fulfil their growth potential. Seventy percent of PE investments in China are now in the growth category, followed by around 20% in PIPE deals (Private Investment in Public Equity).

The typical buyout deals that are commonplace in more mature markets account for only 3% of the total amount invested in China. The capital invested in these growth companies are often used for increasing production capacity, rolling out new stores, providing additional working capital, and/or marketing. So far, returns generated by these investments have been very attractive. The entry multiples are typically ten to fifteen times EBITDA but after a two- to three-year holding period the exit multiples would normally reach about forty times. Additionally, there is little or no leverage involved in this type of transaction.

A consequence of the focus on growth capital is that, unlike typical PE transactions in mature markets where it is the norm for PE houses to take a controlling stake in their portfolio companies, investors in China normally take a minority stake and therefore have less influence over the strategic direction of the business. This explains why identifying a management team that shares their vision has been of paramount importance to PE investors. The value added by PE professionals during the post-investment period is mostly about supporting the existing management team in areas such as streamlining supply and distribution chains, recruiting and retaining talent, and IPO preparation, rather than implementing significant strategic changes.

It has been noted by some industry veterans that the dominance of growth deals and the non-control investment style in China is not that dissimilar to what was experienced by the US and European markets during the initial phase of their development. For example, growth and non-control deals also featured heavily in the UK market during the 1980s but gradually gave way to later stage, control-orientated transactions with increased levels of leverage. It is possible that we will witness the same type of shift in time in the Chinese market. Indeed, an increasing, albeit still small, number of later stage deals have already started to emerge with PE firms taking a controlling position in the target company.

Another key characteristic of the Chinese market is its reliance on the IPO market as an exit route. In 2010, 86% of the VC exits (388 in total) and almost all PE exits (167 in total) were achieved through an IPO. This is in contrast to the European market, where trade sales dominate exits and IPOs rarely exceed 10% of exits by value in most years (CMBOR, 1990-2010; EVCA, 2006-2010.). This feature also explains why the recent launch of ChiNext and the improved transparency and liquidity in the other stock exchanges in China has served as an important impetus for the growth of the PE/VC industry.

