Planning holds key to exits in China

In the first of two articles on private equity investment in China, Jack Lange tells investors how to structure deals to make the exit process as smooth as possible

The past year has been called the *Year of the Exit* for private equity in China. Stock market listings by companies such as China Mengniu Dairy, Ping An Insurance and Tencent Holdings, as well as a number of trade sales to strategic investors, are encouraging signs that realizing gains may become a more common experience for investors.

The timing of these exits contributed to their success. The overseas-market window re-opened at a time when a number of investments were sufficiently developed to support well-received public offerings. Nevertheless, the long-awaited flow of exit transactions reflects a slow, steady evolution of the legal and commercial framework for private equity and M&A in China. The reform process is incremental, experimental, and slower than foreign investors would wish. But, step-by-step, changes are emerging.

In the interim, foreign investors in mainland China have learned that advance planning and structuring at the time investments are made will help guarantee successful exits as transactional activity grows. Attending to structural details is no substitute for making shrewd investments (see box), but the complexities of structuring China deals merit careful thought.

Meet the investee

Imagine a hypothetical case. The investors are two private equity funds, Fund 1 and Fund 2, investing on an equal basis in a consumer goods company. A municipal government has controlled the investee company for most of its life, but it recently went through a management buyout led by its charismatic chief executive, Mr Mou, who, along with a group of other employees, now controls MouCo. CityCo, a creature of the municipal government, holds a minority interest.

MouCo needs capital to fund its ambitious expansion plans and has been spotted as an investment opportunity by the two funds. After negotiations, it is agreed that, in return for their investment, the funds will receive a 40% interest in MouCo. Mr Mou will hold 30%, CityCo will hold 20% and the other employees will collectively hold the remaining 10%.

The funds understand that any business in mainland China must be operated through an entity organized in the country, the most common form of which for a foreign invested enterprise (FIE) with both foreign and domestic investors is a Chinese-foreign equity joint venture (EJV) company. After a series of discussions with counsel, the proposed investment structure evolves.

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The first option would be for both funds to invest directly in MouCo (diagram 1). But the funds are planning for a graceful exit, and they learn that if they sold their interests in MouCo directly they would need government approval and would have to pay local capital gains tax on the sale. If, however, they were to sell the shares of an offshore holding company they would avoid this inconvenience and expense. Thus they introduce an offshore holding company (CaymanCo) into the structure to hold their equity interest in MouCo (diagram 2).

Fund 2 has US pension funds as investors and is concerned that this structure might affect the status of the investment as a good *venture capital operating company* (VCOC) investment for purposes of rules under the US Employee Retirement and Income Security Act (Erisa). This is because Fund 2 would have a non-majority interest in a holding company that would itself hold a minority interest in the ultimate operating company. A further change is made in the structure to solve this problem.

The final structure on which all parties settle involves two major changes. First, an intermediate offshore holding company, MauritiusCo, has been inserted between CaymanCo and MouCo. At the cost of some modest extra administrative burden, this will allow the investors to take advantage of certain favourable aspects of the China-Mauritius tax treaty, while keeping a more familiar (and potentially listable) Cayman Islands vehicle for the entity in which they will hold shares.

Using an intermediate holding company also has the benefit of creating what could be called a structural drag-along. This is an alternative or supplement to a contractual drag-along, whereby the shareholders' agreement of CaymanCo would require minority shareholders to take part in any sale approved by a majority. In practice, dissident shareholders can severely disrupt a transaction that relies on a contractual drag-along. Few prospective buyers will wait while the shareholders go through a lawsuit about their drag-along rights and obligations.

Having MauritiusCo as an intermediate holding company can allow a sale by CaymanCo of 100% of the shares of MauritiusCo, subject only to the corporate approval requirements under applicable law and the company's articles of association. Cayman law would require only board approval for this sale; although a minority shareholder of CaymanCo objecting to the sale might have appraisal rights, it would not be in a position to block the transaction.

The second change is that Mr Mou will also now own his interest through CaymanCo rather than directly in MouCo. This creates a company through which a controlling interest can be listed on an offshore market, or sold to a strategic buyer in a trade sale without Chinese government approval or capital gains tax. As an added benefit, Fund 2's VCOC issue is resolved, because CaymanCo will now hold (through MauritiusCo) a majority interest in MouCo.

