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Private equity in China – bringing it home

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Few markets have generated as much attention among private equity investors in the past few years as the People's Republic of China. And foreign private equity funds already can boast of some solid successes in the PRC. But the environment for private equity in China is still young and rapidly evolving, and private equity investors are now in the throes of adjustment to a set of significant policy changes by the PRC government – changes that might be lumped together under the slogan "bring it on home".

Private Equity's Chinese Characteristics

Most private equity activity in the PRC is in the venture capital and growth capital areas. The kind of highly leveraged public-to-private buyouts of relatively mature listed companies that have made private equity funds such a powerful force in the U.S. and Europe are still unknown in China.

The ability of foreign private equity investors to acquire a controlling interest even in substantial unlisted companies is quite limited. At this stage in the evolution of the country's private sector, successful Chinese entrepreneurs are typically in empire building mode – and they are intensely uncomfortable with even the symbolism of granting a majority equity stake to a foreign financial investor, whatever practical control rights they would retain. In addition, the Chinese government has understood the importance of Chinese enterprises developing internationally recognizable brands in order to compete globally at the high end of the economic food chain, and it has used its extensive powers of approval over foreign investment in China to limit foreign acquisition of control over well known Chinese brands – most prominently in connection with Carlyle's effort to acquire a controlling interest in Xugong Group Construction Machinery Co. For these reasons, even the largest Western buyout funds have in China concentrated primarily on acquiring substantial minority stakes in dynamic privately owned companies, hoping to fund a rapid expansion through both capital investment and acquisitions and to shepherd the company to a successful IPO within two or three years.

Offshore Structure – The Preferred Model

The preferred model that developed beginning in the late 1990s and continued through a number of successful capital markets exits in the early and mid-2000s – in what can be seen in retrospect as a sort of golden age for foreign private equity in China – involved the creation of an offshore holding company in which both the foreign private equity investors and the Chinese controlling shareholders would hold interests. This company ("Holdco") would typically be organized in the Cayman Islands or other jurisdiction that was both tax efficient and suitable as the domicile of a listing vehicle in Hong Kong and other major capital markets. It would own – either directly or, more commonly, through an intermediate holding company organized in Mauritius or another jurisdiction with a favorably tax treaty with the PRC – all or a majority of the equity of the PRC operating company. The operating company would be a foreign invested enterprise, established under the PRC foreign investment regime in the form either of a wholly foreign-owned enterprise ("WFOE") or a Chinese-foreign joint venture company ("JV").

Advantages of the Offshore Structure

This so-called "offshore structure" had a number of advantages for foreign private equity investors. Those advantages share a common theme: far greater flexibility than direct onshore investment in all of the areas most dear to the hearts of private equity investors – capital structure, corporate governance and exit.

PRC company law is still very underdeveloped and rigid, and does not allow for the kinds of capital structures and investment instruments commonly used by private equity investors elsewhere. Convertible preferred stock and warrants cannot be issued by PRC companies, and convertible debt with a pre-agreed conversion price is also not practicable. Governmental approval requirements, limitations with respect to pricing of equity and general inflexibility of the company law regime make it difficult if not impossible to replicate the kind of redemption rights, anti-dilution rights and put or call options that are often central to economic terms of a private equity investment.

Although an investor in a PRC company may, through representatives on the board of directors, have extensive participation in corporate governance and obtain veto rights over many actions of the company, equivalent rights in companies established in the jurisdictions used for offshore holding company structures are viewed as more reliable and enforceable in practice. The possibility of obtaining pledges of offshore holding company shares to secure redemption, put, call and other payment rights as well as corporate governance and other covenants, and which may be enforced through legal action entirely outside of the PRC, significantly expand an investor's means of recourse in the event of a dispute with the controlling shareholders.

