

Cleantech in China.

The 2009 Research Agenda

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Introduction

December 2008's successful Cleantech Forum in Shanghai marked the beginning of an extensive new reporting and information project on clean technology in this important market. This report overview is a prospectus for the project, offering a review of our current thinking of key issues in all aspects of clean technology development in China, and, by extension, global trends and China's impact on clean technology developments in the world. The Cleantech Group will build this new reporting and information project on the foundation of the pioneering reports on China's clean technology industry and investment opportunities published in 2007 and 2008, most recently our primer for investors, *Cleantech Venture Capital & Private Equity Investing In China*.

2008 saw the emergence of many dramatic new realities in the world, realities that manifest themselves as severe crises. Their convergence underscores the urgency with which numerous global activities and systems need to be brought into the 21st century. These include an acceleration of climate change and a broadly heightened sense of urgency by governments, corporations, and populations of the need to address it. These include a destabilizing volatility of resources and commodities, and the consequent recognition that dramatic new approaches are required for energy, minerals, agriculture production, water, and everything material the earth provides and life requires. These include a highly contagious series of global financial, credit, and economic crises that have shaken the foundations of global systems for allocating capital. These include an acceleration of the redistribution of financial and materials resources accompanying the strong emergence of several developing economies. And finally, these include the steady rise of global stress factors—populations, pollution, pandemics—punctuated with stubborn regional conflicts and the proliferation of destructive technologies, devices, and activities around the globe.

About the Cleantech Group

The Cleantech Group™ founded the cleantech investment category in 2002 and is active in driving category growth. Cleantech is now the largest investment category for venture capital in North America and an increasingly important category in China. The Cleantech Forums® are the world's premier cleantech investment platforms, providing unparalleled access to emerging innovation, analysis, networking, deal flow and thought leadership for the rapidly emerging cleantech category. Over \$1.5 billion USD has been raised by presenting companies.

As we launch this project, we are precisely in the midst of this convergence, the intensity, scope and potential impact of which cannot be overstated. The successful promotion of cleantech globally is a focal point because it relates broadly to how societies will sustain themselves in the future. The successful promotion of cleantech is a central—if not the central—component of solutions for most all the crises cataloged above.

The 2008 spike in fossil fuel prices triggered a more intense engagement by scientists, investors, governments, and entrepreneurs with energy-related innovation than has ever occurred before. These energy developments, still in their infancy, are a core example of the pieces that must come together to advance a cleantech agenda and the broad benefits to be gained from the outcomes. Energy innovation in both generation and conservation areas consumed investment capital and, when successful, generated considerable new wealth. Energy innovation was driven by the combined forces of regulation and markets, and its increasing value drove forward technologies on a global platform in everything from basic materials to manufacturing techniques to distribution. A fundamental rethink is underway globally energy systems, including financing total life costs, decentralization of generation and use, and production and storage.

This report overview and the research activities it inaugurates will set out a comprehensive scoping of the cleantech agenda, an extensive discussion of particulars of China's cleantech developments and China within a global context, analysis of investment trends and mechanisms, as well as trends in economics, markets, and regulatory frameworks, with special attention to the global financial crisis and emerging new global financial order. This report and the research activities will explore in detail all key cleantech sectors, their technologies, applications, prospects, and players. We plan to organize and distribute reports, data, and information from this initiative in formats that serve the needs of cleantech investors, developers, entrepreneurs, regulators, technology officers, service professionals, and consumers.

Scoping the Cleantech Agenda

It is the basic nature of clean technology undertakings to be integrative. Whether they focus on energy generation and conservation, material development and conservation, food production and land preservation, public health and welfare, or environmental quality, cleantech undertakings integrate innovations in energy, materials, systems, services, business models, and finance.

The top level scheme we employ to organize this complexity shows the extent of the cleantech agenda and the integrative nature of effective cleantech solutions for sustainability. In the sphere of materials, for example, plastics or ceramics implicate not only land pollution and disposal issues, but oil and energy as well. Structural metals like steel or aluminum and technology metals like lithium and cadmium likewise are significantly interrelated to energy consumption, storage, and waste issues. In practice, aluminum use might be constrained by market forces or regulation to only recyclable applications like food and beverage packaging because of its high energy content.