Diagram 1: primative structure

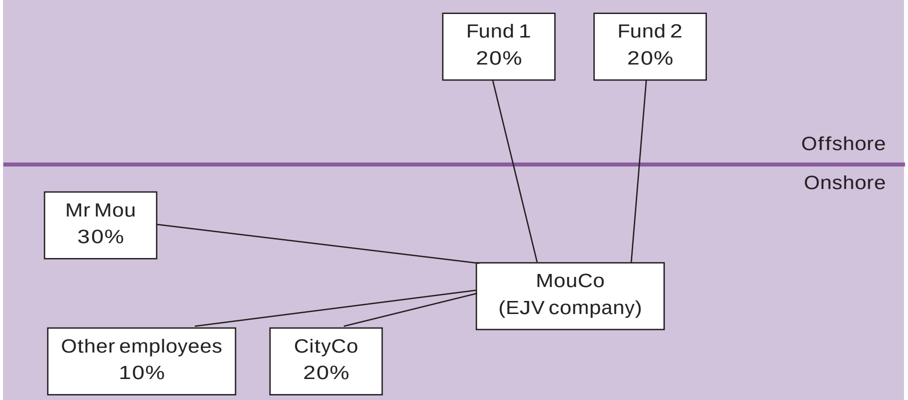


Diagram 2: partially developed structure

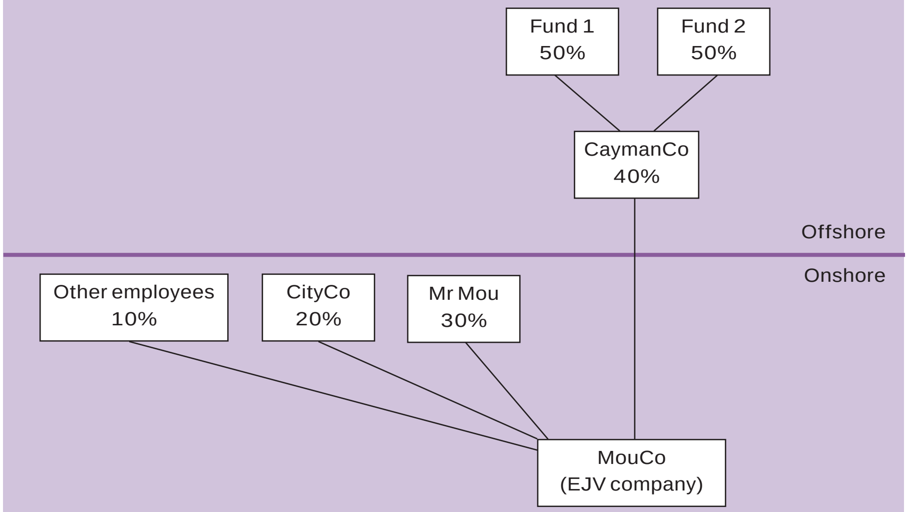
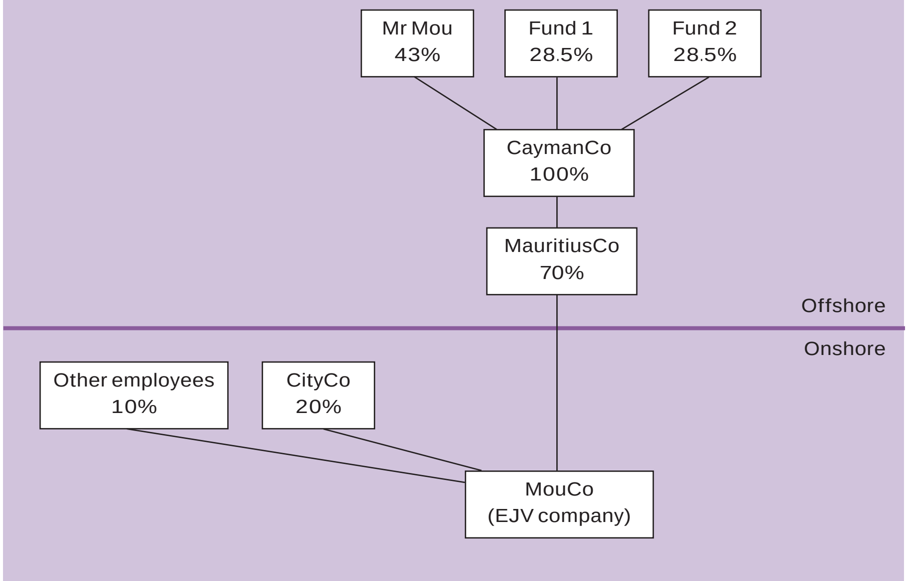


Diagram 3: fully developed structure



To create this possibility in a situation where the foreign investors will hold a minority position, at least some of the domestic ownership needs to be moved offshore. Possible ways to accomplish this, and related government approvals, vary considerably depending on factors such as whether a given domestic investor is an individual, a private company or a state-owned company, and whether the investor already has funds and a potential investment vehicle abroad.

