



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

Orchid Asia VII, L.P.

Private Equity Commitment

Michael Tyler
Portfolio Manager

September 18, 2017



Recommendation:

Staff, together with Hamilton Lane, recommends the Board commit up to \$75 million to Orchid Asia VII, L.P. ("Orchid Asia" or the "Fund"). Orchid Asia V Group, Ltd is sponsoring the Fund to lever their experience in sourcing, selecting, and adding value to Chinese companies.

Firm Overview:

OAVII Holdings, L.P. ("General Partner" or "GP") is seeking to raise \$900 million for Orchid Asia Fund VII, L.P. The GP is under parent company Orchid Asia V Group Ltd, which is an asset management group founded in 1993. Orchid Asia has offices in Hong Kong, Shanghai, Beijing and Guangzhou. As in prior funds, the Fund will continue to focus on backing experienced executives in building franchises in China. They seek to invest in expanding domestic enterprises with barriers to entry that have good growth prospects in the consumer services and products sector, as well as the outsourced manufacturing, retailing, high tech, media and healthcare services sectors. Orchid Asia will pursue a growth capital investment strategy that will focus on partnering with experienced local operating executives building franchise companies in China.

Over 24 years, the General Partner's extensive investment experience and appreciation of Western investment models has provided a unique perspective on investing in the future franchises of the Chinese emerging private sector economy. They believe that there are many proven business models in the United States and Europe that have not fully emerged in China's private sector, and that the development of these business models adapted for China will give rise to many attractive investment opportunities.

The General Partner has managed six funds, with an aggregate total value of over US\$ 3 billion across all funds. Investors include U.S., Europe and Asia's leading institutional investors, university endowments, pension & foundations, insurance companies, strategic investors, and high net worth family offices.

Fund Size:

Orchid Asia is seeking equity commitments of \$900 million.

Investment Strategy:

Orchid Asia will focus its strategy on backing experienced executives in building franchise companies in China. Orchid Asia believes that the three key components to successful investing in China are the following:

1. **Management Team:** Orchid Asia believes in backing an experienced management team in its investments. Orchid Asia will seek to back teams with the following characteristics:

(a) **Trustworthy – Integrity and trust** are the most important traits Orchid Asia looks for in a management team. No amount of structuring or legal language can minimize the risk of a dishonest team.

(b) **Capability and Intelligence –** During the past 24 years, Orchid Asia has learned that, while many local managers have the capability to start a company, many of them do not have the skill sets to build corporate processes that allow a company to scale and grow.

(c) **Driven and Ambitious –** Orchid Asia seeks to back driven and ambitious executives, who are in the early to middle stage of their careers. In Orchid Asia's experience, many of the Chinese overseas returnees have often gone through many challenges in their lives and are very driven in their careers.

(d) **Relevant Backgrounds –** In today's China, many established high-quality companies with long-term growth potential have been founded and managed by western multinational-trained executives and local operating experienced teams with relevant backgrounds.

2. **Business Model:** The second component to Orchid Asia's strategy is to identify companies within identified sectors that have, or are in the process of building, barriers to entry. Orchid Asia believes these types of franchise companies tend to achieve high returns on capital for shareholders and have sustainable competitive advantages over the long term.



3. Valuation and Terms: The GP has extensive experience in structuring deals that are favorable to capital providers. The GP will seek to align the interests of the targeted investment's management team with the Fund and incorporate many control covenants as well as exit provisions in the legal agreements.

Team:

The Orchid Asia team is comprised of 30 members. Most senior members have multiple roles. The Investment Committee (Inv Comm) is a three-person team. Six team members are on the Investment Team (Inv Team). The CFO leads the 10 person Investment Support Team. The Operations Team (Ops Team) has 4 members. The following list shows roles, for the Managing Partner (MP), General Partners (GP), Investment Directors (ID), and other roles of the senior level managers and Operations Team members.