The offshore structure pre-positions the company for flexibility to conduct an IPO either on an international stock exchange outside the PRC (with Holdco as the listing vehicle) or on a domestic stock exchange in the PRC (with the operating company as the listing vehicle). Offshore listings involve fewer government approvals and shorter lock-ups for investors and generally are much easier to execute than domestic IPOs – to the point where, at least up until now, they have been the only viable route to a listing for a private equity-backed Chinese enterprise. The offshore structure also facilitates a trade sale by allowing control to be transferred, free of any PRC government approval or capital gains tax, through a sale of Holdco or an intermediate holding company.

Offshore Structures Under Attack

The principal difficulty in setting up an offshore structure for private equity investment in China has always been in migrating the Chinese investment offshore, given various foreign exchange and other restrictions that have limited the ability of PRC companies and (to a somewhat lesser extent) individuals to invest in foreign companies. Nonetheless, private equity investment in China through offshore structures had built up substantial momentum. Then, in January 2005, the PRC State Administration of Foreign Exchange ("SAFE") began issuing a series of notices that severely restricted "round trip investment" – i.e., investment (whether by contributions of assets or cash) by a PRC person to obtain a controlling interest in a foreign company, which would in turn invest in or acquire a Chinese company affiliated with that PRC person. New investments went on the back burner for close to a year as the private equity and venture capital communities lobbied furiously to roll back the new restrictions. Finally, in November 2005, SAFE issued its Notice 75, which replaced the rigorous approval requirements of its prior notices with what appeared to be a relatively benign registration requirement. Private equity funds breathed a sigh of relief.

SAFE 75 turned out to be only a temporary respite, however. In October 2006, SAFE, the Ministry of Commerce ("MOFCOM"), the China Securities Regulatory Commission ("CSRC"), the State Administration of Taxation, the State Administration of Industry and Commerce and the State-Owned Assets Supervision and Administration Commission of the State Council – all of the heavyweight state agencies involved in the regulation of foreign investment – jointly issued the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "M&A Rules").

The M&A Rules introduced several provisions of enormous importance to foreign private equity investment in China:

The M&A Rules instituted a requirement for MOFCOM approval at the central government level of any acquisition by an offshore company that is "established or controlled" by a PRC person of any PRC company that is "affiliated" with that PRC person. Information relevant to the ultimate control of the offshore company and the PRC company is required to be disclosed. The requirement for central MOFCOM approval is viewed as tantamount to a prohibition, and in fact there do not appear to have been any such approvals granted in the year since the M&A Rules went into effect.

The M&A Rules include the first regulations permitting PRC persons to exchange equity in a PRC company for equity in a foreign company. However, such "share swaps" are only permitted if the foreign company is listed and has a 12 month trading history, or if it is a special purpose vehicle established in anticipation of an overseas listing of the PRC company. In the latter case, the offshore listing must be approved by the CSRC and completed within 12 months of the share swap.

The M&A Rules provide for reporting to MOFCOM in advance of any transaction that would result in the control by foreign investors of a PRC company that involves a key industry; has an impact on the State's economic security; or causes a change of control of a PRC company that owns a well known trademark or an established Chinese brand name. Transactions that are not reported in advance may be unwound. The advance reporting requirement is viewed as giving the central government the opportunity to intervene to prevent transactions that it considers objectionable, even if those transactions are within the approval authority of provincial or local governments.

It is very clear that one of the principal purposes of the M&A Rules is to channel investment into onshore structures – in other words, to rein in the use of offshore holding companies and instead require investors, both domestic and foreign, to invest directly in PRC entities. The goal was to prevent the migration of control of PRC companies into offshore vehicles, except in cases where control was being genuinely acquired for new money by real foreign investors. The M&A Rules contemplate the possibility of offshore structures being established to conduct an IPO on a foreign exchange, but only at the point when the company is ready for its IPO and only subject to CSRC's approval of the IPO.

To complete the picture as it now appears, SAFE in May 2007 issued Implementation Notice 106, which provides guidelines for the implementation of Notice 75. Notice 106, which was originally issued as an internal document and was subsequently leaked, imposes extensive new requirements that must be met before investment by PRC nationals through offshore special purpose companies will be registered by SAFE. Notice 106 further dims the prospects of successfully making a private equity investment through an offshore structure.