At the same time that we stress an interrelated analysis and development of all of these top tier agenda items, we also emphasize the significant complexity within each. Take energy storage and distribution, for example. Distribution and management challenges like daily and seasonal imbalances in generation and demand, as well as net metering and distributed generation require storage for varying amounts of time at varying levels of energy. Evolving technologies include chemical solutions, like batteries and fuel cells, kinetic solutions like water and flywheels, hybrid systems that combine and alternate and peaking energy sources., and smart network management solutions that balance supply and demand across geographies or offer variable pricing to shape daily demand curves.

The cleantech agenda envisioned for the report and research activities we are inaugurating will be flexible, agile, and responsive, because the one certainty in this world of uncertainty is that critical changes will unfold. Among these are macro market and economic effects that directly impact traditional energy generation and the balance points at which innovative options become viable from a return on investment perspective.

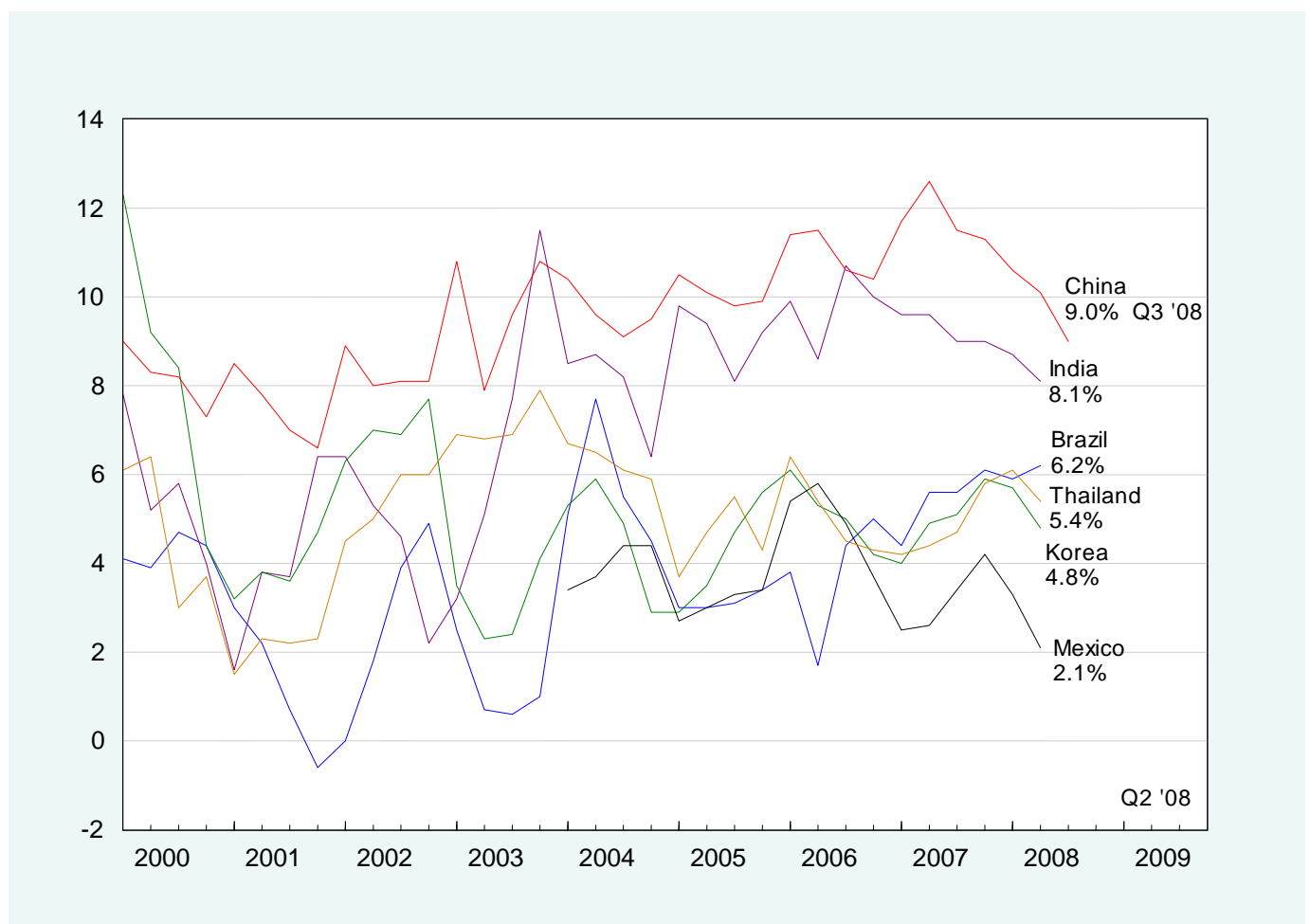


China Cleantech and China in the Global Context

China is arguably the country in the world where both the need and the potential for clean technology is strongest.

For cleantech investors in China, the future is bright. There is an almost optimal alignment of government policy and commitment, consumer awareness, domestic and foreign capital, land, technical expertise, and entrepreneurs to create and sustain a very long run of successful investments. President Hu's central objective, to create a strong "Harmonious Society" is robust in its reference to and promise of the advance of the cleantech agenda.

Economic Growth Rates - Year over year percent change



Emerging economies are generally better positioned than developed countries to emerge relatively unscathed from the global economic crisis, and among all emerging economies, China has maintained the fastest, steadiest growth rates, almost without exception for the last ten years. This is fortunate because in China there is much work to be done.¹

China's recent announcement of a 4 trillion CNY economic stimulus identified energy investment as one of the key infrastructure targets. Approximately three-fourths of the fund is targeted for infrastructure, with investment in the rail system aimed at reducing logistics costs and providing a network of high speed electrical passenger trains. Some 60 airports are scheduled for improvements.

¹ Source: The Conference Board

Shortly after the announcement of the massive stimulus package, the official media began circulating news of a decision to fund nine new nuclear power plants, scheduled to be done in the next two years. That would be in addition to the four plants currently under construction. In another plan, China has announced its intent to double the amount of renewable energy produced by the year 2020.