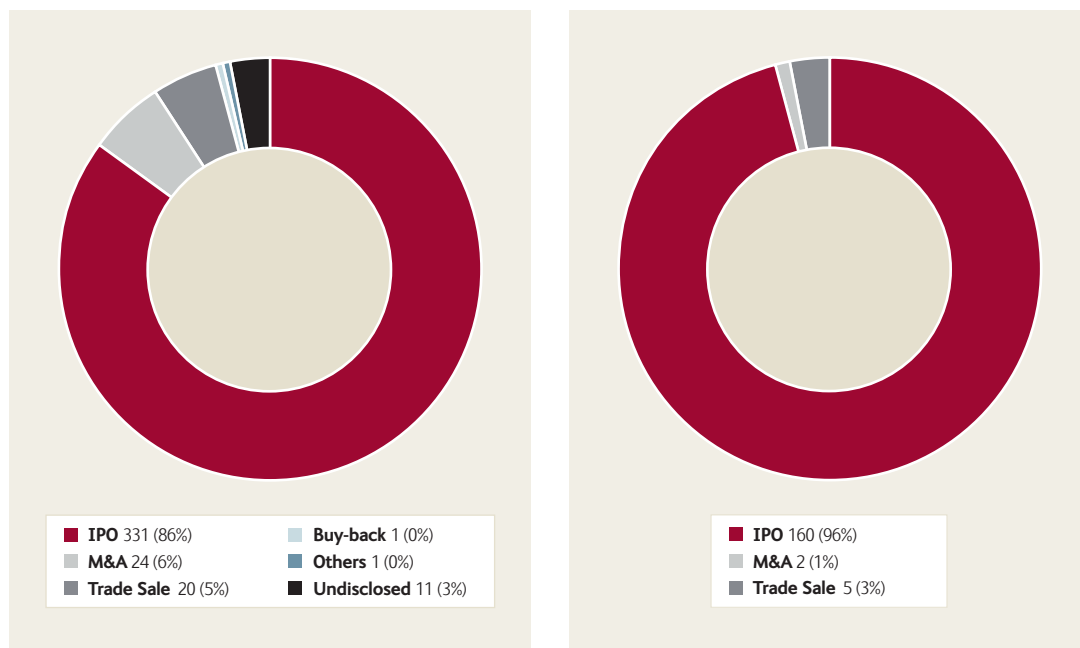


Figure 3 left:  
2010 VC exits

Source: Zero2IPO

Figure 4 right:  
2010 PE exits

Source: Zero2IPO

Most RMB funds raised from Chinese LPs have a typical life span of four to seven years, significantly shorter than the fund length of 10+ years that are prevailing in more mature markets. This reflects the current landscape of the Chinese LP community, where businesses and wealthy individuals are the main providers of capital. These LPs are generally less accustomed to the idea of entrusting their capital to fund managers for a lengthy period of time and tend to demand a far quicker return of capital and profits. Fund managers, while conceding to a shorter fund life, typically request in return an immediate contribution of at least 50% of the committed capital as opposed to calling for capital when an investment or fee is due.

## Investment Options

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A number of foreign PE/VC investment firms have been investing in China since the inception of the market. Historically, investments were done mainly by setting up China- or Asia-orientated funds in overseas jurisdictions, i.e. offshore funds. More recently, it has become feasible for some firms to set up onshore RMB funds for making investments in China.

### Offshore foreign currency funds

Offshore Chinese funds are typically denominated in US dollars (USD) and raised from overseas investors. Unlike domestic funds, offshore funds are subject to foreign investment and foreign exchange restrictions, which, to some extent, limit their ability to compete with their domestic rivals on an equal footing. Investment via offshore funds can be made in the form of 'direct investment' or the so-called 'round-trip investment', although a series of recent regulatory changes have made it increasingly difficult to follow the latter option.

#### *Direct investment*

The direct investment approach is the most straightforward way for an offshore fund to invest in China. It involves acquiring the equity of the target company through various offshore single purpose investment vehicles. Once the transaction is completed, the status of the Chinese target company is then converted into a joint venture or a form of foreign invested enterprise (FIE) under the current Chinese legal framework.

However, the process for foreign fund managers to obtain approvals from the various government bodies in order to complete a direct investment can be lengthy and onerous. For example, approval from the State Administration of Foreign Exchange (SAFE) is required before converting foreign currency into RMB to make the investment; approval from the Ministry of Commerce (MOFCOM) must be obtained to turn the investee company into an FIE, and an approval may also be required from the National Development and Reform Commission (NDRC) or its local counterparts for the deal to go through (if the industry of the target company and the size of the investment fall into certain categories). Exiting a direct investment can be equally difficult due to the restrictions imposed by the Chinese regulatory authority on the IPO of an FIE. In most cases, approvals must be sought from MOFCOM, the China Securities Regulatory Committee (CSRC) and/or SAFE in order to float an FIE on either a domestic or overseas stock exchange.

On a positive note, Chinese regulators have recently started to delegate decisions to a more local level, with a view to easing the approval process for qualifying investments. According to the Foreign Investment Guidance Catalogue issued by the NDRC and MOFCOM, a company's business activity can be classified as 'encouraged', 'permitted', 'restricted' or 'prohibited' with regards to foreign direct investments (Pinsent Masons, n.d.). Provided that the business activity of the target company belongs to the 'encouraged' or 'permitted' categories and the investment amount is below \$100mn, approvals are then required at the local level only. Even if the business activity falls into the 'restricted' category, provided that the size of the investment is below \$50mn, approvals can still be sought at the local level. Local connections and the ability to demonstrate how the investment could add value to the local community often holds the key to a speedy approval process.

### **Round-trip investments**

This form of investment takes advantage of the offshore structure set up by the target Chinese companies, known as Round-trip Special Purpose Vehicle (SPV). Many SPVs were set up by Chinese entrepreneurs during the 1990s and the first half of the last decade in order to convert their domestic businesses into Foreign Invested Enterprises (FIEs) and ultimately benefit from tax incentives offered to the FIEs by the Chinese government. Most of these incentives are no longer available now unless an FIE operates in the 'encouraged' sectors and is based in the less-developed Central and Western regions of China.