The measures introduced in the M&A Rules and the SAFE notices have been widely interpreted as an effort to more strictly control foreign investment. There is some element of this scattered among the policy agendas of the six PRC government agencies that issued the M&A Rules. However, the rules are motivated to a much greater degree by a desire to control the behavior of PRC nationals and to promote certain domestic policy objectives. The tax authorities wanted to cut off the round tripping of funds out of and then back into the PRC in order to better monitor taxable activity of PRC nationals and prevent the establishment of "phony joint ventures" to take advantage of tax incentives for foreign invested enterprises; the foreign exchange authorities wanted to do the same thing in order to better monitor currency flows and ease upward pressure on the value of the Renminbi. State owned asset supervisory authorities wanted to ensure that ownership of state owned assets improperly acquired by private citizens could not easily be spirited into overseas vehicles.

The policy driver that may have the biggest effect on foreign investors – in the long term, it may be hoped, a positive one – is the commitment to develop the domestic stock markets. It was clearly no accident that the heyday of IPOs of major PRC-based businesses in Hong Kong, in 2004-2006, coincided closely with the period when the PRC domestic markets were shut down for IPOs so that the market could undergo a fundamental reform eliminating the distinction between tradeable and non-tradeable shares. Having gone through this protracted and traumatic process, the PRC government now wishes to take full advantage of it. That means keeping more high quality issuers at home, and limiting investment by PRC persons to onshore structures gives the government many more tools to help it achieve that objective.

Forward to the Old Days

The PRC authorities have been remarkably successful in restricting the use of offshore structures for foreign private equity investment. The regulations adopted over the past two years would not restrict the use of an offshore structure in a situation where the foreign investor would control the PRC business, but for the reasons mentioned above such a situation would be a rare exception to the usual pattern of private equity investment in China. After spending much effort searching for legitimate ways to continue making investments through offshore structures, and then rigorously analyzing, and considering ways to mitigate, the incremental risks associated with direct onshore investment, most private equity funds active in China have reconciled themselves to the new order and are moving forward with onshore structures.

The onshore structure to which private equity funds have returned is essentially the same structure that strategic investors have used for investment in China since the 1980s. The investors typically invest in a Chinese-foreign equity joint venture, established as a limited liability company in the PRC. If the company is preparing for a domestic listing, it may have converted, or may later convert, into a foreign invested company limited by shares. Both of these entity forms have the limitations referred to above relative to offshore vehicles. Efforts are often made to replicate as far as practicable by contractual means the rights and preferences that the investors are accustomed to receive outside of China. The ability to do this depends to some extent on how flexible the MOFCOM branch responsible for examining and approving the joint venture documents is willing to be.

The biggest uncertainties surrounding the "new" onshore structure revolve around the prospects for an exit within a reasonable time. The onshore vehicle will need discretionary governmental approvals to conduct either a listing on a domestic exchange or a restructuring and listing on an exchange outside the PRC. It is too early to tell how difficult it will be to get those approvals and how long it will take, and this leaves private equity investors in an uncomfortable position.

The onshore trend will not reverse any time soon, however. In addition to the strong government policies described above, another development has emerged that will reinforce it: the growth of a significant domestic private equity business. Very large pools of capital are being formed by PRC institutions and wealthy individuals to join the private equity bandwagon. These domestic funds will provide tough competition for the most attractive opportunities, and they will be more comfortable with typical onshore structures then their foreign counterparts. Foreign funds will have to adapt to the local rules in order to meet this competition.

Fortunately, not all of the uncertainties are on the down side. The best thing that could happen to foreign private equity investors in China is the development of a deep and healthy domestic capital market. If that happens, and the domestic exchanges become a dependable outlet for IPOs of private equity-backed enterprises at robust valuations, it will make up for a lot of shortcoming in investment structures and terms – and may cause the "golden age" of offshore structures to recede into distant memory. ■

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