How much overall investment will be triggered by the stimulus package is difficult to predict. Some analysts have compared this initiative to Deng Xiaoping's historic visit to Shenzhen in 1992, an event that restarted the reform process and encouraged a massive deployment of investment by provincial and local governments alongside central government investment. Now, after several years of downward pressure on fixed asset investment by the central government, expressed in banking rules, direct allocation policy and a series of campaigns to cool the economy, this green light for renewed and expanded local investment could have substantial impact.

One of the unique aspects of China, which underscores both the challenges and opportunities in the market, is that growth in electricity demand has been sustained and intense, and of course the country is naturally endowed with vast reserves of coal but limited oil and natural gas. Demand for power will remain strong alongside some of the other targeted infrastructure investments, like the high speed rail lines that are planned to link the major coastal cities. China is the fastest urbanizing large population in the world, adding an urban population the size of Frankfurt every four weeks. Capital invested and energy expended per dollar of GDP growth in China have been far from optimal, and in many industries that impact the environment, China's measures are in dire need of improvement. This creates a double-leveraged opportunity, to grow basic output in energy, clean water, urban infrastructure, and key industrial commodities while simultaneously implemented a steep improvement of efficiency in the existing plants, which in aggregate are already often the world's largest.

China Cleantech - The Policy View

China's government policy for cleantech industries rapidly evolved over the last several years. The currently active 11th Five Year Plan, China's main public statement of policy priorities, is not the first to address environmental and sustainability issues, but it brings an intensity of focus that is quite new. For example, the original version of the 11th Five Year Plan called for an investment over its life of US\$200 billion in "social environmental protection." At that point, it sounded like a massive number. Under the somewhat different circumstances faced today, this might prove an underestimation.

The plan categorizes focal areas into environmental protection, conservation measures focused on energy and resources, and renewable energy. In other parts of the plan, not explicitly linked to the energy and environmental agenda, the plan promotes technology developments and outbound investment expansion that would also have important impact in cleantech areas.