The restructuring required to get the domestic investors offshore may raise difficult tax, accounting and foreign exchange issues. It could also raise issues in relation to the continuity of management requirement under the listing rules of the Hong Kong Stock Exchange. In many cases it will be practicable to get some, but not all, of the China investment offshore. In the hypothetical case, CityCo and the employee shareholders other than Mr Mou are left onshore as minority equity holders in the EJV.

Drawbacks

There are some disadvantages to this kind of hybrid onshore-offshore arrangement. In terms of equity capital structure, the EJV form is rigid. Percentage interests in MouCo's registered capital, which is the sum (denominated in this case in US dollars) of the value of all equity contributions to the company, represent the equity interests of the investors in MouCo. As an EJV company, MouCo does not have capital stock divided into shares, and cannot issue preferred stock, convertible debt or other instruments that have been used to such good effect by financial investors.

MauritiusCo's equity interest in MouCo will simply be the percentage interest that its equity contributions represent in the total value of equity contributions to the company. The private equity investors can of course (and in this case certainly will) get typical private equity convertible preferred stock in CaymanCo, but they will not have any preference of any kind over the domestic investors in MouCo itself.

The EJV is also unsuited to the venture capital norm of successive rounds of financing at ever-increasing share values. If MauritiusCo makes any follow-on investments, it will do so effectively at the same valuation as the first round, according to the principle of one dollar of contribution equalling one dollar of registered capital.

With growth expected, this is good for

Choosing partners wisely

Transaction structure and market conditions play a big role in determining whether investors can make a successful exit from a deal. But the motivations and abilities of the management and founding shareholders who operate the business are often more influential. At the time of investment, the investor may be able to make a reasonable evaluation of management's capability. Beyond that, there are many uncertainties, deepened by what may be some subtle cultural differences.

If the expected exit is a trade sale, are the management and founding shareholders going to cooperate, or are they empire builders who will find it impossible to let go? If the expected exit is an overseas initial public offering (IPO), will the management be able to embrace the standards of transparency and accountability demanded by underwriters and investors in overseas securities markets? In general, is there enough trust and willingness to be guided by the investors in those areas where they can add the most value, such as financing and M&A transactions?

Private equity investors are virtually unanimous in saying that what they are investing in fundamentally is not a company, nor a product, nor a technology, but people. The most successful private equity investors have been the ones who have had the right experience and instincts to team up with management and founding shareholders whose interests and motivations would stay aligned with their own. In China, even more than anywhere else, the way you get out will be determined not so much by how you go in, as by whom you go in with.

the funds. While they will have to deal with Mr Mou to price subsequent rounds of share issuances by CaymanCo, having the largest domestic investor offshore with them ensures the funds will be able to make subsequent rounds of investment without too much difficulty and, thanks to the registered capital system, at valuations that will be a good bargain if the company prospers.

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However, in down rounds, the rather dysfunctional registered capital system will only amplify the usual difficulties by obstructing investment at a reduced valuation acceptable to all parties.

To add more complication, there are other corporate forms – notably the cooperative joint venture (CJV) and the foreign invested company limited by shares (FICLS) – that might have been available for MouCo. While each of these would have alleviated some of the defects of the EJV structure, these structures have their own disadvantages. More often than not, unless the investee company is already well along in preparing for an initial public offering (in which case it may have been converted into a company limited by shares), the Chinese operating company will be an EJV.

Another disadvantage of the combined onshore-offshore structure that may affect exit has to do with introducing debt into the capital structure. Even if third party debt to leverage the equity investment is not contemplated, having shareholder debt in the structure would make it easier to take capital out of MouCo and increase options for exit through mechanisms such as a leveraged recapitalization or a redemption of the funds' CaymanCo shares. It would be quite easy to include a shareholder loan in the structure if MauritiusCo wholly owned MouCo. However, CityCo would undoubtedly be prevented by Chinese legal restrictions from making a shareholder loan to MouCo, and having such loans on anything other than a pro rata basis would alter the economic fundamentals of the deal.

The hybrid structure, the best that can be devised in the circumstances, is not perfect. But by getting a controlling interest in MouCo into an offshore holding company, the private equity funds have created a structure that gives them considerable flexibility to achieve an exit in various ways. The second article in this series, to appear in next month's IFLR, will look in detail at the possible exit routes available to them. ■

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