Companies with this structure have been popular targets of offshore PE/VC funds. Investments from these funds can be made directly into the offshore SPV of these companies, which avoids converting foreign currency into RMB. More flexible transaction structure, e.g. convertible loans and ratchets, can also be adopted, which would not have been possible if the direct investment option is used. This is because the current Chinese legal system does not offer this degree of flexibility for direct investments into domestic companies. An added benefit is that it is possible to exit the investment by listing the round-trip SPV on overseas capital markets.

The opportunities to make round-trip investments, however, are diminishing. Amid concerns over the potential loss of tax revenue and foreign exchange control, the Chinese government has introduced a series of new regulations (e.g. Ordinance 10) since 2005, which have made it increasingly difficult for domestic companies to set up offshore structures. As there are fewer investment candidates with Round-trip SPVs available, managers of the offshore PE/VC funds are forced to be more reliant on other investment options these days.

### **RMB funds**

In more recent times, global investors are increasingly looking into the option of setting up RMB funds with the hope of removing some of the hurdles they face when investing in China. There are two main structures available for setting up RMB funds: Foreign Invested Venture Capital Investment Enterprise (FIVCIE) and Foreign-Invested Limited Partnership (FILP) (CVCA, 2010). At this stage, neither of these provides foreign PE/VC players the same level of investment freedom that is available to their domestic rivals. The latest development in RMB funds are the new rules piloted by the Shanghai Municipal Government and known as the Qualified Foreign Limited Partners (QFLP) program (Shoesmith, Wu and Deng, 2011). This marks a considerable improvement in the treatment to PE funds formed by non-Chinese fund managers.

#### **FIVCIE**

FIVCIE refers to a foreign-invested enterprise established to make venture capital investment in China. It was introduced in 2003 and marked the first attempt by the Chinese government to allow foreign investors to establish RMB funds in China. Most FIVCIEs are co-operative joint ventures (known as FIVCIE CJV), which, as a legal form, bears similar characteristics to those of a limited partnership. A number of benefits offered by FIVCIE CJV are listed below:

- It is not required to seek government approvals when making equity investments in Chinese companies, provided that the target company is in the 'encouraged' or 'permitted' category.
- It is free from SAFE's foreign exchange control when converting foreign currency for domestic investments.
- It is permitted to repatriate the initial capital and the investment gains back to their foreign investors when a divestment is made.
- It is tax transparent.
- The companies backed by FIVCIE CJV can be floated on the domestic market.

Despite the various benefits, the structure also has a number of limitations, which mean that it is only suitable for a small number of foreign PE/VC firms. The main limitation is that FIVCIEs are required to focus on high/new technology investments and the manager of the fund has to have substantial investment experience in this area. Investors wishing to target more general sectors are therefore kept out. Other limitations include a very strict minimum capital requirement, which has to be made up substantially in cash.

### **FILP**

FILP was introduced in early 2010 to enable foreign investment firms to set up limited partnership RMB funds with the participation of both Chinese and overseas LPs. Unlike the FIVCIE structure, FILP is not restricted to high-tech venture capital investments, thus enabling global PE firms to target a wider range of industries. The downside is that it continues to be subject to investment restrictions, meaning they are denied access to 'prohibited' businesses and are required to go through an onerous approval process for investment in 'restricted' businesses under the Catalogue of Guidance for Foreign Investment Industries. Another significant drawback is the lack of clear guidance on the settlement of foreign exchange capital. For these reasons, the FILP structure on the whole does not provide material benefits to global PE/VC firms and as such are rarely adopted in practice.

### **QFLP**

In more recent years, the Chinese government has shown willingness to foster a competitive PE/VC industry that can provide an alternative source of funding for its enterprises. They also acknowledge the importance of keeping experienced foreign GPs and LPs in China to help the industry to achieve a higher level of maturity and sophistication. At the local level, many municipal and provincial governments have shown a keen interest in attracting well-established global PE/VC managers to their jurisdiction. As a result, there have been ongoing developments in the policy environment, which should offer more flexibility and clarity in time for foreign firms to set up RMB funds. The Qualified Foreign Limited Partner program (QFLP) introduced in Shanghai earlier this year represents an important step in the right direction.