Category	Development Goals
Environment Protection	<ul style="list-style-type: none">• Percentage of municipal sewage treated: 70%• Percentage of municipal garbage treated: 60%• Primary pollutants discharge: 10%• Forest coverage: 20%
Energy & resources conservation	<ul style="list-style-type: none">• Energy consumption for unit GDP reduce 20%
Renewable energy	<ul style="list-style-type: none">• Proportion of renewable energy consumption against primary energy consumption increase to 10% by 2010 and 16% by 2020

Supplementing the 11th Five Year plan has been a series of additional and important policy announcements. These include a report called China's National Climate Change Programme, released in June 2007, China's latest submission to the Ad Hoc Working Group on Long-term Cooperative Action under the UN Convention on Climate Change, released September 2008, and a recent white paper released by the State Council Information Office on China's policies and actions on climate change.

The stimulus program announcements include substantial investments in water, energy, and environmental protection and remediation. In addition, transportation investments and proposed investments in other areas have a cleantech impact, substituting electric train transport options between major cities, for example.

For two decades, observers have questioned the will and capacity of environmental officials to promote their agenda in the face of China's economic and industrial development tidal waves. That has now changed. The seriousness of this agenda can be seen in increasing penalties for flagrant violations, which among other things are increasingly the trigger for public unrest. Central, local, and provincial officials were once measured solely on GDP growth and FDI attraction. They are now facing a more balanced scorecard, a trend that was given momentum by a series of highly visible environmental catastrophes, like the Harbin benzene spill. Now, officials at the provincial, district, and city level will see their career prospects dim if they do not meet important pollution and energy efficiency goals.

How does the political priority assigned to areas of public interest and sensitivity related to the environment, public safety, and quality of life impact actually reach the ground?. Progress in the implementation of adequate municipal water treatment is one good example. In several cities water treatment facilities were inoperable as designed and constructed. In the past, the cities would have continued to insist on self management of the water treatment plants, to maintain flexibility in the use of financial resources and also reduce transparency in the real productivity and adequacy of the treatment. But in the emerging environment where waste water measurement is being actively monitored and reported back to Beijing, many 2nd and 3rd tier cities have been forced to admit they do not have the expertise to properly manage these facilities. They engaged professional firms to operate and maintain the treatment plants, and they bear the cost. Local populations and businesses are both beneficiaries of this trend.

This is a great step forward. While Beijing and Shanghai and other major cities have established sophisticated expert teams to manage their energy and environmental facilities, most of China's 100 cities of more than one million people have not developed their own capabilities at a high enough level. Therefore, increasing the outsourcing of facility operations and maintenance to private or state owned experts is unavoidable. Ultimately, this will not only result in resources being properly allocated but also improved efficiency in the use of these resources.

The same trend is emerging in coal fired power plants. Emissions targets were widely ignored until 2005, but now there is a mandate from the central government to implement verifiable and standardized monitoring of both sulfur dioxide (SO₂) and nitrous oxide (NO₂) emissions as well as output efficiency, expressed in grams of coal required to generate a watt of power. New regulatory pressure is being felt up the supply chain to the mines themselves, with increased monitoring of quota compliance, miner safety and environmental impact.

In water treatment and thermal energy generation these changes have created a regulation-driven market supporting existing firms and start ups, domestic and foreign, that has very attractive growth characteristics. An example in the thermal power space is LPamina, which provides services and technology to upgrade existing coal fired power plants with modern technology and state of the art processes. These firms can increase the efficiency of an existing coal fired power plant by at least 1% and reduce emissions by up to 70%. The efficiency improvement may not sound like much until one considers that a 1% improvement in a 300 MW coal fired power plant is equal to 9000 railroad cars of coal per year, with a payback well under 2 years.

An important benefit of moving the coal industry forward is that this facilitates the migration from gasoline and diesel based vehicles directly to electric vehicles. This is already a key consideration in massive investment underway in high speed electric trains to move passengers around and between key metropolises in China—Beijing and Tianjin, Shanghai and Hangzhou, for example. The trains will substitute for oil-propelled automotive and commercial aircraft on these routes. The train from Beijing to Tianjin costs less to ride than just the tolls on the highway. China is also pushing forward with interim technologies available today (biofuels, hybrid drive, fuel cell), but these would not be economically viable if we were able to generate clean electricity at the appropriate scale.