Name	Title: Role(s)	Yrs. Experience	Prior Experience
Gabriel Li	MP: GP, Inv Comm, Inv Team	21	China PE, Consulting
Edmond Wong	MD: GP, Inv Comm, Inv Team	27	Consulting
Teck-Shang Ang	MD: GP, Inv Comm, Inv Team	23	China PE, Banking
Richard Mao	MD: GP	22	Management and Operations, Healthcare
Jue Wang	ID: GP, Inv Team	13	Consulting
Allen Chen	ID: GP, Inv Team	11	Consulting
Kevin Huang	ID: GP, Inv Team	10	Consulting
Ben Guo	Operating Director: GP, Ops Team	31	Consulting, Operations (Manufacturing, Hi-Tech)
Queenie Zhang	Operating Director: GP, Ops Team	21	Operations (Food-Beverage, Consumer Goods)
Vincent Gu	Operating Associate: Ops Team	17	PE, Big 4 Corporate Finance
Yilan He	Operating Analyst: Ops Team	11	China PE
Ken Siu	Chief Financial Officer: GP, Inv Support Team	14	China PE
Dorothy Li	Financial Controller: Inv Support Team	17	China PE
Trevor Chan	Director, Business Dev: GP, Inv Relations	21	China PE, AVCJ

Even though the team is relatively large for a fund of this size commitment, Orchid believes that sustained success in Chinese private equity requires extensive and detailed upfront deal diligence, which is work force intensive. Orchid has plans to add additional professionals to its existing team after the final closing of the Fund.

Investment Instruments:

The Fund will make equity investments in five key sectors, which are all driven primarily by domestic consumption or by taking share from international competitors. The sectors are 1) Branded Consumer Products and Services, 2) Retailing, 3) Medical and Healthcare, 4) Technology, Media and Telecoms, and 5) Specialty Manufacturing.

Market Opportunity:

Orchid Asia believes that this is a turning point in the private equity industry in China and the right time to invest for the following reasons:



- a) There are now significant numbers of executives with experience in well-run commercial businesses in China. In addition, Orchid Asia believes overseas western-trained and experienced local Chinese business leaders, who in Orchid Asia's experience, were practically non-existent in the past, are now appearing in China in much higher numbers and with sufficient experience to build new businesses.
- b) Global financial markets are valuing high-quality Chinese companies at international multiples. Orchid Asia has observed significant development of China's capital markets in the past decade.
- c) Orchid Asia believes that globally competitive companies have begun to emerge from China since the 1990s, and many more are expected to emerge from China going forward. Just as Japan, Korea and Taiwan went through their initial stages of copycat manufacturing, China emerged from producing poor-quality goods in the 1980s to becoming the world's powerhouse in manufacturing in 2000.
- d) Orchid Asia has observed that deregulation and opening of new sectors within China in the past two decades have led to many more opportunities where many services sectors, such as the financial services, distribution services, media services, telecommunication services and professional services sectors, are opening up to foreign investment due to the WTO agreements.
- e) Orchid Asia has observed that substantial government investment in Chinese telecom and physical infrastructure over the past two decades has created new opportunities for business formation. This led to the creation of multi-billion dollar market cap companies such as Alibaba and China Mobile among many others.
- f) The One Belt, One Road proposal by the Chinese President is intended to create new opportunities for Chinese companies to export products and services to Eurasia and diversify the China economy's focus from domestic consumption to globalization.

Investment Highlights:

Focus on key sectors								
<p>The Fund will continue its successful focus on 5 sectors which are primarily driven by domestic consumption or taking share from international companies. Examples of each sector follow. In branded consumer products and services, examples of investments are an oral care company producing toothpaste products, a bereavement care service provider, a real estate and property management company, a branded snack foods company, selling infant products, and of course, in China, a tea company. Retailing investments successfully targeted have been in mid-end apparel manufacturing, watches, higher end fashion retailing, high-end confectionary retailing and sporting goods retailing. The medical and healthcare area has been investing in a facial implant manufacturer, a leading pharmaceutical company, a medical lab test outsourcing company and a medical equipment distributor. Technology and information technology investments such as an online agricultural supply-chain platform, online automotive advertiser, and online travel services had produced strong returns. Lastly, specialty manufacturing such as producing control boards for appliances, auto parts, backup generators, and toolboxes, for domestic and export consumption have all been winning sectors.</p>								
Consistently Strong Investment Performance								
<p>Each of the Funds demonstrated a viable investment strategy and a flow of investment opportunities through Orchid Asia's network of operating executives. Orchid Asia is one of the few private equity firms in Asia that have had over two decades-long history of investing in China. For this reason, the Manager is able to attract many companies in China to work with them. Over the past few years, Orchid Asia has received information from over 10,000 potential investee companies, averaging more than 100 companies per month, or more than three companies per day. Of these opportunities, the team has visited hundreds of companies but invested only in a handful due to Orchid Asia's disciplined selection process.</p>								
Performance of Orchid Asia (OA) as of March 31, 2017								
<i>Fund</i>	<i>Vintage</i>	<i>Gross MoC</i>	<i>Net MoC</i>	<i>Net DPI</i>	<i>Net IRR</i>	<i>Top Quartile?</i>	<i>PME Spread vs MSCI China</i>	<i>IRR Spread ¹</i>
OA III	2005	5.4x	3.7X	3.2x	21.9%	Yes	+ 1,477 bps	+ 936 %
OA-IV	2007	1.5x	1.3x	1.0x	6.8%	No	+ 480 bps	- 163 %
OA-V	2011	2.1x	1.7x	1.4x	29.0%	Yes	+ 2,085 bps	+ 1,337 %
OA-VI	2014	1.2x	1.1X	0.3x	13.1%	No	+ 771 bps	- 585 %
¹ IRR Spread vs Top Quartile using Hamilton Lane Rest-of-World Venture Capital, Buyout & Growth index								



A Team Of Proven China Investors

Orchid is of the very few private equity firms in China that has significant operations, management consulting, and most significantly, deal exit expertise. Most of their investment professionals have extensive backgrounds in management consultancy, private equity or operational expertise in running companies. They do not have a team with investment banking backgrounds, as their strategy does not involve financial engineering or large buyouts.

The Orchid Asia team's operational and deal structuring experience allows them to win deals based on Orchid Asia's long-established track record of IPOs and exits, as well as a strong 4-person Operations Team. The two senior members, Ben Guo, a former COO, and Queenie Zhang, a former CFO, have over 25 and 17 years, respectively, of industry experience working with multinational company operations. They have consistently impressed CEOs with their operational expertise. During deal negotiation with a company, Orchid Asia typically uses a dual-team approach to the founder to win deals. The investment team members and one of the operating team members will jointly meet with the founder/management team. While the investment team members lead negotiations on terms, legal, and structure, the operating director focuses on the potential key operational improvements. At the same time, Orchid Asia's established brand and reputation in the industry is one of the key success factors for winning deals from competitors.

Investment / Risk Considerations:

General Risk Factors

The long-term nature of private equity investments requires a long-term commitment, with no certainty of return; although the fund typically has various protection mechanisms and covenants with investments. There is not a guaranteed market to sell interests, and there may be restrictions on transferability. There may be uninsured losses requiring Fund coverage, including events out of the Fund's control such as floods and earthquakes. The Fund may compete with other funds or investors for investments desirable for its portfolio. The illiquid nature of investments could mean the Fund is not able to exit in a timely manner. The fund may invest in junior securities, which are subject to greater chance of loss in a downturn environment. There could be material changes in the general economic conditions of China, such as a slowdown of growth or currency volatility, or restrictions on mergers. Any of these factors could lengthen holding periods and make investing and exiting more difficult.

Specific Risk Factors: Uncertain Economic and Political Environment

Probably the largest risk associated with investing in Asia in general, and China in particular, is not with this fund itself but the macro environment. There are potential economic and political environment risks over which Orchid Asia would have no control. While there are always global economic and political uncertainties, a Korean peninsula conflict would likely have financial effects on China. Conflict would likely exacerbate volatility in the financial markets and cause consumer, corporate and financial confidence to weaken, increasing the risk of a "self-reinforcing" economic downturn. A climate of uncertainty may reduce the availability of potential investment opportunities and increases the difficulty of modeling market conditions, reducing the accuracy of the financial projections. Such uncertainty would likely have an adverse effect upon the portfolio companies in which the Fund makes investments.