Under the pilot program, a qualifying non-Chinese fund manager may establish a 'foreign-invested equity investment enterprise', i.e. a FIE PE fund, through a less complex local approval process. Provided that a FIE PE fund is denominated in RMB and that all of the capital raised for the fund comes from Chinese investors (except an up-to-5% contribution made by the qualifying non-Chinese fund manager in foreign currency), it would be treated as a 'domestic' fund. This means that the fund may invest in any industries that are open for domestic funds, a freedom never available for funds established by foreign managers in the past. If a FIE PE fund has any non-Chinese LPs, it would still be subject to the industrial sector restrictions. The only improvement in this case is that SAFE's approval is no longer required for the fund to convert foreign LP's capital into RMB for equity investment as long as the foreign investors are qualifying large institutional LPs. One down side is that, once qualified to participate in the pilot program, a FIE PE fund is required to report major transactions to the Shanghai Municipal Government on a regular basis. The program on the whole has been warmly received by non-Chinese fund managers; recently, a large global buyout firm has reportedly obtained the approval from the Shanghai government to raise the first RMB fund under this program.

## Sources of Funding

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China is known for its large foreign exchange reserves and the pools of capital that are controlled by central and local governments, financial institutions, domestic enterprises and wealthy individuals. As fundraising becomes increasingly challenging in western markets in the post-crisis era, many global PE/VC managers are hoping that Chinese LPs will bridge the gap and be an important source of funding for them. In reality, at least at present, the capital available for PE/VC funds managed by foreign firms is limited.

So far, only three major Chinese LPs have invested in offshore PE/VC funds managed by non-Chinese managers: China Investment Corporation (CIC), China's sovereign wealth fund set up specifically for investments abroad, SAFE Investment Company, a subsidiary of State Administration of Foreign Exchange (SAFE), and China Development Bank (CDB), the largest of China's three policy banks.<sup>1</sup> Other LPs either have no permission or no intention to commit to offshore funds. Raising RMB funds opens a few more doors for global managers but the number of institutional LPs they have access to at present remains small. The National Social Security Fund (NSSF), the largest institutional LP for RMB funds, can only consider funds raised by local managers; commercial banks in China are yet to be permitted to commit to PE/VC funds; and insurance companies, while having just been granted permission to invest in onshore PE funds, are prohibited from investing in VC funds and do not have the right infrastructure in place to engage in any investments. Other challenges confronting global managers are the competition for capital from domestic players, the lack of LP discipline and culture among non-institutional LPs, and Chinese LPs' historic preference for direct investment over the option of entrusting their capital to others to manage.

### Institutional LPs for RMB funds

#### *National Social Security Fund (NSSF)*

Considered the most important institutional LP in China for RMB funds, NSSF has over RMB700bn worth of assets under management (equivalent to approximately \$110bn). In 2008, NSSF was granted the permission to invest up to 10% of its total assets in onshore PE/VC funds and has subsequently committed to a number of RMB funds managed by domestic equity investment companies. It is worth noting that a RMB fund must file its documents at the National Development and Reform Commission (NDRC) in order to be eligible for NSSF funding, but, at the same time the NDRC only accepts documents filed by funds under the management of domestic equity investment companies. At this stage it remains unclear how a non-Chinese fund manager may file the documents of their fund with the NDRC and ultimately secure commitments from NSSF.

#### *China Development Bank (CDB)*

CDB's investment history in PE/VC funds goes back to the late 1990s although most of the funds it has invested in are strategic funds designed to boost the economic cooperation between China and other countries. There have been press reports that CDB is planning to leverage its fund investment experience and raise a \$9bn fund of funds to invest in PE/VC funds by the end of 2011. But, it is unclear whether the fund of funds will only target non-Chinese managers.

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<sup>1</sup> The other two policy banks are the Agricultural Development Bank of China (ADBC), and the Export-Import Bank of China (Chexim). These banks were established to provide finance for economic and trade development and state-invested projects.