Specific programs in partnership between NGO (non government organizations) and the Chinese government are also having an impact. JUCCCE (Joint U.S. China Cooperation Clean Energy) has launched a mayoral training program with the support of the Chinese government. Beginning in 2009, mayors from cities across China will receive JUCCCE training on how best to develop their cities and communities and manage their energy and environmental resources. Given that many of these mayors already oversee huge populations and are on a ladder to future, more senior leadership positions in China, this initiative promises to have a significant impact and further expand business opportunities for suppliers who can meet the heightened expectations of this group.

EFFICIENCY should be the focus of VCs in China for the next few years. China consumes more than three times the world energy average to produce one dollar of GDP, much higher still relative to leading developed countries, and this cannot be sustained if China wants to continue to grow harmoniously. Highly speculative technology investments in China will prove increasingly difficult to finance, certainly before the technology is at a commercial stage. However, technology exists today in lighting, building materials, and smart power grid management that is scalable and investable.

... Gary Rieschel, Qiming Ventures

China Cleantech - The Market View

There is no debate that China for well over a decade has deferred an adequate level of investment in almost all environmental and clean energy needs. By some estimates, environmental degradation costs offset 4%-6% of China's GDP. Across China, only 44% of seriously polluted water is treated, and 59% of cities have unacceptable levels of air pollution. A milestone point impressed upon the public by the Beijing Olympics. During that month, the air quality in the city was sharply improved in a rather short period of time with strong regulatory measures, which constrained automotive use in the city and industrial activity for a radius of 100 kilometers. This was a blunt instrument, a drastic remedial program, and the cost has not been assessed, at least publicly. But government and Beijing citizens alike saw that environmental improvement is a real prospect, not an abstract concept.

There is likewise no debate that the government and the public are aligned in their desire to improve the environment, expand clean energy, improve the overall efficiency of production and transportation, and build a new China based on cleantech practices. Investment in environmental protection has been expected to grow 15%-17% annually, and reach a level of about US\$15 billion in 2010. Plans are to double renewable energy as a proportion of all energy, from 8% in 2008 to 15% in 2010. These figures may prove to be on the low side as more emphasis is put on infrastructure.

Of course cleantech anywhere develops at the intersection of regulatory, market, and investment forces. In China, given the deep role of the government in the economic reform process, this is doubly true. Factoring in the policy and market perspectives we will consider in the proposed research, we can construct a preliminary overview of potential cleantech sectors and the relative strength of supportive forces or levels of development.

	Solar	Wind	Water Treatment	Energy Efficiency	Solid Waste Mgmt	Energy Storage	New Materials
Government Policy Support							
Technology Maturity							
Level of Commercialization							

This preliminary overview will be significantly developed in the course of our reporting in the coming year, as energy trends, for example, will be sensitive to commodity prices and the dynamics of the global economic downtrend. But we are confident in saying that China is more likely than many other countries to maintain its projected commitment. To the extent regulators will shape the market and commercialization process, we can expect Chinese regulators to take a long-term view and maintain focus on long-term cleantech goals.

Investment levels in environment related industries have grown at a steady 15% for several years, and a \$200B commitment was made for such investment in the 11th Five Year Plan that is currently operative.

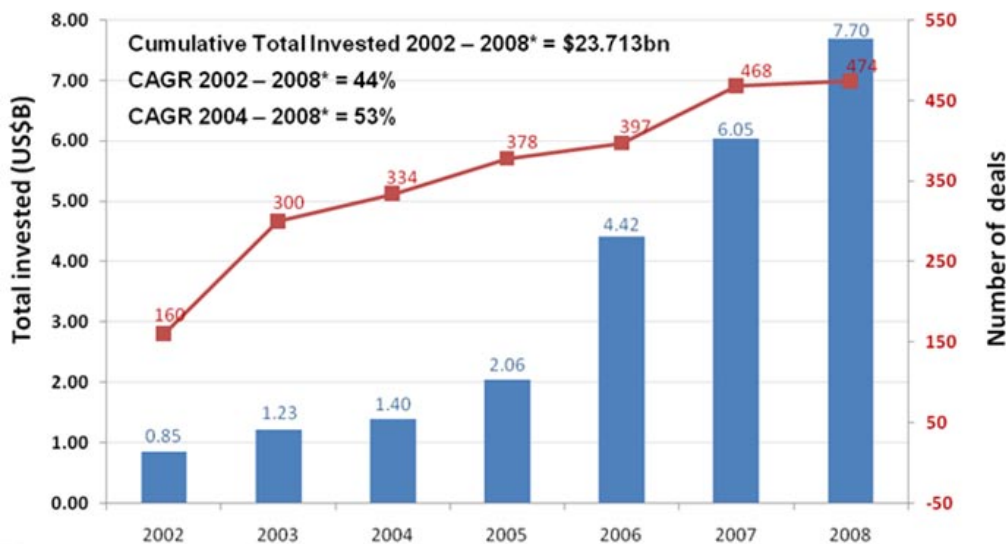
In our previous report on cleantech in China, we noted the focus of VS and PE investment in photovoltaic cell and module manufacturers in 2006 and 2007, which helped the solar segment of the market dominate PE/VC investing in China cleantech, to that point. First and foremost this was driven by rapid growth, export potential and strong exit opportunities. The portability of the product fits into the perception of what drives growth in China and sustains the viability of Chinese enterprises. These drivers include access to dual markets, a fast-growing domestic market for renewable energy and a global export market. This same perception is relevant to technology products in other new and quickly emerging sectors, including wind power generation, energy storage, and energy efficiency.