Specific Risk Factors: Investment in PIPE (Private Investment in Public Equity) Securities

Orchid Asia normally seeks to drive value creation initiatives as an active minority investor, but may take a more passive role in PIPE investments. Funds V and VI have sizeable PIPE exposure and concerns remain around public market volatility as well as the GP's ability to add value in these positions. The recent increase in PIPE exposure reflects more favorable pricing of public investments relative to private opportunities. Mitigating this potential risk, the GP seeks public investments not acquired from the open market, like cornerstone IPOs and block trades. Relative pricing has to be attractive compared with private competitors and the investment team has to have an existing



relationship with management. The performance of PIPE investments in Funds V and VI has generated an aggregate realized gross IRR of 24% (as of 3/31/17). Managing Director Edmond Wong's focus is on the PIPE investments, which is complementary to his experience with hedge fund products. Orchid Asia maintains a 25% limit on investing in publicly traded securities.

PSERS History & Performance:

The table that follows summarizes Orchid Asia V and VI's performance with 6.30.17 adjusted valuations. Both prior funds have applied the "partnering with executives and building barriers to entry" strategy, which has generated attractive returns, despite a number of economic downturns in the past two decades. Orchid Asia V and VI are funds with exposure primarily to China.

Fund (\$M)	Portfolio	Vintage	Commit.	Contributions	Distributions	NAV	Net IRR	MoC
Orchid Asia V	PE	2011	\$40	\$35.4	\$49.7	\$10.8	28.4%	1.7x
Orchid Asia VI	PE	2014	\$75	\$27.4	\$3.5	\$27.1	10.4%	1.1x
Total			\$115	\$62.8	\$53.2	\$37.9	25.3%	1.5x

Portfolio Fit:

A commitment to Orchid Asia VII will be allocated to the Private Equity portfolio. An additional commitment to Orchid Asia will allow PSERS to continue its relationship with a high-conviction manager that is well positioned to execute on its investment strategy of supporting executives in growth industries with high barriers to entry. This commitment will sustain China growth exposure in the overall portfolio.

The table below summarizes PSERS' projected exposure inclusive of a recommended \$75 million commitment to the Fund: (adjusted to 6/30/17)

Investment Type (\$M)	Active Commitments	%	Market Value	%	Unfunded	%	Total Exposure	%
Private Equity	\$ 14,696.9	65.3%	\$ 5,357.8	67.6%	\$ 3,406.8	70.5%	\$ 8,764.6	68.7%
Special Situations	4,554.8	20.2%	1,033.0	13.0%	791.7	16.4%	1,824.7	14.3%
Venture Capital	2,797.0	12.4%	973.8	12.3%	574.8	11.9%	1,548.6	12.1%
PE Internal	465.4	2.1%	555.3	7.0%	61.6	1.3%	616.9	4.8%
Total	\$ 22,514.1	100.0%	\$ 7,710.7	100.0%	\$ 4,834.9	100.0%	\$ 12,754.8	100.0%

Investment Committee Disclosure:

Relationship with Hamilton Lane:	None Disclosed
Placement Agent:	None
PA Political Contributions:	None Disclosed
PA Impact:	None Disclosed
Conflicts:	None Disclosed
First Time Fund With PSERS:	No, PSERS committed \$40M to Orchid Asia V (2011 Vintage) & \$75M to Orchid Asia VI (2014 Vintage)
PSERS AIC Approval:	September 18, 2017



Oversight Responsibility:

Investment Office:	Charles J. Spiller Deputy CIO, Non-Traditional Investments Darren Foreman Senior Portfolio Manager Michael Tyler Portfolio Manager
External Consultant:	Hamilton Lane



Hamilton Lane

September 5, 2017

Board of Trustees
Commonwealth of Pennsylvania
Public School Employees' Retirement System
5 North 5th Street
Harrisburg, PA 17101