### ***Insurance companies***

In September 2010, Chinese insurance companies were granted permission to invest up to \$33bn into the local private equity market. Investments in offshore private equity funds are yet to be permitted (Wu and Deng, 2010). Investments in venture capital funds have also been ruled out due to the inherent difficulties associated with early stage investment. The major insurers in China, such as Ping An Insurance, China Life Insurance and People's Insurance Company of China, are reportedly looking into the practical steps of starting a private equity program. But progress is slow and no commitment has been made to any private equity funds so far.

### ***Government-guided funds***

There are reportedly over RMB20-30bn (\$3-5bn) worth of government-guided funds available for venture capital investment. These funds were set up by central or local governments with the aim of promoting entrepreneurship, innovation and local economy. Most of this pool of capital has been invested via VC firms, including FIVCIE vehicles set up by foreign VC firms. The downside is that these guided funds generally demand priority rights over other investors such as receiving distributions ahead of other investors and ranking their claim to the fund's assets above other investors in the event of liquidation.

### ***Enterprises and wealthy individuals***

Given the scarcity of institutional LPs, there has been a greater reliance on state-owned, listed and privately-owned enterprises and wealthy individuals as a source of funding for RMB funds. Anecdotal evidence suggests that enterprises and individual LPs contribute to over half of these RMB funds. These LPs, however, often lack the discipline that we typically observe in institutional LPs or the appreciation for the long term nature of the asset class. They are more inclined to interfere with the management of the funds and are less willing to honour their commitments in times of worsening economic conditions or individual circumstances.

## Final thoughts

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Despite the great opportunities afforded by China's PE/VC market, fundraising, investing and exiting here is by no means easy. A detailed knowledge of the market, extensive local business networks and the ability to navigate the regulatory quagmire are difficult to develop without having already operated in the market for a lengthy period. Although a stream of new policies and pilot schemes have been introduced, some barriers and restrictions will remain for overseas managers. In the meantime, the competition posed by the domestic players is becoming more intensive. In fact, in terms of investment activity, the market share of overseas managers has already been eroded by their domestic rivals in the recent years, declining from the initial 80% of the market to about half in 2010.

Given the various difficulties and challenges, investing and fundraising in China is probably not suitable for everyone. Instead, what many European managers have been doing is to maintain their geographical focus while dedicating resources to help their portfolio companies tap into the growth in the wider Chinese economy. Some large pan-European players have set up offices in key cities in China with the sole purpose of helping their existing portfolio companies to source cost-effective suppliers, improve operational efficiency, and/or expand the market share of their products. Many small and mid-market managers have been doing the same, although mostly through employing a small team of local specialists directly rather than via an established office. Some managers are reportedly looking into ways of sharing their resources in China in order to benefit from scale. These strategies are clearly sensible alternatives for many European managers at this stage, and in some cases have already borne fruit.

**Mei Niu**

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mniu@bvca.co.uk

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# The British Private Equity and Venture Capital Association (BVCA)

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The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. Our members come from venture capital, through mid-market, to private equity/large buyout houses from all over Britain.

Our voice is one of authority when speaking for, or negotiating on behalf of, the UK industry. Our aim is to aid understanding, clarity and transparency around the activities of our members, promoting our industry to entrepreneurs and investors—as well as Government, trade unions, the media and the general public.

We provide a growing list of services and best practice standards for our members across a spectrum of activities covering a network of interconnected committees, which focus on segment-led, legal, technical, regulatory, investor-led and service-led needs. We also provide networking opportunities, training courses, research, publications, public affairs and communications on behalf of the industry.

With a membership of over 450 firms, we represent the vast majority of all UK-based private equity and venture capital firms and their advisors. The benefits of becoming a member—whether full or associate—are wide-ranging and only briefly described above.

For further information  
contact the BVCA

1st Floor North  
Brettenham House  
Lancaster Place  
London WC2E 7EN

T: +44 (0)20 7420 1800  
F: +44 (0)20 7420 1801  
E: [bvca@bvca.co.uk](mailto:bvca@bvca.co.uk)

[bvca.co.uk](http://bvca.co.uk)

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