In a well-developed analysis of the market, we plan to take account of these aspects of all cleantech sectors and Chinese enterprise involvement in them. As noted above, China's domestic liquidity situation remains relatively stable and the government's capacity to invest without incurring extreme deficits is such that the domestic market will figure prominently, especially as the world's more developed economies redirect their attention to economic recovery and already are showing an inclination to accommodate cleantech-driving policy to urgent recovery needs.

China Cleantech - The Investment View

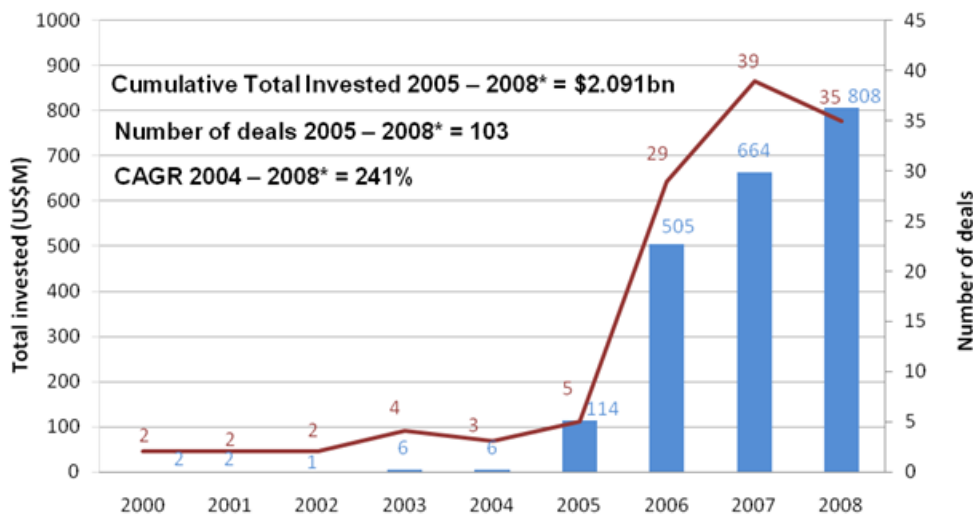
The sheer scale of the coal power industry, water treatment, air pollution amelioration, and solid waste management in China demands investor and entrepreneur attention. But it is not only a question of size but a convergence of many factors. China has a proven need for massive cleantech development, and this need now appears to be matched by a government and public commitment to get it done. China historically is a society that has proven again and again it can mobilize successfully, whether to build a huge terracotta army, a vast Dujiangyan irrigation system, a Great Wall, a Grand Canal or a Three Gorges Dam.

Chart: Global Cleantech VC Investments 2002 - Q32008



Source: Cleantech Group

Chart: Cleantech VC/PE Investments in China 2000-Q32008*



Source: Cleantech Group & China Venture

How will cleantech investment opportunities in China fit into the global patterns and trends? If our belief in the relative steadiness and sustainability of China's commitment to cleantech development is correct, we would expect China to provide a more stable investment environment than global average, and in fact as China ramps up cleantech spending, it would contribute to stable growth of global numbers. This in fact appears to be the case. Even considering the global investment challenges, China cleantech investment in the first 9 months of 2008 equaled investment for all of 2007. Beginning in 2005 and through 2008Q3 VC and PE flows into China began to show rapid gains. There was a strong jump in 2006, and a continued 31.5% gain in 2007. Through 2008Q3, the 35 deals totaled \$808M. All of this rapid growth has largely been driven by government policy developments, global commodity prices and China's success in solar PV product manufacturing.