Re: Orchid Asia VII

Dear Trustees:

Orchid Asia Group ("Orchid Asia") was founded in 1993 and is a well-known China growth-focused investor with a longstanding brand, seasoned leadership and an experienced investment team. Peter Joost, who has since retired, founded the firm; Orchid Asia is actively led today by Gabriel Li, who joined the firm in 1997. Orchid Asia is targeting \$900 million in commitments from limited partners for its seventh growth equity fund, Orchid Asia VII L.P. (the "Fund"). The Fund expects to make equity investments between \$20 and \$150 million in 20 to 25 companies with a minimum enterprise value of \$50 million. Orchid Asia expects to hold a first and final close in November 2017. The General Partner will commit 5.56% of commitments (a minimum of \$50 million) alongside the Fund; in addition, the GP will commit up to 7% (\$68 million) for employee co-investment.

Orchid Asia is a well-known and preferred partner in China due to its long investing history, deep networks and its ability to generate synergies with its public equities strategy. The General Partner has significant local coverage with multiple offices across the region in Hong Kong, Shanghai, Beijing and Guangzhou. As a result of his longstanding coverage of the China market, Mr. Gabriel Li is a significant influence within the firm and is actively involved in most investments; however, deal leads are spread down to the Investment Director-level, demonstrating a broad distribution of responsibility and the firm's emphasis on talent development. While there has been some turnover, as is common in China-focused teams, it has been well-managed with limited impact to prior fund performance. Orchid Asia has developed significant expertise in the consumer and technology sectors. The General Partner will continue to take a sector-focused approach to growth investing with an emphasis on pricing and downside protection. Orchid Asia focuses on entry price as a part of downside protection; the GP has been able to source investments on a proprietary basis by leveraging personal relationships. Orchid Asia typically takes minority positions due to the growth nature of its investments but retains operational and management influence through a lead investor role, board seats and negotiated negative controls. The GP seeks to drive value creation initiatives as an active minority investor, but may take a more passive role in PIPE investments. Orchid Asia has demonstrated its ability to outperform as a minority investor generating attractive aggregate performance, continuing its emphasis on realizations, as demonstrated by top-quartile DPI performance and focusing on capital preservation, generating fewer realized losses with each successive fund.

The Orchid Asia investment thesis can be summarized as follows:

- Orchid Asia is an established China investor with significant local presence and an experienced senior investment team lead by Mr. Gabriel Li.
- Personal relationships have been a significant source of deal flow; direct deal flow facilitates pricing discipline and downside protection.



Hamilton Lane

- Orchid Asia has demonstrated their ability to influence companies through non-control positions by retaining operational and management influence.

Hamilton Lane's recommendation is based upon the following analytical factors and is made within the context of Commonwealth of Pennsylvania Public School Employees' Retirement System's ("PSERS") investment guidelines.

- Detailed due diligence, including interviews with industry peers and private equity professionals. The on-site due diligence visit was performed on August 14, 2017.
- Evaluation of the composition of the investment team, how they work together, compensation structure and other factors that help determine whether a group is likely to be able to replicate past successes as currently configured.
- Evaluation of the Fund's proposed investment strategy within the context of the current investment environment.
- The strategy proposed for the Fund is appropriate for the Private Equity Partnership component of the portfolio.

The individuals at Hamilton Lane who were involved in the due diligence process for the Fund are:

Mingchen Xia – Managing Director, Hong Kong Office
Vivienne Watganai – Senior Associate, Hong Kong Office
Stefanie Chan – Analyst, Hong Kong Office

Based on the above, Hamilton Lane recommends that PSERS commit up to \$75 million in Orchid Asia VII, L.P. Hamilton Lane makes this recommendation considering the General Partner's qualifications and PSERS' overall investment guidelines.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors, considering an investment in the Fund, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of the Fund. Hamilton Lane does not provide legal or other non-investment-related advice.

Sincerely,

Michael Koenig,
Managing Director

Corina English,
Vice President