Still, cleantech in China represents a very small percentage of total PC and VE investment. Strictly defined recent cleantech deals amounted to 7% by number of deals, 6.3% by total dollars invested. An important trend seen inside these figures is that early stage technology investments are trending strongly toward cleantech sectors.

As our research program progresses, we expect the significance and trajectory of the various global problems will become clearer, and we hope to develop a basis for dimensioning China's opportunity and impact in terms of investment. Further, we plan to continue development of data collection and analysis related to parameters of importance to domestic and cross-border investors. This work includes building on trend lines we have already developed addressing investor types and specific investors, sectors of interest, deal size and deal structure, IPO trends and other exit trends. Given the present situation with global liquidity, credit markets, and equity markets, investors are facing, tracking China's regulatory and market responses and reactions to global turmoil will be an important part of this work.

Across all categories of investment, there are trends evident in China's current stage of reform that will be important for cleantech. The radical diversification of ownership structures for commercial entities, the broad distribution of wealth and investment capability, and the multiplication of interest groups are important and fundamental features of China's near and mid-term future. Among other implications, we can expect more *ad hoc* venture funds will be established that will be active in cleantech. Some of these will be private; some semi-public, some hybrid, and some public. Some will operate on a relatively level playing field. Some will be privileged. The diversification of investors domestically will create both an opportunity and a need for cross-border investors. Winners will be those who develop innovative models of alignment and cooperation, if not formal models of co-investment.

A handful of cleantech enterprises invested by VCs are now in the process of being listed, merging or acquiring others. There will be early stage failures, and pressures to consolidate will be important elements in the value proposition experienced VCs and PEs will bring to China. Entrepreneurship in technical areas will continue to be driven strongly by returning students and experienced returning scientists and engineers. This pipe has always been a key to China's project to accelerate technological transfer from overseas. Hopefully, the intellectual property environment will improve.

Private market investing by PEs and VCs as primarily been focused on later stage investments in pre-IPO firms. In 2006, an estimated \$420-\$526mm in private deals were completed, however in 2007 the amount declined to around \$290mm. 2007 financings were dominated particularly by the two private equity financings of pre-IPO solar PV manufacturing firms, 118mm financing of Yingli Solar, led by Baytree Investments in Q1, and Actis Capital led \$82mm financing of Shunda Holdings.

. . . *Cleantech Venture Capital & Private Equity Investing In China, 2008*

Cleantech IPOs in China



Source: Cleantech Group & China Ventures

Equity markets are likely to remain uncertain for at least the next 12 to 24 months. Chinese investors in the "A" share market are experiencing their first long downturn, which began in October 2007, and they will reenter the market with caution. IPOs are at a very low level this year, and that has impacted the number of private equity deals in all sectors, as time to exit stretches out. The good news is that cleantech is likely to be the forefront of recovering sectors, both in terms of real economy activity and the equity markets.

Conclusion

From the confusion of the current global financial crisis there will emerge a new order, with significant consolidation of financial sector and real economy players and a great wave of new entrepreneurship, much of it focused in cleantech industries. In this overview, we have emphasized a convergence of forces and factors that make China a flagship carrier of this growth, and the wealth creation it will support. If we look back at the Asian financial crisis of 1997-1998, we can see an example of China maintaining stability in its domestic market, providing a force for stabilization in the region, and emerging from crisis was the regional leader of growth.

The Cleantech Group and Deloitte remain deeply committed to supporting our members and our clients. Among the challenges in dealing with China is information. It has never been a problem of too little information. Rather it has always been too much information, too much that is unreliable and too much that is difficult to synthesize into useful, actionable understanding. In setting forth our research agenda for 2009 our goal is precisely that, to provide information and insight that are useful and actionable in this most important and interesting of cleantech markets.

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